



Global Financial Markets Perspective
Third Quarter 2006

The Pluto Paradigm*

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The typical American likely wakes up every morning expecting the sun to be shining, the coffee to be brewing and the morning paper to be at the doorstep. He or she goes to work by car, bus, or train and logs in to a computer to read emails and perform daily tasks. In general, each of us expect things to be the way they were the day before, the week before, and even the year before. However, most of us also understand that technological and scientific progress has changed our lives. For instance, children cannot imagine a life without color televisions, camcorders, cell phones, iPods and other modern day conveniences. Somehow, many baby boomers survived their childhoods without these “luxuries”, but were fully ready to adopt them later on in life as “necessities.” While change can often be disruptive (and is often unwelcome), it is unstoppable. Often, these changes are earthshaking but the forces bringing about the change are hardly noticeable. When such a change takes place it can be classified as a “Pluto Paradigm.”

Why the “Pluto Paradigm?” In August, we all woke up to the determination (made by the International Astronomical Union) that Pluto was no longer a full-fledged planet – despite having been a solar-system mainstay ingrained in students since grade school. And, surprisingly enough, nothing fell out of the sky or changed the molecular structure of the solar system. Maybe two decades of corporate downsizing encouraged planetary scientists to tighten up on the number of planets—as a result Pluto got demoted to dwarf status. Let’s face it – change is hardly new to the cosmos, and it is certainly not new to investors. The critical issues are to recognize the apparently innocuous event and then to deal with resultant changes and their impact on investments. When such effects occur as economic phenomena they can have a dramatic impact on investors. Similarly, political fiat can have effects but with unintended consequences.

New economic policies, whether they emanate from either fiscal or monetary policy decisions can change traditional relationships. Bulging budget deficits don’t cause interest rates to rise as most Americans know by now. And strong economic growth doesn’t cause inflation as China and India know. These Pluto Paradigms require some thought and could alter the fundamental structure of the economy or the way we make investment decisions. One example was Y2K and the shift in technology spending to avoid a global computer shutdown. Although this one event passed without a hint of financial dislocation, the displacement of business spending triggered the bursting of the technology bubble and the collapse of many burgeoning technology businesses that were expected to lead the new economy in the twenty-first century.

Today, housing is the most talked-about “bubble” in the investment community by far, trumping oil prices, upcoming mid-term elections, budget and trade deficits, Iraq, health care costs and pension obligations. Like the Y2K bubble before it, the housing boom was predictable (in hindsight). In this case the Pluto Paradigm was triggered by the Fed’s inability to stimulate

growth in business loan demand and to lower interest rates all the way down to a measly 1%. When mortgage rates fell in tandem, buyers saw an opportunity to get more home for the same monthly payment. As transactions exploded, sellers caught on to the trade and pushed their asking prices higher. As long as the Fed kept rates low, the Pluto Paradigm hibernated. Like a cocktail party that runs late into the night, the fundamental underpinnings for an endless rise in both home sales and home prices evaporated—especially when the Federal Reserve changed course and began to push interest rates higher. The glut of unsold new homes held by speculators coupled with record numbers of unfinished homes about to hit the market sounded the death knell to the never ending housing boom (a term uttered by many a realtor on media broadcasts). As with the indigestion that was inescapable during the information technology meltdown, the liquidation of housing inventory may well trigger a further fall in prices.

What we find concerning is the common view that housing's decline will be largely a 2007 event, even though average home sales have already fallen for more than a year (by 13.2%) and residential investment has fallen for three quarters. In fact, the National Association of Realtors points out that five states have suffered more than 20% year-over-year declines of existing home sales (Arizona, California, Florida, Nevada and Virginia). The fact is that the sharp decline has already occurred. We have counted on housing's decline to offset the demand pressures that have generated higher inflation and the Federal Reserve's tightening response in August. Indeed, after three years of 3.75% real economic growth and growth of 5.6% in the first quarter of this year, we believe a slowdown in the U.S. economy is inevitable – especially given the fact that economic growth averaged 1.1% in the two and a half years prior to the Bush tax cuts in 2003. But, the other shoe may be about to drop—housing prices. A rise in interest rates coupled with an energy price surge would take the bloom off the housing rose. If speculative home buyers pull out of the market and prices fall then a downward price spiral may be close behind. A similar spiral occurred in the early Nineties. For realtors, the Pluto Paradigm has become all too real.

As our regular readers know, tax rate cuts work, and work well, for individuals, employers and even the government, which sees its revenues increase dramatically when tax cuts are enacted and left in place over time. During the third quarter, the government's establishment survey reported that in the 36 months since the tax cuts became law, 5.3 million new jobs have been added to the economy. The unemployment rate dropped from 6.1% when the bills were signed to 5.4% at the end of 2004 and to 4.6% today. Hourly wage rates for workers are up 3.9% on the past year and they increased at an annualized rate of 4.6% in the most recent period – the highest quarterly rate in nearly 10 years. Incomes are up too. As Stephen Moore noted in the Wall Street Journal, “the percentage of Americans earning more than \$50,000 a year rose from 40.8% to 44.2% between 2002 and 2004.” And the top sliver (those in the top 0.5% of income) now pays four times more in total taxes than do all Americans in the entire bottom 50 percent!

