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Katrina's Wake

The national economy must do the heavy lifting.

REBUILDING the Gulf Coast storm area is projected to cost $150-$200 billion. This would make Katrina the most expensive natural disaster in U.S. history.(1) But the full price tag could prove much higher if the U.S. economy stalls in the storm's wake.

Some observers are concerned that disrupted industries, displaced workers, ruined businesses, skyrocketing energy costs, higher federal deficits, material shortages and other storm effects may push the economy into recession. The good news is that America's $12.5 trillion economy is responsive and durable. It can absorb Katrina's devastation without much lasting effect.

Consider these signs:

• **Economic momentum.** During the third quarter, signs pointed to a U.S. economy continuing on a vigorous expansion. Evidence included rising job creation, falling unemployment, optimistic business sentiment, strong corporate profits, and productivity gains.(2) While September's devastation will distort third quarter statistics, fourth quarter results may indeed offer a more reliable gauge of the economy's direction.

Economists expect unemployment and weak local commerce in the region to affect various business indicators in the coming months. Then, in 2006, the injection of massive reconstruction spending will boost the numbers, resulting in only a modest impact on the economy over time.

• **Energy costs.** Refineries and drilling rigs in the Gulf of Mexico are periodically subject to storm disruption. The difference now is the tight energy market. Gasoline prices briefly spiked after the storm, but returned soon to pre-Katrina levels. By mid-September, wholesale prices implied a $2.67 per gallon average.(3) The recovery was due, in part, to quick reopening of many affected refineries and the federal government's actions to ease the supply disruptions.(4)

This price volatility will continue until petroleum supplies gradually increase, worldwide demand falls, or both. Fortunately, the U.S. economy is more responsive, growth-oriented and energy efficient today than in the 1970s and is therefore less vulnerable to rising energy costs.(5)

• **Inflation.** Rising prices may be the biggest threat to the nation's economic outlook. The storm hit just as the labor department reported higher inflation driven by energy costs. In August, prices climbed 3.6% from a year ago, which is the largest increase in four years. However, core inflation (excluding food and energy) remains moderate, showing a 2.2% annualized increase in August.

• **Federal Reserve policy.** The Fed may now face the hard choice of either helping the economy rebuild the Gulf Coast or fighting inflation. If energy costs are driving prices higher, the Fed may continue raising rates to curb the expansion. But excessive monetary tightening may produce too much drag on growth.

Conversely, cutting rates may keep the economy humming right through Katrina reconstruction. But the stimulus could overheat inflation, especially if employment stays strong and wages begin climbing. The Fed must also anticipate and

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(1) According to economy.com, total government aid resulting from 9/11 totaled about $64 billion in current dollars. The initial $62.3 billion in Katrina aid paid out by early October is more than three times the federal cost of the four hurricanes that hit Florida in 2004. ("Early Estimates On Katrina Costs Hit $200 Billion", The Wall Street Journal, 9 Sept. 2004, A1)

(2) In the past two years, real GDP has expanded at an annualized rate of 4.1%; business investment has grown 11.8%; productivity growth has averaged 5.4% per year; and U.S. factories are producing at historical levels. ("Resilient Economy, The Wall Street Journal, 8 Sept. 2005, A18)

(3) "Katrina's Impact Depends on How Business Reacts", Business Week, 19 Sept. 2005, p31.

(4) President Bush released part of the U.S. Strategic Petroleum Reserve and temporarily eased environmental and transportation regulations so existing gasoline inventories could reach customers quicker. ("Economy Shows Resilience in Face of Massive Jolt", The Wall Street Journal, 6 Sept. 2005, A1)

(5) While GDP has doubled since 1979, petroleum consumption has risen just 12%. Also, spending on energy by consumers in Q2 2005 was 4.7%—compared to 7% three decades ago. ("Resilient Economy", The Wall Street Journal, 8 Sept. 2005, A18)

