

WHAT DO THE US AND EUROPE HAVE IN COMMON? A LACK OF LEADERSHIP AND FINANCIAL DISCIPLINE

In light of all the uncertainty in the market, this seems like a good time to get some “big picture” perspective with RiverPoint’s Chief Investment Strategist, Leon Loewenstine.

RiverPoint Report: Leon, how are we currently viewing all of the uncertainty in the markets -- uncertainty about the domestic economy and its impact on corporate profits, uncertainty with the Euro Zone and how it will resolve its issues, and uncertainty in Washington about, well, seemingly everything?

Both the US and Europe lack leadership at the top and clarity on how to deal with their challenges.

Leon Loewenstine: The issues in Europe and the U.S. have a lot in common. They both lack leadership from the top and clarity on how they plan to deal with the current financial and economic challenges. The good news is that the problems are solvable but they require strong leadership to convince the people that they know what they are doing and will enforce stronger financial discipline going forward.

European leaders are meeting on a regular basis and seem to be getting closer to some kind of financial bailout similar to what the U.S. went through in 2008 and 2009. The challenge is who is going to pay for it. The Germans do not want to bailout the Greeks but if they don’t the crisis could spread to Italy and Spain. Since the French and German banks hold a significant amount of Greek debt, they are in between a rock and a hard place. They know what happened when the U.S. let Lehman Brothers go under and do not want to repeat that mistake. We expect a resolution to be reached over the next few months that would result in the Germans and French providing financial support to their partners either through the European Financial Stability Facility (EFSF) or some similar structure. But until that happens you can expect the financial markets to remain choppy.

At home, we also have significant financial and economic challenges but they, too, are solvable. We just need leadership at the various levels of government to come together and unite us, not divide us. As Mel Gibson said in *Brave Heart*, “unite us and the people will follow you.” The people want and need a leader, someone that inspires confidence towards the achievement of a

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common goal. Unfortunately, we seem to lack that kind of leadership in Washington at most levels. However, hopefully the “Super Committee” will exhibit the kind of leadership we need. We are encouraged by the opportunity before this committee, and optimistic that they will positively surprise us.

RR: Michael Spence, winner of 2001’s Nobel Prize in Economics, recently said the following:

“Government cannot solve the problem alone, much less make the problem go away overnight. But government can take action that improves productivity, investment returns, and conditions for innovation, thereby increasing the pace and enhancing the long term-results of structural adjustment. To be viable, policy measures must include comprehensive tax reform; a balanced deficit-reduction program; investment in education, skills upgrading, infrastructure, and technology...”

Does that resonate with you, the feeling that our government’s role in solving our issues should be that of an enabler versus taking direct action?

The role of government is not to create jobs, but to provide businesses with incentives to invest and innovate.

LL: Exactly, the role of government is not to create jobs but to provide the opportunity and conditions for businesses to want to invest and innovate. The entrepreneurial spirit in America remains alive and well but they need to know what the rules and regulations are and know that they are not going to be changed in twelve months. We need a “super” Super Committee with an agenda that addresses tax reform for both individuals and corporations. In a recent meeting with Senator Rob Portman – a member of the Super Committee – we asked him about the outlook for tax reform. He called himself a “hawk on tax reform” and genuinely believes that the Super Committee has an opportunity to reform the tax code and eliminate things that do not make sense. Senator Portman is seen as a pivotal figure within the Committee, having the trust of lawmakers on both sides of the aisle. Portman knows the issues and knows how to work a budget, having worked as Director of the Office of Management and Budget under President George W. Bush.

