

"The Long and Short of It"

Quarterly Newsletter from
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First Quarter, 1998

Wall Street calls it the Goldilocks economy - not too hot, not too cold. We cannot help but wonder (after eating her meal, and now dreaming of eternal bull markets) when Goldilocks will wake up to find the Bears have come home....at least for a little corrective action.

During the First Quarter of 1998, despite ongoing concern about the impact of the Asian crisis, the equity markets turned in a solid performance with the Standard & Poor's 500 offering a total return of 13.94%. So, after another record setting quarter of dollar flow into the equity market -- after accomplishing a year's worth of work in three months -- we are left with the task of describing a perfect economy while searching for a flaw large enough to stop the momentum.

Manifest Destiny on Wall Street

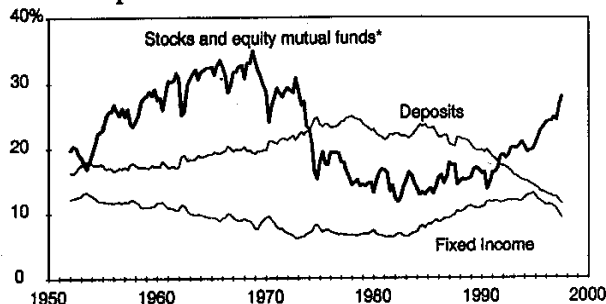
At Paine Webber, in an article titled "The Big Shift - Barely Begun," February 8, 1998, by Edward M. Kerschner, they are calling it The Big Shift. With low inflation, low interest rates, increasing productivity, and an aging population, the households in the United States should continue to move away from cash and other deposits toward stocks and equity mutual funds.

Not too Hot...

Ample global capacity, anti-stimulative global fiscal policies, and the proliferation of the productivity revolution (recent data show that third quarter 1997 productivity in the U.S. manufacturing sector surged 9.3%) should ensure that inflationary pressures remain subdued for the foreseeable future.

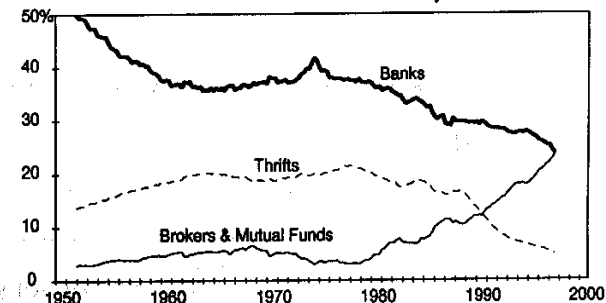
In addition, unlike the 1970s, there is much less risk of "cost-push" inflation because of weaker unions

Chart 1
Households' portfolio allocation of financial assets



*Includes bank personal trusts, life insurance
Source: Federal Reserve.

Chart 2
Relative share of total financial intermediary assets



Source: Federal Reserve.

and greater foreign competition. According to data from the Bureau of Labor Statistics reported in the New York Times, union membership fell 150,000 (about 10%) in 1997 despite (i) the addition of 2.8 million jobs (ii) a big recruiting drive, and (iii) speculation unions would make a comeback after the successful UPS strike.

If inflation remains subdued, interest rates should stay low and trend even lower, further reducing the attractiveness of traditional bank savings products. Reduced inflation also helps support stock P/Es. Falling inflation causes P/E ratios to expand because the present value of future earnings increases, i.e. with lower interest rates, future cash flows are not discounted as much.

Not too Cold.....Yet.

With a slowing labor force growth rate, growth in the economy will more and more rely on productivity gains. Fortunately, the information revolution and the baby boomers are combining to give us an older, more productive workforce, using more productive assets and thus creating significant growth. These two factors are unlikely to change any time soon, so unless we come across some extraordinary economic shock (or find a way to get rid of the baby boomers), we have to presume the bull market will remain intact.

The biggest threat to continued strength in stocks is the Asian crisis, although there is varying opinion on how much effect it will have. The Milken Institute hosted a March conference in Los Angeles on global affairs. Despite the array of different viewpoints, there was a general agreement that considerably more economic pain lies ahead in much of the region as the recessions unfold, but worst-case possibilities of a downward spiral and a new round of competitive devaluations seem unlikely.

The group concluded that the situation would get worse before it gets better, but disaster will be avoided. The reasons that the hemorrhaging will be contained are the widespread recognition of the problems, some remedies being adopted and hopeful signs that China is adopting useful steps.

While the Southeast Asia problems are not over, it is helpful to put some perspective on the situation. Roughly 90% of the S&P 500's profits come from the U.S., Europe, Canada, and Mexico. If all U.S. companies made no money this year in the major Southeast Asian countries, S&P earnings would be hurt by 2%.