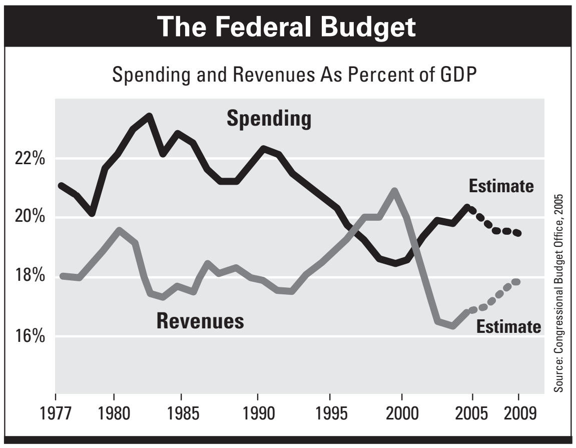
(6) Both corporate and individual tax receipts are up some $262 billion. Despite 7% higher spending, rising federal receipts reversed the upward-trending budget deficit. In fiscal year 2005, it was estimated at 2.2% of GDP—down from 3% in 2004 and 4% in 2003. (Source: Congressional Budget Office, 2005)

Tax Cuts and Deficits

Hear both sides of the story before casting your lot.

What's better for the economy—lower taxes or a balanced budget? This will be a hotly debated question as Congress and President Bush spar over the costs to rebuild the Gulf Coast. At stake is the extension of the 2003 tax cuts, future economic growth and the government's fiscal stability.

Balanced budget proponents say that the 2003 tax cuts on personal income, dividends and capital gains rates reduced federal revenues and worsened the deficit. They warn that making the cuts permanent would produce even more federal red ink and establish a dangerous pattern of fiscal imprudence. Most deficit hawks point to the surplus that arose in the late 1990s as evidence that tax hikes and spending cuts advance economic activity.[1]



Supporters of tax reform claim that higher taxes discourage risk taking, business spending, consumer purchasing and other activities that fuel economic growth. A slowing economy would result in lower federal revenues, which is the last thing the government needs as it struggles to control the deficit while fighting a war and helping the Gulf recovery effort.

They propose even lower taxes to supply individuals and businesses with the capital needed to invest and spend on new endeavors. Moreover, they believe the private sector can allocate this capital more productively than the government. The expected result would be a rising economy and expanding tax base that generate more wealth, higher living standards and more federal revenues.

The tax cut boom

The 2003 tax law was a second attempt to restore growth after the dot-com bubble crash, the 2001 recession and aftermath of 9/11.[2] Since the tax cuts were implemented, the economy has experienced a robust expansion driven by investment and productivity gains.

Through July, real GDP averaged 4.3%, whereas growth before the tax cuts was only 2.4%. From June 2001 to May 2003, total annual GDP was $10.9 trillion; after the tax cuts were implemented, the economy produced about $12.2 trillion per year.[3]

Over 5 million new jobs were added as a result of new business formations, rising venture capital activity and increased initial public offerings. At this point, every job lost during the bursting of the technology bubble and market decline of 2000-02 has been matched by a new job.[4] The stock market rebounded in 2003-04, restoring about $2 trillion of investor wealth lost in the 2000 crash.

As a result, the rising economy since 2003 has boosted federal revenues. In fiscal year 2005, tax receipts climbed by more than $262 billion—the largest single year increase in history. This raised the government's share of the economy to 17.5% of GDP—close to the 17.9% postwar average.[5] According to U.S. Treasury numbers, personal withheld tax revenues are up 7.3% compared to last year, and social insurance and retirement receipts have grown 6.4%.

The higher revenues have brought down the federal budget deficit. The Congressional Budget Office (CBO) estimates the 2005 deficit at $273 billion—or about 2.2% of GDP. This $58 billion is less than the original 2005 forecast and far below the $412 billion, or 3.6% of GDP, in 2004. In August, the CBO projected that the deficit would trend down to 2.4% in 2006 and fall to 2.0% by 2010.

The storm rebuilding effort will force an upward revision in the deficit. But the fact remains that the revenue component of the budget has improved with tax cuts.

