

Volume 01 / Issue 01

## Thank you

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Before moving to the heart of this month's essay, I wish first of all to simply say "thank you". If you are reading these lines, a good friend of mine, if not myself (perhaps with insistence, sorry!), has recommended that you spend some of your precious time to read this letter.

Why would anyone in his good mind write another monthly report on the subject of finance? There are thousands of newsletters, some of which are excellent and some are even, I dare say, free. So why choose to enter this crowded arena? The reason I wish to share my thoughts with you can be summarized in a five letter word, a-n-g-l-e.

The one recurring thought that has struck me all along the years is that the inherent complexity of economics (and some insist in calling it a science) enables each and every one of us to basically have an opinion. Now opinions, everyone has one, on just about everything. Just as the "perma-bulls" will always find numerous and valid arguments to demonstrate the fantastic opportunities offered by our brave new globalized world (remember Dow 36'000, the Japanese miracle?), the "perma-bears" will demonstrate, with equally convincing arguments, that the world is coming to an end and now is the time to be totally self-sufficient, farm our own land and hide gold bars in a safe. In Switzerland we would maybe add a few bottles of wine in the "to do list" before the Apocalypse. As a result, most of us shall remember and reflect on the bearish statements as they will tend to ignite "fear", but still wrestle in the markets in the hope of a positive outcome because of our irresistible attraction to "greed".

This letter, I hope, is not simply another opinion. It is an effort to reduce the mismatch between the inherent complexity of economics and the simplifying shortcuts often taken to cope with that complexity. I shall generally seek to take an outside view, looking for comparable situations in the past rather than limit myself to an inside view that may narrow the information inputs. My hope is to offer the reader an alternative picture. By doing so, we may discover that some of our widely accepted certainties are built on a few fallacies. This approach might also demonstrate from time to time that correlation does not imply causation and that the most evident links may be very misleading.

The website!

<http://www.thestainesletter.com>

*“Although we Americans strive to provide equality of economic opportunity, we do not guarantee equality of economic outcomes, nor should we. Indeed without the possibility of unequal outcomes tied to differences in effort and skill, the economic incentive for productive behavior would be eliminated, and our market-based economy — which encourages productive activity primarily through the promise of financial reward — would function far less effectively.”*

— Ben Bernanke, Chairman  
of the Federal Reserve,  
February 6, 2007

From time to time this may initiate one or more investment ideas that I believe could benefit from this misrepresentation of reality. Finally, pursuing this theme of provoking a different thought process, I shall add links to a few articles that I have found of interest during the month. **In the first few letters, I shall be sharing my thoughts on a few macroeconomic currents that I believe are generally overlooked, in some way laying down the foundations of The Staines Letter. Once done, rest assured that the length of my letters will be on average about 7-10 pages.** Now let’s move to the red meat of this month’s essay.

## One for all and all for one!

This was the rallying cry of the musketeers, proof of their unconditional solidarity and strength. Now in a completely different register, this also stands true when looking at the evolution of income and wealth in particular in Anglo-Saxon countries.

Income and wealth disparity is an emotive topic and my comments below are restricted to the effects and unintended consequences of this fact. I shall limit myself to a cold assessment and address this topic with neither fear nor favor, letting numbers speak the truth and taking no sides.

What I shall try to demonstrate is that even if there is wide disagreement amongst researchers on whether income disparity has been accelerating and is creating growing inequality, what can’t be argued is that the disparity is a fact and its size is phenomenal. The result of this gigantic gap between different income groups has numerous effects that need to be taken into consideration when assessing past economic trends and behavior. This disparity creates biases and even a few dislocations that reach far further than first meets the eye. Also, as we shall see, these may create investment opportunities should they persist or reverse.