Another perspective coming from the global affairs conference is geographical. The level of Thailand's real GDP is about the size of that of the state of Indiana's, and Indonesia's real GDP is about as big as North Carolina's. The total GDP of the so-called "Asia Eight" is comparable in size to that of America's rust belt, while China's GDP about matches that of the American Southwest. The United States, Japan and Europe comprise only 12% of the world's population, but account for 78% of the world output.

Just Right.

As mentioned in our letter in the First Quarter, by many measures the stock market is expensive. By our own research, looking at the market from the bottom up, i.e. company

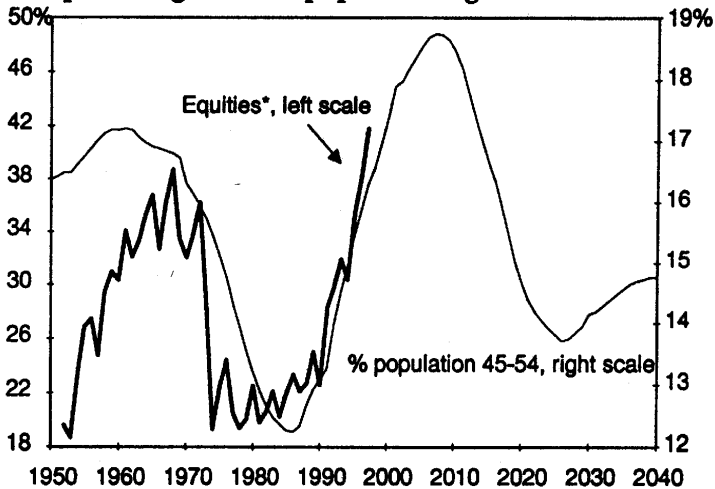
by company, the First Quarter's performance pushed valuations into the realm of "very expensive" even after considering all of the rosy assumptions about the economy and corporate profits. As a result, we're growing somewhat cautious in the short-term. However, the market could go higher in the short-term if the impact of Asia is smaller than expected on First Quarter earnings reports.

The difficulty in contemplating anything more than a minor correction is that the profile of the economy, like the market, is only the symptom of something much larger that is taking place.

Deposits at banks today account for just 12% of household financial assets, down from a peak of 25% in 1978 and 18% in 1991. Equities' share of household financial assets is now 43%, surpassing the prior 1968 peak of 39%.

Chart 15

Stocks as a percentage of household financial assets, and percentage of U.S. population aged 45-54



* Includes bank personal trusts, life insurance, mutual funds, pension funds.

Source: Federal Reserve, Bureau of the Census.

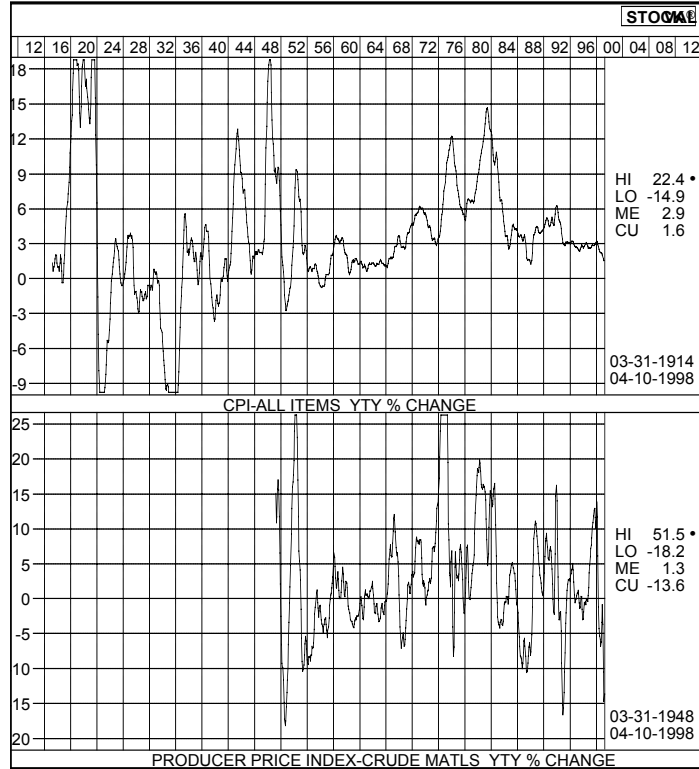
A similar shift to equities occurred in the early 1950s and continued for 15 years. The drivers of the first big shift were low interest rates, low inflation, low expected return on real estate, and the growth of the 45- to 54-year-old age group. Four factors combined to end this earlier shift: war, inflation, financial phobia concerning the stability of the financial system, and demographics.

