



Capital Ideas

The Recession is Over! Long Live The Recession!

Have you seen the news? The recession is over! All of that gloom and doom stuff was ridiculous. It has been tough. But the Dow is up 40%+ (who cares that we are still down 35% from October 2007) in the last four months. Fewer people are unemployed. Housing sales have risen four straight months. Happy days are here again!

At least that is what the Obama administration and Wall Street want you to believe.

I, too, believe that we are over the worst. But it is far too early to believe that we have recovered.

The other day I was reading the August 7 issue of *The Kiplinger Tax Letter*. The last topic in the letter was "Who Pays Taxes." The top 1% of filers pay 40.4% of all federal income taxes according to IRS data for 2007. Those taxpayers earned only 22.8% of the total reported adjusted gross income (AGI). To be a member of the 1% club, a filer (joint or single) needed an AGI of \$410,100. My guess is that this number will be lower when the 2008 numbers become available.

The highest 5% paid 60.6% of total income tax even though they earned only 37.4% of all AGI. To be in that group you needed an AGI of \$160,000. 71.2% of all federal taxes were paid by the top 10% who made 48% of all AGI. The bottom 50% of all filers paid 2.9% of the total income tax.

That is all interesting, but here is what really struck me: to be included in the top 10% of tax filers—and, remember, this includes joint returns—you needed an AGI of \$113,000. That is not what I expected.

So next I read the current issue of *The Kiplinger Letter*. The lead article was on housing. The lead was that "prices have an additional 5% - 8% to drop before bottoming at about 40% below the 2006 high." It goes on to talk about how rising unemployment is spurring additional foreclosures and shrinking the pool of potential buyers. There is an 8.8 months' supply of unsold homes.

Then came three sentences (not in succession) that really hit me: "by the end of 2010, a record one in six mortgages will be in foreclosure: 3.2 million by the end of this year.... Defaults will rise on option adjustable rate mortgages in 2010 and 2011, as rate resets crest on the wave of 2 million 'name your payment' loans. What's more, about 30% of all mortgage holders... a record 15 million of them... remain underwater, owing more on their loans than their homes are worth."

Wow! Put that information from two separate articles together and you can see we are still not out of the water. Look around your neighborhood and knock out one of every six homes. Now look around your neighborhood and knock out three out of every ten as underwater. The rate may not be that high in your neighborhood, but it may be higher. I have been noticing for sale signs in my neighborhood. And, they stay.

Now, take into account that an AGI of \$113,000 puts you in the top 10% of tax filers. Then, think about where your house appraised last time.

Consider all of the people you know who bought a new home or did cash-out refinancing on an existing home between 2000 and 2007. Let's say the mortgage was \$250,000 (very reasonable for a family in the top 10% of income earners). Let's be generous and give them a 30-year mortgage at 5.5%. That requires a monthly principal and interest payment of \$1419. Add an escrow of \$381 (just a guess) for taxes and insurance and you have a total payment of \$1800 per month or \$21,600 per year (yes, there is an interest deduction, but you still have to pay the total amount each month). Tack on a car(s) payment of \$700 per month, plus gas and maintenance costs. Then add \$10,679 in credit card debt (the national average for anyone holding a credit card in 2008 according to the Nilson Report, April 2009). Throw in a couple kids and a dog or two. Then deduct a contribution to a 401(k) plan.

Now you see what I saw. In an economy where retail sales wag the dog, how is this family in the top 10% of income earners going to pull us out of this recession? Their mortgage is underwater, they

are up to their eyes in debt, and one of the wage earners may have lost his/her job since they filed their 2007 tax return. Then you look in the paper, and every state and local government is trying to squeeze more tax out of us "rich" folks. The federal government is printing money like it is free (it is—we rich taxpayers will foot the bill). Wow!

So how can the stock market continue to rise? Magic!

The market took a severe beating (you didn't notice, did you?) But the government has used our tax dollars—and those of our children's children's children—to shore up certain segments of the economy, primarily the financial industry and the automobile industry (trade in your clunker now—those are your tax dollars). It appears that we have hit bottom. This could turn out to be a dead cat bounce (love that technical term).

The only money anyone below the top 10% has in the markets is in an IRA if they lost their job or in a 401(k) if they have managed to hold on to their job. So they are going to have little to no effect on the markets.

The only folks driving the markets are the institutions and rich folks like you. If you are retired and put your retirement distribution into an IRA to live off, you are still deemed rich (remember that, for around 66% of retirees, Social

Security is their primary source of income).

So we have a pretty good idea who is not moving the market. It is certainly not the masses. It is the institutions.

Institutions don't lose their jobs. They can go bankrupt. But the ones with investable dollars are not the ones going bankrupt. I don't believe the Chinese government will go bankrupt any time soon. As long as there are small (and large) investors, PIMCo will continue to buy bonds.

And, the institutions are still hoarding cash. So there is plenty of upside to the market. As long as they see the potential to increase the value of their assets, they will continue to move money into the market and drive up prices.

The rest of us are along for the ride.



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Capital Advisers, Inc.
21 Glenwood Avenue
Suite 107
Raleigh, NC 27603