*“Most working-age Americans are in fact on track to have more retirement wealth than most current retirees.”*

- The 2006 Economic Report of the President at the Joint Economic Committee – February 16, 2006

Let's start with the numbers to get some perspective. Every year since 1966 the IRS has released data on income tax returns from over 100'000 filers. This has enabled numerous studies on income distribution. It is essential however to understand that these studies are based on tax units, not individuals. Why is it so important? There is much disagreement on whether tax units fairly represent the changes in income distribution across time. One of the many arguments out there is that tax units tend to represent a varying number of individuals (singles, married couples, families), that the huge growth in tax-favored savings plans (401 k) has resulted in billions of dollars of investment disappearing from tax returns; transfer payments (subsidies, welfare, social security) are generally excluded from tax-return-based studies; the dramatic changes in tax laws induce income shifting behavior (the large shift of income from corporate tax returns to individual tax returns after the 1981 and 1986 tax acts that reduced the rates of individuals versus businesses), and capital gain excluded studies do not account for the change to stock options from a type taxed as capital gains to a type taxed as salary. Many of these factors tend to skew the results and exaggerate the disparities. Nevertheless, these factors tend only to slow the rise in disparity and do not appear to inverse the trend. (*for more information see: Has U.S. Income Inequality really increased? By Alan Reynolds Policy Analysis No .586 Cato institute*).

A number of arguments come to mind that could also tend to underestimate the disparity. Amongst them I can think of non reported income. Every year the BEA publishes data comparing its estimates of the amount of income that should be reported to the IRS and what is actually reported on tax returns. The gap between the two is generally between 9% and 13.5%. Simple common sense would lead to suspect that it is somewhat easier for top wealth earners to structure their income in a tax efficient way that is not available to the bottom earners. If not only because the structural costs of this tax efficiency gain create a natural threshold before which it makes no economic sense.

*“The point is, when they are as large as you will see they become macro, and when you have macro size numbers, you have to take notice because it skews the picture and may even change some perceived rules of economics.”*

So the exact numbers may be somewhat uncertain. The point is, when they are as large as you will see they become macro, and when you have macro size numbers, you have to take notice because it skews the picture and may even change some perceived rules of economics.

What do I mean by macro size numbers?

From the flow of funds report of the Federal Reserve as of the 30<sup>th</sup> of September 2009 we can find the following on the aggregate wealth side:

Household liquid assets ( <u>liquid financial assets only</u> ):	23'695 billion
<b>Less Household consumer credit:</b>	<b>2'496 billion</b>
<b>Net Liquid Assets:</b>	<b>21'199 billion</b>

We now have to add another big component much in the news recently of the household balance sheet...

Household Real Estate:	16'536 billion
(now let's be conservative here and take a 20% further hair cut to the stated value)	13'228 billion
<b>Less Home mortgages:</b>	<b>10'323 billion</b>
<b>Net Home Equity w/20% hair cut:</b>	<b>2'905 billion</b>

Let's now add pension fund and life insurance reserves...

Pension fund and life insurance reserves:	12'757 billion
<b>NET WORTH (w/20% hair cut on real estate)</b>	<b>36'861 billion</b>

*“... the aggregate net worth is over 20% higher than it was 10 years ago. If you compare the ratio of assets to liabilities households have almost four times more adjusted assets than liabilities... in aggregate, the US household does not appear bankrupt or living way beyond its means.”*

I come up with this number without adding the \$6.5 trillion of equity in private businesses, and by cutting the real estate value by 20% from the Fed’s value as of the 30<sup>th</sup> of September 09, which by the way already fell in value by almost 20% from the 30<sup>th</sup> of June 09 flow of funds report three months ago! Net worth as provided by the Fed in the “Flow of Funds Accounts of the United States” for Households and Nonprofit Organizations is 53.4 trillion as of the 30<sup>th</sup> of September 2009. To say my adjusted number is conservative could somewhat be an understatement.