The truth about deficits

Despite contrary evidence, tax reform opponents still claim that the 2003 tax cuts were a costly mistake. The intense disagreement produces enough misinformation to confuse the issues and lead many to inaccurate views of tax policy. In recent years, the mass of evidence has supported the following:

- **Tax cuts don't create deficits.** The notion that tax cuts compromise federal revenues is a half-truth. Tax cuts reduce federal collections over the short term, but produce higher growth rates, increased wealth and rising federal revenues over the long term. Conversely, a tax hike immediately boosts federal receipts, but drags down the economy as people and businesses spend less, send capital overseas and seek to minimize taxes at the expense of more productive activities.
- **Rising deficits don't guarantee higher interest rates.** Linking economic growth to a budget surplus is a relatively new theory popularized by Treasury Secretary Robert Rubin and the Clinton administration.[6] But history shows no clear relationship between interest rates and deficits. Despite swelling deficits in the 1980s, interest rates were lower and economic growth higher than during the 1990s.[7] Further, there's scant evidence

(1) What they don't mention is that other factors helped create the temporary surplus. On the spending side of the equation, military outlays dropped substantially as policy makers erroneously assumed that the Cold War's end would eliminate the need for a large U.S. military presence. Further, from 1996 to 2000, spending on Social Security, Medicare and Medicaid actually fell from 8.2% of GDP to 7.6%. On the income side, the bull stock market and Internet bubble doubled tax collections on capital gains. But the red ink returned in 2001 as these uncontrollable factors shifted. It is estimated that half of the big swing from surplus to deficit was due to the stock market crash and the economic slowdown, while the other half resulted from tax cuts and higher federal spending. ("The Deficit: America's Credibility Gap", Fortune, 8 March 2004, pp 136-138)

(2) The first attempt gradually reduced marginal tax rates and provided tax rebates designed to boost consumer spending. This proved to be weak medicine, however, since the policy targeted consumer activity rather than supply side capital formation. The second attempt aimed to offset a collapse in business investment by accelerating the marginal rate cuts and dropping the rate on both dividends and capital gains. Policies intended to increase business investment and production have proven more beneficial to economic growth than those designed to stoke consumer demand. This offers strong evidence for the supply side argument. ("The Tax Cut Expansion", The Wall Street Journal, 12 July 2005, A16)

(3) "Clinton, Katrina & Tax Cuts", National Review Online, 23 Sept. 2005.

(4) The strong employment numbers are coinciding with a larger population of active workers. Labor force participation is now around 66% today, compared to a 63% postwar average. The 4.9% jobless rate is almost a percentage point below its level during the same stage of the late-90s economic expansion. ("The Great American Jobs Machine", The Wall Street Journal, 8 Aug. 2005, A10)

(5) "Tax Cut Dividends", The Wall Street Journal, 17 Aug. 2005, A10.

that rising deficits harm a country's relative currency value or produce poor returns in the stock market.[8] Moreover, drastic changes in the U.S. economy and world capital markets have altered many of the forces that drove the crowding out theory.[9]

• The current deficit level is moderate by historical standards. Original CBO projections showed the 2006 budget deficit at 2.4% of GDP. After Katrina, economists revised this to 3% to 3.5% of GDP.[10] But even this level is neither unprecedented nor dangerous from an historical perspective. In previous recessions, the deficit peaked at 5% of GDP. Deficits are only too large if they usurp the private economy's need for capital and labor, which produces an inflationary surge.

• Not all deficits are the same. Much depends on the reason for the deficit and whether the capital markets think the federal government is acting prudently. The deficits of the last few years have resulted from a recession made worse by the terrorist attacks, as well as the military buildup to fight the war. The deficit's effect on long-term debt also matters. In the 1980s, economists concluded that the cumulative size of the national debt is more critical than the deficit's size. The U.S. currently owes an aggregate debt equal to 37% of GDP, and the CBO expects it to peak at about 40%. Above 50% is considered the danger zone.

• Uncontrolled spending has driven the deficit higher. Federal outlays are rising about 7% per year, and the long-term trend is disturbing. The CBO projects that by 2030, the three major entitlement programs will consume half of all federal receipts.

The last time Congress showed any budget discipline was in the high deficit years of the mid-1990s. Federal spending (as a share of GDP) fell throughout most of the 1990s, mainly due to reduced defense spending. But spending rose again in 2000 and has been climbing ever since, reaching over 20% of GDP in fiscal year 2005.[11]

Growth priorities

The argument about tax cuts and balanced budgets points to a broader ideological struggle over the role of government and markets in our economy.

Preoccupation with a moderate-sized deficit might crowd out the more prudent emphasis on growth. In fact, the true economic cost of Katrina and Rita may be realized in how lawmakers respond to the fiscal strain. The economy has enough momentum, excess capacity and efficiency to bear the financial burden of restoring the Gulf. But the downstream effects of tax policy and spending decisions will impact inflation, output, employment, distribution, innovation and other factors of growth for many years.

