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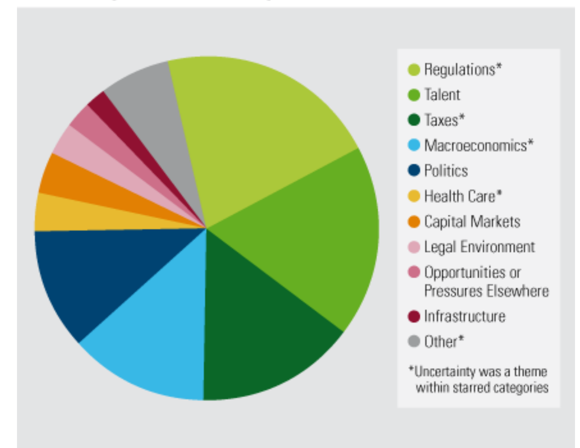
The Tax Code and U.S. Competitiveness

Most Commonly Mentioned Impediments to Investing and Creating Jobs in the U.S.



Source: "Prosperity at Risk: Findings of Harvard Business School's Survey on U.S. Competitiveness" by Michael E. Porter and Jan W. Rivkin (January 2012).

While investors prepare for tax hikes in 2013, it isn't surprising to learn that taxes have become increasingly important when it comes to the economy and U.S. competitiveness. The Harvard Business School recently published results of a survey on U.S competitiveness, which aims to lay out facts and realities of international competition and implications for the U.S. In October 2011, about 10,000 alumni completed an in-depth survey on U.S. competitiveness. According to the survey, the greatest current or emerging weaknesses are perceived to be America's tax code, political system, K-12 education system, macroeconomic policies, legal framework, regulations, infrastructure, and workforce skills. Respondents were deterred from investing in the United States not only by a high statutory corporate tax rate, but also by the sheer complexity and uncertain future of the tax code.

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Mitchell McLeod Pugh & Williams, Inc. - Adviser Corner

As clients, or as regular readers of our newsletters, it should not come as a surprise to you that our firm does not advocate investment strategies based upon "market timing." The performance of capital markets over the last two quarters reinforces that philosophy. It is difficult to determine what has changed since 2011's third quarter, when the stock market experienced a decline of over 13%. Economic news and corporate earnings did not improve dramatically. Nor did Eurozone concerns and geopolitical tensions suddenly disappear. Yet equity investments have returned over 20% since 9/30/11. We view this as additional evidence that attempting to predict market movements over short periods of time is a risky approach to portfolio management. We prefer to rely on things that we can control - asset allocation and diversification in the portfolio, quality of the securities held, and keeping costs and expenses low. This type of investment philosophy is far more likely to produce positive results than one attempting to forecast future events.

Monthly Market Commentary

Most of the economic news released during the past few weeks pointed toward slow but steady progress in the U.S. economy, despite some market volatility that was attributed to news out of the Federal Reserve. Markets rallied based on a Ben Bernanke speech that suggested the economy was not out of the woods yet and that quantitative easing remained an option if things worsened. Markets also collapsed on the release of the minutes from the Federal Reserve Open Market Committee, which indicated that the economy was stronger than the Fed had anticipated and offered no hints that more quantitative easing was being considered.

Employment: March saw a disappointing 120,000 jobs being added; the lower number was mainly a result of a large decline in private-sector retail jobs and the continued contraction of the public sector. This is a significant drop from the revised 240,000 jobs in February and revised 275,000 jobs in January. The unemployment rate fell slightly, to 8.2%.

Manufacturing: Manufacturing data in February remained mixed but still showed an improvement from January, at least in terms of durable-goods orders. As export demand weakens and growth slows in the auto sector later this spring, Morningstar economists are not expecting a lot of growth (or declines) from manufacturing in 2012. The economic key continues to remain in the hands of U.S. consumers, with a potential added boost from housing and construction markets.

Housing: Real estate data continued to be relatively inconclusive as abnormal weather wreaked havoc on the data, causing most real estate numbers to show better results on a year-over-year basis than on a month-to-month basis. The Case-Shiller Home Price Index (seasonally adjusted) for the three months ending in January was flat compared with December, while the year-over-year numbers showed some improvement. Month-to-month pending contracts for February were down 0.5% and have now declined for two of the last three months, while year-to-year pending contracts were up a stunning 9.2%.

Although the media remains thoroughly confused, with many outlets featuring month-to-month weakness while others ran headlines trumpeting a new boom based on the year-over-year numbers, Morningstar economists believe that the truth lies somewhere in the middle.

Retail: The International Council of Shopping Centers reported 4.1% year-over-year same-store sales growth in March, matching the gains in February. Warm weather and an earlier Easter helped boost the numbers, with both apparel and department stores showing an improved growth rate.