If you compare this number, with the same conservative adjustments, to where household net worth was standing 2 years ago, at the very top of the previous bubble cycle, it has lost about 10 trillion. No doubt, this is a big drawdown. But if you look at net worth over the past 10 years, since June 1999, net worth has increased by 7 trillion. Not a great compounding rate but the aggregate net worth is over 20% higher than it was 10 years ago. If you compare the ratio of assets to liabilities, households have almost four times more adjusted assets than liabilities. “The consumer is up to its neck in debt” how many times have you heard that one? Wrong. Again in aggregate, the US household does not appear bankrupt or living way beyond its means.

This is in **aggregate**. Let’s dig beyond the aggregate to see who owns what of the pie.

From the Survey of Consumer Finance on 2007 published by the Fed in February 2009 we can see the following distribution of Family net worth by percentile of income by family (in thousands):

	<b>Median</b>	<b>Mean</b>
All families	120.3	556.3
<i>Percentile of income</i>		
Less than 20	8.1	105.2
20-39.9	37.9	134.9
40-59.9	88.1	209.9
60-79.90	204.9	375.1
80-89.90	356.2	606.3
90-100	1’119.0	3’306.0

Notice how the upper percentiles skew the distribution. The Median is where **half the number of families** owns a net worth above and the other half below. The Mean is the arithmetic average and therefore **the result if you add all the net worth of the group and divide that number by the number of families in the group.**

How is this wealth distributed amongst percentiles? From an impressive study by Arthur B. Kennickell p.63 from January 7, 2009 “Ponds and Streams: Wealth and Income in the U.S., 1989 to 2007”, we find the following based on the 2007 SCF:

*Percentile of the distribution of family net worth*

99-100	33.8%
95-99	26.6%
90-95	11.1%
50-90	26%
<50	2.5%

*“So basically when you look at net worth in aggregate, the US household is pretty well off. But in fact, and that is why I have been repetitively bothering you with the word aggregate, the top 5 percentile of American households own 60.4% of net worth. The bottom 50 percentile own close to nothing.”*

So basically when you look at net worth in aggregate, the US household is pretty well off. But in fact, and that is why I have been repetitively bothering you with the word aggregate, the top 5 percentile of American households own 60.4% of net worth. The bottom 50 percentile own close to nothing. Of the top 50 percentile, the top 10 own 71.5% of the US net worth. Since 1989, this distribution has been relatively stable with a tendency of accentuating disparity in favor of the top 95-100 and to the disadvantage of the 50-95 (a hint on the slow road to disappearance of the middle class?).

What about income? Thanks again to the same study, we find the following (p.78):

*Income*

99-100	21.4%
95-99	15.8%
90-95	10.0%
50-90	38.2%
<50	14.6%

The disparity is evidently not as large. Still, the top 5 percentile of family income take 37.2% of total income. The bottom 50 percentile only 14.6%. Of the top 50%, the top 10 take home 47.2% of total income.

Is this the extent of the disparity? Not quite. Thanks to a study from Thomas Piketty and Emmanuel Saez of February 2003 “Income Inequality in the United States, 1913-1998” with figures recently updated to 2007, we discover that it is worth looking even closer to the top 1% of families’ income based on tax data (this method yields a meaningless difference in the income share including capital gains of the top 1 percentile of 23.5% versus 21.4% from the previous study):

Income including capital gains	
Top 1%	23.5%
Top 0.5%	19.31%
Top 0.10%	12.28%
Top 0.01%	6.04%

“The disparity gets exponential as you move up the income ladder. The 0.01% super rich receive a little less than **half** of what receive the bottom 50%. The upper half top 1% takes 82% of the pie received by the top 1%.”

“So the big picture is that in terms of income 0.01% of households take home 6% of the income, the top 1% almost a QUARTER, and the top 10% almost HALF.”

The disparity gets exponential as you move up the income ladder. The 0.01% super rich receive a little less than **half** of what the bottom 50% receive. The upper half top 1% takes 82% of the pie received by the top 1%.

Think of a huge cake, with three children around it. The mother starts cutting a small slice for the first kid and then cuts another slice for the second. Just as she is about to cut the third slice the child tells the mother “I see three slices Mom, I’ll take the big one!”.