All of this good news has also been good for federal and state governments. Federal tax receipts increased by 15% last year and 13% in the first nine months of this fiscal year, which, as the Journal points out, means the nine-month increases for the past two years represent the highest growth rates in 25 years. Reducing the capital gains tax rate from 20% to 15% resulted in an increase in capital gains tax receipts of 79% from 2000 to 2004. Cutting the dividend tax rate by more than half – from 39.6% to 15% -- increased dividend tax receipts by 35% from 2002 to 2004. And corporate tax receipts have nearly tripled since 2003, reaching \$250 billion for the

past nine months (26% higher year over year). At the same time, state budgets are running big surpluses as opposed to deficits early this century. Many governors have enacted tax cuts in their states and not surprisingly tax revenues have increased as has economic activity. Yet, there is still resistance to tax cuts on the basis that they are unfair. (See Tom's article "The Great Inequality Distortion" on National Review.)

President Bush's tax reductions have been the most successful economic growth and opportunity program of any president in a quarter of a century. Yet, many investors fail to recognize the importance of these economic policies in keeping America growing. As we head into a sixth year of economic expansion, credit should be given where it is due yet the November elections are a worry to some investors who fear that many of the President's stimulative tax cuts may not be renewed. The Democrats may trigger a Pluto Paradigm when tax policy is discussed in early 2007.

Think for a moment about what this morning would have looked like if it were 150 years ago. You wouldn't have had electric light, running water or indoor sanitation. You couldn't have gone to work by car, bus or train. You couldn't have used a computer, which performs calculations in seconds that would take decades with pen and paper. In short, you would probably not have found this morning very comfortable or enjoyable – if you had been alive to experience it. Back then, the average for life expectancy was around 30 years – today its 80!

As Johan Norberg points out in a recent edition of the Wall Street Journal: "The people we should thank are the innovators and entrepreneurs, the individuals who see new opportunities and risk exploring them – the people who find new markets, create new products, think out new ways to handle commodities commercially, organize work in new ways, design new technology or transfer capital to more productive uses." The introduction of innovation and wealth into our lives was scrutinized especially by socialists like Marx and Lenin who both opined that wealth came at someone else's expense. Yet, since 1950, extreme poverty has been reduced to 20% from 60% in developing economies. The reduction has been led by those countries that have the most trade and investment with the United States.

Fortunately most people believe that capitalism creates wealth and freedom. As more countries embrace capitalism, free trade, and economic interconnectedness, the rest of the world will become wealthier. Since its independence, the United States has evolved from an emerging market to the "Arsenal of Democracy" to a model for the "New Economy." Our remarkable growth since 1820 has benefited from democratic institutions, a belief in capitalism, private property rights, an entrepreneurial culture, abundant resources, openness to foreign investment, the best universities, substantial immigration and relatively transparent markets. We have also been helped by timely investment in infrastructure, technology and human capital. Advantages such as these are not easily changed. In fact, they tend to help correct problems such as the investment bubble of the late 1990s and the accompanying wave of corporate scandals. U.S. innovation in economic technology has also ushered in a new era of world growth. President Reagan's two tax cut programs in the 1980s led 172 other countries to implement reductions in tax rates—and a resultant improvement in economic activity. The Federal Reserve Board's shift from trying to control the money supply to stabilizing interest rates ushered in a twenty-five year

bull market in bonds. Moreover, other countries have adopted the Fed's policy of controlling interest rates to manage inflation. Pluto is everywhere.

If freedom, democracy, individual liberty, and economic liberalization – all vital cornerstones of the U.S. experiment – are embraced by developing economies then lower tax rates, strong profits, and ample bank credit should result in growing global wealth – a needed trend that increases liquidity in both developed and developing nations as they adopt American financial innovations and market structures. As financial technologies are deployed throughout the world, they will increase prosperity by multiplying the value of human capital, social capital and real assets. As long as the wellspring of entrepreneurialism, innovation and wealth creation in the dynamic capitalist system are alive and well, financial markets should continue to reward investors. Consider the fact that in the first nine months of this year Indian companies announced a record 112 foreign acquisitions with a combined deal value of \$7.2 billion. This trend has the potential to transform industries around the globe including natural resources, information technology, healthcare and auto parts manufacturing to name a few. Even the island of Sark, considered the last feudal state in Europe, is feeling the Pluto Paradigm – the Seigneur recently announced a shift to democracy.

Global financial markets are important barometers of fear, hope, security and the health of the world's economy. And while you might not know it from today's "Bad News Sells" headlines, the stock market message is one of reasonable hope, confidence and optimism about the state of the world. Because of our economic interconnectedness, literally hundreds of millions of share-owning investors are voting daily on the great issues of war, peace, prosperity and hope for the future. And their vote is optimistic.

Nothing happened to Pluto in terms of location, size or continued existence. What did happen is that the solar system world will change dramatically for education, planetariums, publishers, physicists, astronomers and astrologists. We have backtracked in our travels to identify a few of these paradigms to attempt an explanation of how well our economy and financial markets have fared over the past twenty-five years. Identifying the next Pluto Paradigm could have significant investment implications going forward.

***1: PARADIGM:** Example, Pattern; *especially* an outstandingly clear or typical example or archetype. **2:** a philosophical and theoretical framework of a scientific school or discipline within which theories, laws, and generalizations and the experiments performed in support of them are formulated; *broadly:* a philosophical or theoretical framework of any kind.

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