Quarter-end insights: The first quarter of 2012 saw the U.S. economy gaining strength as other world economies slowed. Morningstar economists believe that slow but steady U.S. GDP growth, moderating inflation, and rising employment growth may be on tap for the remainder of the year. While better employment has helped a number of sectors, including housing, restaurants and even health care, other sectors such as industrials continued to worry about slowing demand from Europe and China. Slowdowns in these regions may be harmful to individual companies but not necessarily to the overall U.S. economy—many of those goods are not produced in the U.S. Overall, companies poised to benefit from a relatively strong U.S. economy with limited exposure to non-U.S. markets may be better performers. This includes small-cap companies that typically had a smaller portion of their revenues from non-U.S. sources. Around the world, government data suggests that China's typical 10% growth rate is likely to fall to 7.5%. A slowdown in China combined with a less generous U.S. Federal Reserve will likely bring in commodity prices, significantly affecting commodity-based economies (such as Australia and Brazil) as well as capital goods-related exporters (such as Germany).

Social Insecurity

All of us who work feel the bite that Social Security taxes take out of our paycheck. Most of us take comfort in the hope that when we retire, Social Security will be there, giving back all the money that we paid into the system over the course of our careers. Isn't that how it works?

Well, the short answer is no, it doesn't work that way. The Social Security taxes deducted from your paycheck are not sitting in a special account someplace, earmarked to be returned to you upon your retirement. Instead, the taxes you pay today are used to pay benefits to today's beneficiaries, just as when you retire, the benefits you receive will come from the taxes paid by people who are still working. This arrangement works as long as there are enough people sending in taxes; it doesn't work so well if the number of current workers per retiree is decreasing.

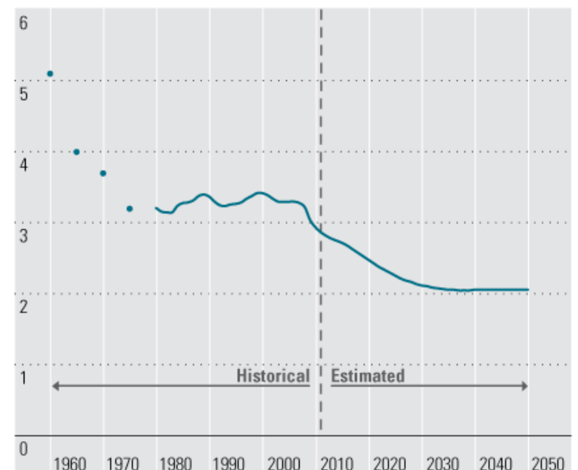
The baby boomer generation (those born between 1946 and 1964) have started to retire in 2010. This large group's retiring, coupled with increasing life expectancies and decreasing birth rates, means that the number of retirees will grow faster than the number of workers. According to the Social Security Administration, the number of workers sending in Social Security taxes to pay each retiree's benefits has plummeted from 42 workers per beneficiary in 1945 to 2.9 in 2011. What is more is that this number is projected to go down even further to 2.1 workers per beneficiary by 2035. Since the ratio of workers to retirees is expected to continue declining, a shortfall in future Social Security funding is likely.

Annual cost for the Social Security program is projected to exceed non-interest income in 2011 and remain higher throughout the remainder of the long-range period. Social Security funds are projected to increase through 2022, and then to decline and become exhausted and unable to pay scheduled benefits in full on a timely basis in 2036.

What does all this mean for you? Well, that depends on how old you are and what changes the United States government decides to implement. If you are nearing retirement, it is unlikely that your Social Security benefits will change dramatically. Younger workers, however, are more likely to see sweeping changes in the way Social Security works in the form of higher taxes, lower benefits, or a combination of the two.

Bear in mind that Social Security was never intended to provide Americans with all of the income they would need in retirement. Social Security is only one leg of a three-legged stool that also includes pension plans and personal savings. With concerns mounting over the stability of one leg of the stool, you need to take control of your retirement by investing in personal savings plans such as IRAs and 401(k)s.

Ratio of Workers to Beneficiary



Source: The 2011 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds, May 2011, Social Security Administration.

Investing in Bond Funds

If you don't want to invest all your assets in the stock market, you may need to consider either cash or bonds for your portfolio. While cash is relatively safe, returns are likely to be less than 1% given the low interest-rate environment. Bond funds are an alternative but most people don't have a good understanding of what to expect. You may want to consider buying a bond fund to give your portfolio stability or help generate income. Unlike individual bonds, bond funds hold a number of fixed-income securities with varying maturities. Therefore, investing in a bond fund provides a diversification benefit. In order to save yourself from making costly mistakes, it helps to thoroughly check up on what a bond fund owns before you buy in. Two basic determinants of bond performance are interest-rate sensitivity and credit quality.

Interest-rate sensitivity is important because an inverse relationship exists between bond prices and yields. If interest rates fall, bond prices rise, and vice versa. The credit quality tells you how risky the bond fund is, which can help determine if the fund fits your risk profile. Consider these factors before you go bond-fund shopping. Just as you wouldn’t want to have all of your stocks in one style, you also want to diversify your bond portfolio. A well-rounded bond portfolio should have some exposure to most of the following bond types: Government, mortgage-backed, municipal, corporate, and world bonds. It is important to understand that the right combination of bond funds ultimately depends on your investment goals and risk profile.

Diversification does not ensure a profit or protect against a loss in a declining market.

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