With this in mind, the best avenue for long-term financial health is to advance policies that will encourage economic growth while taming the deficit through major cuts in discretionary spending and entitlement reforms. This will require fiscal discipline, proven supply side policies and political courage.

Maintaining low taxes—and indeed, making them permanently lower—is the best fuel for the national economic engine. A good first step would be to make the 2003 tax cuts permanent. Most of these cuts expire by 2010—and the higher dividend and capital gain rates return in 2008. Congress was preparing to debate these issues in the 2006 budget reconciliation bill before the storm crisis delayed the action.

The governing coalitions in Washington agree that rebuilding the Gulf will strain government finances. The most relevant question is whether we want to embark on the project with a sluggish economy or a vigorous one that can provide the revenue growth to keep the deficit contained. ■

(6) This economic view is known as the *crowding out theory*. It proposes that rising deficits add to the national debt, which ultimately forces interest rates up as the government competes with other borrowers for capital. The result is less capital flowing into the private sector and slower economic growth. Their philosophy is based on the notion that a balanced budget leads to strong growth, even though higher taxes are needed to raise the revenues to pay off the national debt.

(7) In 1990, the deficit was 3.9% of GDP while interest rates were around 3.5%. In 2000, the budget had a 2.4% surplus and real interest rates were 3.6%. From 1983 to 1990, the economy grew 4% annually, despite high deficits. From 1993 to 2000, the economy expanded at 3.9% annually. In 2004, the deficit reached 3.5% while rates were at a 30-year low.

(8) Federal deficits are associated over the short term with bull stock markets, while budget surpluses have been followed by lower equity returns. In the last six periods when the deficit spiked relative to GDP, the stock market averaged 12% annualized in the following two years. ("Pray For Deficits", Forbes, 27 Dec. 2004, p 188)

(9) The U.S. bond market alone has almost tripled in size since 1990—from $8 trillion to over $20 trillion. Also, the international sector is now more prevalent that in the past. Both of these sources provide much more capital to fund the national debt. Furthermore, the U.S. government's practices are not considered imprudent since nearly every major nation is running deficits. Finally, inflation has a more important role to play in the general direction of interest rates, and the Fed has maintained a strict policy on controlling inflation growth with rate hikes and tight money. ("Duking It Out Over the Deficit", Fortune, 26 May 2003, p40)

(10) "Katrina Will Force Hard Choices", Business Week, 26 Sept. 2005, p 29.

(11) Federal revenues boomed during the late 1990s due to the Clinton tax increases and the rising stock market. Revenues hit a postwar record of 20.9% of GDP in 2000, then declined during the recession. ("Hooray for the Deficit", The Wall Street Journal, 8 Feb. 2005, A18)

RESILIENCY

The Key to Successful Investing

We all encounter transitions in our lives. If you are resilient, you can better navigate change, bounce back and seize new opportunities. You can persevere during difficult times and have a positive outlook through trials and tribulations.

Resiliency is a trait or personal characteristic that you can nurture. In Making Sense of Life's Transitions, William Bridges wrote,

> "There are ways of facilitating transitions, and they begin with recognizing that letting go is at best an ambiguous experience...They involve developing new skills for negotiating the perilous passage across the 'nowhere' that separates the old life situation from the new."

Other characteristics of resilient people:

- They feel good about themselves and are rarely affected by criticism.
- They are emotionally stable and are not easily "rattled" in stressful situations.
- They don't give up in difficult situations.
- They stay in control of the direction their life is taking.

To learn more about resiliency and how this trait can influence your happiness and well-being as you grow older, pick up a copy of Aging Well: Surprising Guideposts to a Happier Life. This book is based on the longest study of aging in the world, the "Study of Adult Development" at Harvard University.

George Vaillant, M.D., author and a member of the research team since 1967, believes this study "offers significant reliable data that tell us what successful aging is and how it can be achieved." In a nutshell, Vaillant, describes positive agers in terms of resilience:

> "As they surmount the inevitable crises of aging, the study members seem constantly to be reinventing their lives. They surprise us even as they surprise themselves. In moments of sorrow, loss, and defeat many still convince us that they find their lives eminently worthwhile. They do not flinch from acknowledging how hard life is, but they also never lose sight of why one might want to keep on living it."