From this updated study of Piketty and Saez let’s highlight a few numbers for the sake of perspective:

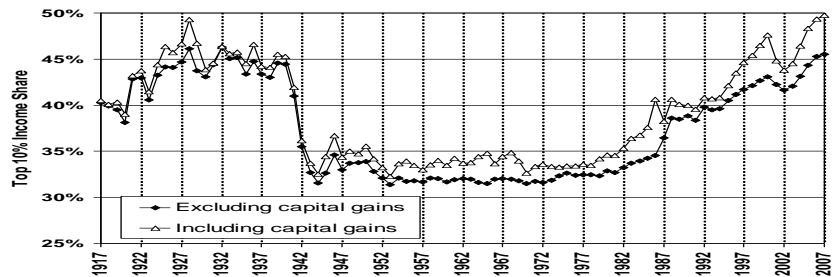
- **The top 0.01% households had an average income of \$35’042’705 with the minimum threshold at \$11’476’646. They received in 2007, 6.04% of all income, the highest figure for any year since the data became available.**
- **The top 1% of households had an average income of \$1’364’494 with the minimum threshold at \$398’909. These happy folks received 23.5% of income, the second highest on record, after 1928.**
- **The top 10% had an average income of \$288’771 with the minimum threshold at \$109’630. This larger group has 49.7% of income, again the highest on record.**

So the big picture is that in terms of income 0.01% of households take home 6% of the income, the top 1% almost a QUARTER, and the top 10% almost HALF.

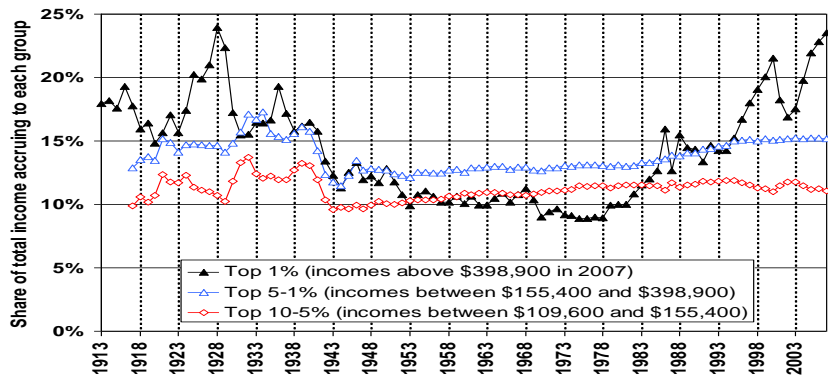


Just in case you wondered what it looks like graphically across time, the three charts below speak for themselves:

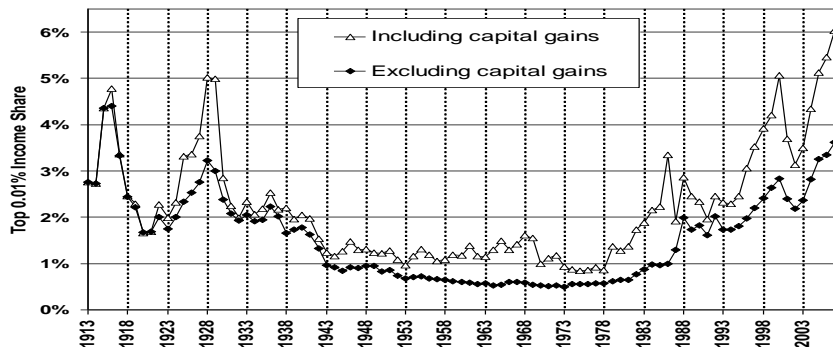
Top 10% Income Share



Top 1%, 5-1%, 10-5% Income Share



Top 0.01% Income Share





*“Crudely, we know that **most** households have very little wealth but that households in **aggregate** have a huge amount of net wealth thanks to the weight of a **small** number of super rich.”*

*“What I shall now try to demonstrate is that a disparity of this size, in the largest economy of the world, where consumption is 70% of GDP and contributes over 20% of world GDP, gets you not only a long way in understanding the global economy but also that it might put into question a number of popular views.”*

**The trillion dollar question from the above chart is whether this trend will continue or reverse.** From the charts above we notice that the share of the Top 1% has doubled over the past 30 years, whilst the share of all those below has stayed relatively constant (as mentioned previously, the speed at which this rise in share of income for the top 1% is calculated may have some flaws that could overestimate the steepness of the rise).