The same factors that motivated the shift to equities in the 1950s and 1960s are at work again today, but the conditions that brought the first shift to an end seem unlikely to reappear any time soon. In addition, demographics should not turn negative for about another 15 years. The percentage of the population that is 45 – 54 should reach a peak of 18.7% in 2007, and then stay close to that peak level for the next five years. And note that back in the 1960s, the percentage of household assets in stocks continued to rise even after the share of 45 – 54 year-olds in the population had started to turn down.

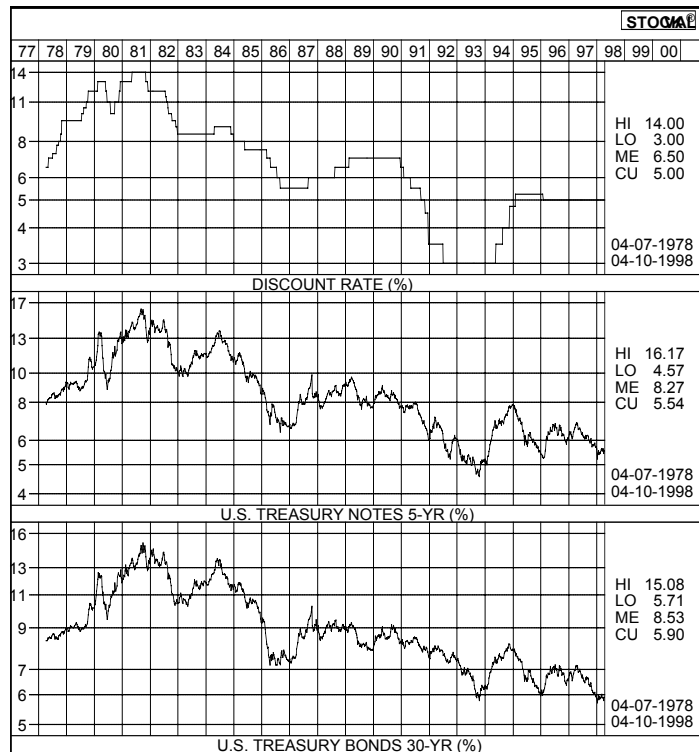
The current situation, i.e. favorable economic conditions, a lack of more appealing alternative investments, the tremendous amount of assets looking for a place to go, and favorable demographics makes a strong case for continued strength in the stock markets.

A Happy Ending?

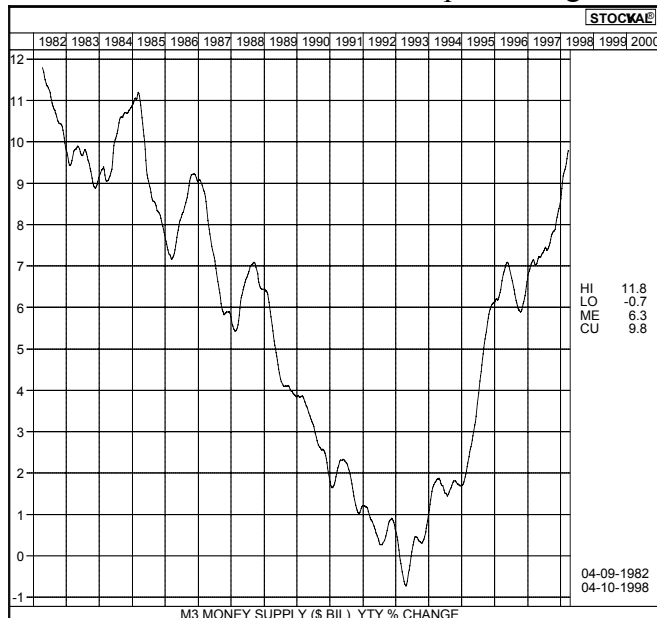
One part of the economy where we see the beginning of what could be trouble is in monetary policy. In our current slowing environment, the Federal Reserve probably has to be more accommodative than it should be in the long run to sustain growth. Retail price inflation, measured by the CPI, is now at 1.6%. This is the lowest reading since the mid-1960s. Inflation as measured by the Producer Price Index of Crude Materials has shown even more weakness, declining 13.6% over the last year.



As a result of these observations, one might be led to believe the Federal Reserve has been a bit restrictive in its policy. In looking at interest rates, the discount rate has been held steady, indicating no change in policy. The longer maturity bond rates are declining, which reflects expectations of a slowing economy and declining inflation. But M3, the broadest measure of money supply, has been growing at increasing rates since 1993, currently providing fuel to the economy at the rate of over 9% per year. As one sage put it, "Inflation allows you live in a more expensive neighborhood without moving. By definition, inflation is not a



change in the price level, but an increase in the money supply. M3 says we have inflation. It is not reflected in the prices of goods and services, but in the price of assets,



to wit, the stock market. While these are certainly good times in the economy and significant real wealth is being created, keep in mind that inflation does not create real wealth, only perceived wealth. To the degree this bull market is being fed by inflation, there will surely be some losses when the environment turns less positive.