Regardless of age, successful living requires both practical strategies and emotional fortitude. In all situations, resiliency will help you to overcome challenges and grab hold of opportunities that you encounter along life's journey.

Katrina's Wake

(Continued)

manage the inflationary effects of the massive federal spending directed to the Gulf Coast.

• **Consumer confidence.** The University of Michigan's consumer sentiment index plunged 14% in September to 76.9—the lowest since 1992. Since July, the index is down 20%, which is the largest two-month decline since 1978. This raises the prospect of slowing consumer purchases in the coming months. But consumer spending doesn't always follow sentiment downward, as demonstrated in the months after 9/11.

• **Pro-growth environment.** The right policy mix is essential to help the economy do the heavy lifting for Katrina recovery. This will prove instrumental in boosting economic activity and corporate profits, creating jobs, encouraging new savings and investment, and fueling entrepreneurial business startups.

Once Congress deals with the initial crisis, it should resume work on the 2006 reconciliation bill and focus on extending the capital gains and dividend tax cuts, along with other pro-growth legislation, such as permanent repeal of the estate tax. The 2003 tax bill helped add an estimated \$1.5 trillion to the economy and \$3 trillion in stock market wealth. It also raised federal receipts by 15% in the most recent fiscal year.[6]

There's also the fiscal stimulus of federal spending on Katrina. The rebuilding project could extend the life of the expansion by injecting about \$50 billion into the system over the next six months, resulting in a 1% to 2% boost in GDP.

Many economists expect growth to fall 0.5% to 1% during the second half of 2005. But this would leave the economy expanding at a respectable 2.5% to 3.5%. Although this falls short of the 4.1% average, it is certainly acceptable, considering the task awaiting our free market system in the Gulf Coast region. ■

In My Opinion. . .

Robert J. Cole, Jr., CLU, ChFC, CFP®

How Does *Your* Garden Grow?

For over twenty years I have practiced the meditation of Tai-Chi. About fifteen years ago, my wife and I built a wonderful oriental garden in our back yard. Its flowing waterfalls and inviting shade have given us both many hours of pleasure. This garden is the spot where I do my Tai-Chi exercises, so it also has been a spot of high energy for me.

Not long after we constructed the garden, a summer storm took down one of the large trees that was near our deck. We had purposely built a bench around the base of this tree to give people a chance to sit under its wonderful shadow. We were left with a stump and the afternoon sun which made the deck uncomfortably warm. Still, we left it that way for a number of years. The same storm had damaged the maple tree that covered the entire garden. Over the advice of the tree repair people (who wanted to cut it down), we attached a steel cable to the main limb which had a large crack in it. We hoped that the cable would provide the support needed for the tree to mend itself.

Things stayed the same until last summer when it was obvious that our beloved maple was dying. We finally gave in and had it cut down. Overnight, our "shade" garden was now exposed to the full brilliance of the sun. It wasn't long before the plant life responded. Most of the shade plants were cooked and the algae production in the ponds multiplied to the extent that the filtration system was overloaded. The Koi fish had little protection. Something had to be done.

As we went through the process of looking at alternatives, it occurred to me that, once again, the garden was teaching us a lesson. Sometimes in life we have the joy of getting things "just perfect". The natural tendency is to want to preserve this achievement. But, alas, such preservation is rarely possible. Change is the biological imperative of the universe and no one or no thing is above its relentless movement. Many times, after such a transformation occurs, we find ourselves immersed in sadness for what was. All of our energy is absorbed by regret. This is a predictable reaction, but if it continues for too long it becomes dysfunctional.

I often tell our clients that a financial plan is not a firm outline of the future, but rather a guideline for framing the decisions that the winds of change will bring us. Life will always present change to us and we must be willing to adapt our plans to the new scenario. Often this will involve the redirection of resources and the willingness to see things from a fresh perspective. Then, revitalized with the excitement of possibilities, we once again advance into our futures.

I am happy to report that the transformation of our garden was completed this last week. While it retains the essence of its past, it now embraces the new conditions and is thriving. Sure, there was sweat, money, and challenges associated with this project, but there will always be a tuition for the school of change. Still, the costs of trying to hold on to a defunct past are far more.

Until next time, that's my opinion….

Robert J. Cole, Jr., CLU, ChFC
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