Did I say Macro numbers? On the basis of a conservative 37 trillion of net wealth, 5% of families own a little less than two thirds of it (60.4%) and 10% own almost three quarters (71.5%)! Future cash flows in the form of income appear to be sustaining this gap with the top 5% of families taking over a third of annual income (37.4) and the top 10% taking almost half (47.4%)!

Crudely, we know that **most** households have very little wealth but that households in **aggregate** have a huge amount of net wealth thanks to the weight of a **small** number of super rich.

What I shall now try to demonstrate is that a disparity of this size, in the largest economy of the world, where consumption is 70% of GDP and contributes over 20% of world GDP, gets you not only a long way in understanding the global economy but also that it might put into question a number of popular views.

Let’s start with the widely popular view that the aggregate US consumer does not save and is a profligate spender on the road to ruin.

We have seen that aggregate numbers for wealth and income can be misleading in understanding the “average household”; we must do the same effort when understanding savings. We know by the constant hammering by the press that the US in **aggregate** is not a saver but is that really true? Is the “average household” really not saving?

To find out we must turn to the study by Dean M. Maki and Michael G. Palumbo “Disentangling the Wealth Effect: A Cohort Analysis of Household Saving in the 1990s” of April 2001. The “wealth effect” implies that an increase in wealth directly causes households to increase their consumption and decrease their saving.

Below are the saving rates in 1992 and 2000 by Income Quintile:

Income Category	Savings rate		
	1992	2000	Difference
Total	5.9	1.3	-4.6
81-100	8.5	-2.1	-10.6
61-80	4.7	2.6	-2.1
41-60	2.7	2.9	0.2
21-40	4.2	7.4	3.2
0-20	3.8	7.1	3.3

*“In fact the **majority** of US households are saving and probably just as much or more than any other demographically equivalent developed country. But, in **aggregate**, the size of the share of income of the top quintile being so much larger than the others overshadows the aggregate savings rate giving the false impression that US households are not saving!”*

Notice how during the raging bull market of the 90’s, the wealth effect worked its magic on the top quintile. Those with the highest incomes and therefore those who have surely most profited from an increase in their net worth have swung from saving 8.5% on their income to -2.1% in 2000! The bottom three quintiles, 60% of the population, have actually increased their rate of savings over that period. This makes sense as an asset boom benefits most those with assets which see their wealth soar and therefore reduces their need to save any income enabling them to consume more than they earn by spending some capital gains. Those with little or no assets are likely to be benefiting from a stronger economy which is reducing unemployment and enabling the lower quintiles to slowly build a pool of savings (saving enough for the initial home down payment for example). Now look at the total. The total moved from a 5.9 savings rate to 1.3 in 2000 almost exclusively because the top quintile stopped saving, thus suggesting the exact opposite of what the majority has actually done. Statistically, the extremely elevated income concentration completely deforms the savings picture. In fact the **majority** of US households are saving and probably just as much or more than any other demographically equivalent developed country. But, in **aggregate**, the size of the share of income of the top quintile being so much larger than the others overshadows the aggregate savings rate giving the false impression that US households are not saving!