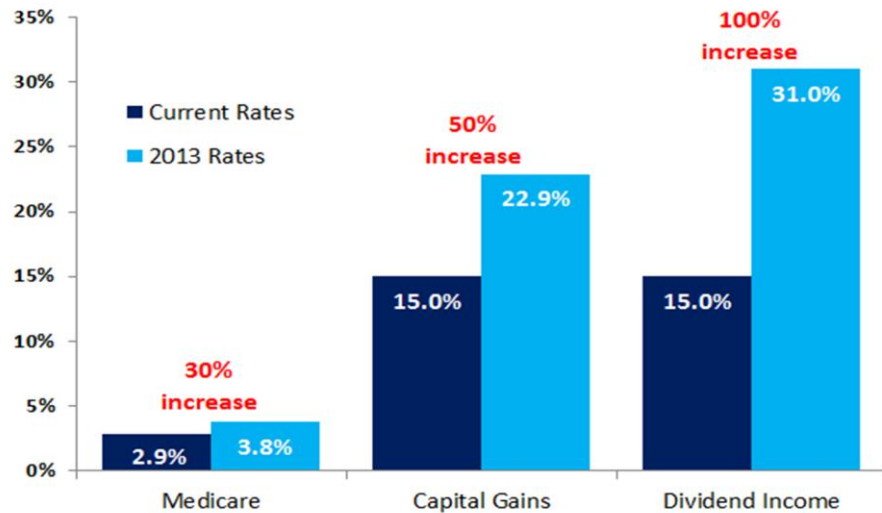
Senator Portman also indicated that everything is on the table, including entitlements. Wow! Wouldn’t that be a massive positive surprise to see Congress actually address entitlement spending? Although we are not overly optimistic that this will be accomplished, it is nice to know that at least they will be talking about entitlement reform. We certainly have it on our Christmas wish list and you just never know. Since this Committee is in a very strong position to truly make a difference and potentially go down in history as the driving force behind tax and entitlement reform, we hope they will take this opportunity seriously. We all know how individuals in Congress love the spotlight; well, this is truly an opportunity of a lifetime. Let’s see if they step

up to the challenge.

RR: You mentioned tax reform as an issue facing our nation – aren't taxes set to increase in the near future?

LL: We know that our President continues to ask the wealthy to pay their fair share, but what seems to be forgotten is that taxes on the wealthy, barring any legislative action, are already scheduled to increase significantly in 2013.

Future Tax Rate Hikes



Taxes on America's wealthy are set to rise in 2013.

Specifically, high-earning Americans are facing a 30% increase in Medicare taxes, a 50% increase in capital gains taxes, and the tax on dividend income is set to more than double! America's corporate tax rate is also one of the highest in the world, and Washington has made no effort to bring it in-line with other countries, putting US companies at a competitive disadvantage. No wonder US companies are moving their offices overseas. On top of all that, the recent economic crisis has led Washington to over-regulate corporate America in areas that had nothing to do with the financial crisis.

RR: To your point regarding regulations, several high-profile CEO's have recently come out strongly against the administration for its regulatory policies.

Steve Wynn, CEO of Wynn Resorts:

"I'm saying it bluntly that this administration is the greatest wet blanket to business and progress and job creation in my lifetime. And I can prove it and I could spend the next three hours giving you examples of all of us in this marketplace that are frightened to death by all the new regulations, our healthcare costs escalate, regulations come from left and right, a President that seems, you know – that keeps using this word distribution."

David Farr, CEO of Emerson Electric:

“I think the biggest issue that I’m watching right now is they’re not really, either in the US or Europe, really addressing the gut issues. I mean the US has enormous regulations coming at us right now. The incentive to invest in the United States is negative. And from my perspective, people talk about ‘we want clarity.’ Well, I’ve got all the clarity I need. They’re spending, they’re regulating us, they’re talking about raising the tax rates.”

Politicians seem more focused on keeping their jobs than making it easier for businesses to create new jobs.

LL: I think those quotes really hit the nail on the head. Politicians in Washington seem more focused on keeping their jobs than trying to help businesses create jobs for Americans as we navigate this difficult economic time. Common sense needs to take over at some point, and common sense dictates that Washington should become less anti-business. Small businesses are the largest creators of new jobs in the US; trying to add new jobs in this environment of increasing taxes and regulations is not helping the situation. A recent study found that nearly 80% of lawmakers have no academic background in business or economics; it’s no wonder that they don’t understand what drives business decisions. Don’t get me wrong, we are not opposed to higher taxes – it’s just that you can’t cut spending and raise taxes at the same time and think you are going to create jobs or grow the economy. Everything needs to be done in moderation.

Because of all of this, we are maintaining asset allocation a bit on the conservative side but at the same time, we are taking advantage of the opportunity to increase exposure to equities with attractive dividend yields. Companies with dividend yields significantly higher than the yield (1.9%) on a ten year U.S. Treasury bond include Emerson Electric (3.2%), Rogers Communication (4.0%), Verizon (5.6%), Genuine Parts (3.6%), and General Mills (3.1%). There are also a number of stocks trading at fire sale prices such as Ecolab, which has increased earnings-per-share twenty consecutive years, Caterpillar, trading at only ten times 2012 earnings, as well as Johnson Controls and Occidental Petroleum, both trading at a measly nine times 2012 earnings. As always, we will stay disciplined in our buying and look to take profits when valuations become full. In the meantime, our fixed income allocations will help preserve capital and provide a reasonable level of income until confidence returns to the market.