Moreover, asset inflation is taking place worldwide. Despite the media attention toward the U.S. bull market, the S&P 500 finished out the quarter in 15th place.

One interesting, and important, piece of information we recently came across is that Federal taxes took in 19.8% of GDP in fiscal 1997, a tax burden that is expected to rise to over 20% next year. The feds have not gobbled up that much of the nation's income since the spike in tax rates during World War II. Tax rates have never been this high on a sustained basis. Is this increase in the average income tax rate required to make up for a decline in transfer tax rates for estates? Let's take a look.

A little of what is going on in Washington D.C.:

Senate Finance Committee Chairman William Roth unveiled on March 26 an IRS restructuring plan that he calls the "most comprehensive overhaul of the Internal Revenue Service ever put forward." According to Roth, the roughly \$20 billion plan is designed to protect taxpayers from the "awesome power of the IRS," to increase oversight of the agency to prevent abuses, and to hold IRS employees accountable for their actions. Roth said some of the most important reforms include:

- Creating an oversight board with limited authority to look at collections abuses and other taxpayer problems under Internal Revenue Code Section 6103;
- Pulling most of IRS' inspection division out of the Service and relocating them to the Treasury Inspector General's office;
- Giving the commissioner of internal revenue the statutory authority over a major internal reorganization; and
- Requiring IRS to fire employees who commit perjury, falsify documents, or violate the rules to retaliate against a taxpayer.

President Clinton's fiscal 1999 budget request contains proposals that would restrict or eliminate the use of several commonly used estate planning devices. Many families have formed limited partnerships to hold their investment and business assets. Such entities serve numerous purposes including asset protection, ease of transferring diverse assets to

the next generation and centralized management. Because owners of limited partnership interests lack control over the business, and the interests usually lack marketability, a limited partnership interest is worth less than its pro rata share of the underlying assets. Transferring ownership of family assets through transfers of limited partnership interests can therefore be accomplished at a reduced transfer (estate or gift) tax cost. President Clinton's first proposed change would eliminate the use of valuation discounts in many family limited partnerships.

President Clinton's second proposed change would prohibit the use of *Crummey* powers for the gift tax annual exclusion, i.e. the ability to transfer \$10,000 per year gift tax free to as many people as we want. The requirement for this benefit is that the gift of the \$10,000 be a gift of a present interest – the right to the present use and enjoyment of the \$10,000. A gift in trust, the preferred way to make many gifts, is usually not a present interest because enjoyment of the property is subject to trustee discretion. This problem has traditionally been overcome by giving the beneficiaries a *Crummey* power – the right to withdraw the gift to the trust for a limited period of time. If it is not withdrawn within the time period, which is almost always the case, the right to withdraw lapses and the gift remains subject to the terms of the trust.

Finally, President Clinton would repeal the personal residence exception to the Section 2702 special valuation rules. Explaining this provision would take more room than we have, and more time than you probably have an interest in investing. Suffice it to say that it is one of the last gifts Congress gave us in the transfer tax area. It permits the owner of a personal residence to transfer ownership of the home at a substantially reduced tax cost while permitting the owner to live in the home for a period which is shorter than his or her lifetime.

While President Clinton is trying to eliminate the tax benefits of family limited partnerships legislatively, the Internal Revenue Service is working on it administratively. Recently, the Internal Revenue Service National Office took the position that a gift of a limited partnership interest was a gift of a future interest, and thus did not qualify for the \$10,000 annual exclusion. The positions taken by the Service in the past year regarding family limited partnerships are having the intended chilling effect upon attorneys and their clients. Nevertheless, it is important to note that the situations examined so far have been abusive situations, such as the taxpayer creating the partnership on his deathbed. Bad facts almost always make bad law. We think family limited partnerships are still a legal means of reducing transfer tax costs, as evidenced by President Clinton's attempt to solve the tax drain legislatively. Nevertheless, families using limited partnerships should go into the process recognizing the Service's antagonism towards them, and be prepared for potential litigation – especially if the facts are bad.

As is apparent from the above developments, the President and the Internal Revenue Service are trying to eliminate the opportunities now available for making estate and gift taxes voluntary. While part of our fun is trying to find new ways to save taxes, it will not hurt to take advantage of the ways we now have before they go away. If we can help you in that process, give us a call.