*“Finally, the savings rate, which is the ratio of personal saving to disposable income according to the National Income and Product Accounts (NIPA) excludes capital gains on financial and other assets (house) but includes taxes on capital gains which reduce the saving rate. If this is not flawed accounting, what is?”*

*“This implies that the larger the income and wealth disparity of a country, the more the wealthiest will impact disproportionately the savings rate.”*

*“The savings rate will increase only if the very wealthy, who have all the means to spend as much as they wish, decide to put on the breaks.”*

Finally, the savings rate, which is the ratio of personal saving to disposable income according to the National Income and Product Accounts (NIPA) excludes capital gains on financial and other assets (house) but includes taxes on capital gains which reduce the savings rate. If this is not flawed accounting, what is?

So we know that a little more than half of US households are saving, and that it is only those in the top quintile who are pushing the aggregate down. The high income households are accumulating net worth from capital gains, while other households may be accumulating net worth by saving. This implies that the larger the income and wealth disparity of a country, the more the wealthiest will impact disproportionately the savings rate. Clearly not what we are used to hear in the financial press who has consistently and wrongly predicted the death of the US consumer! The low savings rates in the US and UK are often used as an argument to imply that spending can not rebound until such time the savings rate reaches a level consistent with historical averages. Nope. The savings rate will increase only if the very wealthy, who have all the means to spend as much as they wish, decide to put on the brakes. As we have seen, there is plenty of accumulated wealth to be spent; it is the willingness of the wealthy to spend it that determines the savings rate, not the spending habits of the large majority of households.

In developed countries that offer different levels of social security and unemployment insurance, another reason for the disparity in the savings rate, is demographics. If you were living in an emerging country with the absence of any material social security net and the living memory of an unstable (or much worse) economic and political environment you would be motivated to save as much as possible whatever your age. In developed countries, saving rates are generally lower because they vary in function of the standard life-cycle model of consumption behavior. A younger population shall have a lower savings rate than an older population.

*“Only the wealthy are spending beyond their income, and the only reason they are doing so is because their wealth is increasing through capital gains and largely offsets this increase in spending.”*

*“The current account deficit is largely a function of wealth disparity and the spending habits of the very wealthy. It is a natural development arising from wealth concentration and not the sign of a weakening financial situation for the aggregate consumer.”*

Does this have further implications? It clearly does. Another widely held view is that the current account deficit (exports minus imports) in the US is unsustainable. The reason being that over the long term there must come a time when the consumer has to stop spending more than he is earning and start building his wealth again (we shall skip the financing aspect in this essay). That would be true if “the average consumer” was actually spending beyond his means. He is clearly not as we have seen. Only the wealthy are spending beyond their income, and the only reason they are doing so is because their wealth is increasing through capital gains and largely offsets this increase in spending.

So not only is wealth disparity, as we have seen, significant enough to enable an extremely low and even negative savings rate for an extended period of time, but the wealth and income concentration, if anything is trending higher, which currently provides further support to this trend. The current account deficit is largely a function of wealth disparity and the spending habits of the very wealthy. It is a natural development arising from wealth concentration and not the sign of a weakening financial situation for the aggregate consumer. There is probably a correlation but no historical causation.

Another conundrum? There has consistently been astonishment to why consumption has been so robust, even in the face of weakening sentiment (consumer confidence).

Surely, the “average” consumer will show weakening confidence which shall result in slower spending during times of rising unemployment, falling asset markets or natural disasters. He will cut some discretionary spending, but as most of his spending budget is on non-discretionary items there will be limited leeway for cutting. The small group of very wealthy and the middle class however, those actually spending on discretionary items, are significantly less likely to change their spending habits.

*“The proof of the pudding is in the eating. Total GDP over the past two years (3<sup>rd</sup> quarter 07 – 3<sup>rd</sup> quarter 09) has risen 0.6%. Guess which is the only component, except for double digit federal spending, that is positive? Yes, consumption, up 2.8%. All the other components are down double digits!”*

The wealthiest have accumulated significant wealth over time and this enables them to make little or no changes to their budget. As for the middle class, it has benefited up to now from this accumulated wealth through the mechanism of cheap credit and rising asset prices. The rise in house prices in particular, created a sense of increasing wealth regardless of income. The remortgaging enabled the middle class to finance its consumption. The financing itself was enabled by the large accumulated wealth in the form of deposits with the banks. This clearly helps in understanding why consumer spending, in aggregate, has been robust during mild recessions. It is the wealth effect that effects spending the most, and this wealth is held by a small number of individuals.

The proof of the pudding is in the eating. Total GDP over the past two years (3<sup>rd</sup> quarter 07 – 3<sup>rd</sup> quarter 09) has risen 0.6%. Guess which is the only component, except for double digit federal spending, that is positive? Yes, consumption, up 2.8%. All the other components are down double digits!

What about money flows? Let’s go back to the study by Arthur B. Kennickell p.56 and p.63 from January 7, 2009 “Ponds and Streams: Wealth and Income in the U.S., 1989 to 2007”.

On page 56 we find the **percent of families** having various types of assets and debts for 2007, among which:

Item	<50	50-90	90-95	95-99	99-100
Certificates of deposit	6.2	24.3	34.2	32.9	27.0
Stocks	7.2	22.7	43.7	59.5	65.4
Bonds	0.2	0.9	6.1	15.6	24.4
Non money market fund	2.3	15.0	36.5	47.6	52.7
Principal residence	42.9	93.7	96.6	96.9	98.8
Mortgage (principal)	33.5	64.2	60.5	66.3	54.4
Installment debt	53.2	43.8	34.6	22.8	17.7

*“The bottom 50 percentile own only a 0.6% share of the total net worth invested in stocks! The top 5 own 82.4%! Same for bonds except that the bottom 50 owns simply no bonds at all. The top 5 percentile own 93.6% of the total net worth invested in bonds!”*

*“Bonds and stocks are not evenly distributed across some shapeless pool of investors. They are heavily concentrated with the wealthy. This group has a different investment horizon and risk aversion than would have a more evenly diversified income group of investors.”*

On page 63 we find the **shares of the components by percentile:**

Item	<50	50-90	90-95	95-99	99-100
Certificates of deposit	3.1	46.6	11.5	23.7	15.1
Stocks	0.6	9.0	8.0	30.5	51.9
Bonds	0.0	1.5	4.8	31.2	62.4
Non money market fund	0.4	11.6	10.3	30.9	46.7
Principal residence	12.6	48.9	11.0	18.1	9.4
Mortgage (principal)	25.3	50.1	7.6	12.9	4.1
Installment debt	52.8	35.5	4.3	3.2	4.2

The bottom 50 percentile own only a 0.6% share of the total net worth invested in stocks! The top 5 own 82.4%! Same for bonds except that the bottom 50 owns simply no bonds at all. The top 5 percentile own 93.6% of the total net worth invested in bonds!

If you wish to know whether ownership of an asset is supportive or not for its price you want to know who owns it. Bonds and stocks are not evenly distributed across some shapeless pool of investors. They are heavily concentrated with the wealthy. This group has a different investment horizon and risk aversion than would have a more evenly diversified income group of investors. The compounding effect of the skewed distribution of income to the very top 5 percentile has continuously supported the demand for stocks and bonds. In an effort to predict the direction of asset classes it is useless to look at aggregates; one has to concentrate on the wants, desires and motivations of the very top earners.

I believe the key to consumer spending is asset prices as they impact most those with the means to spend. But it is not a linear relationship. Thanks to the extended diversification that the 95-100 percentile enjoy from their diversified portfolio of assets, only a significant fall in asset prices that changes the long term expectation of returns (the investment horizon is longer when you have a couple of million/billion aside) will tend to change their spending habits. Property prices only have a marginal effect as they impact most those in the 50-90 percentile (middle class) and much less so those in the 90-100.



*“The small group of very wealthy, the outliers, have a black-swan type impact on many aspects of the economy and for whom causation and outcome must be viewed very differently than when looking at the average. And who is average anyway? On average, the typical human being has one breast and one testicle!”*

## Summary

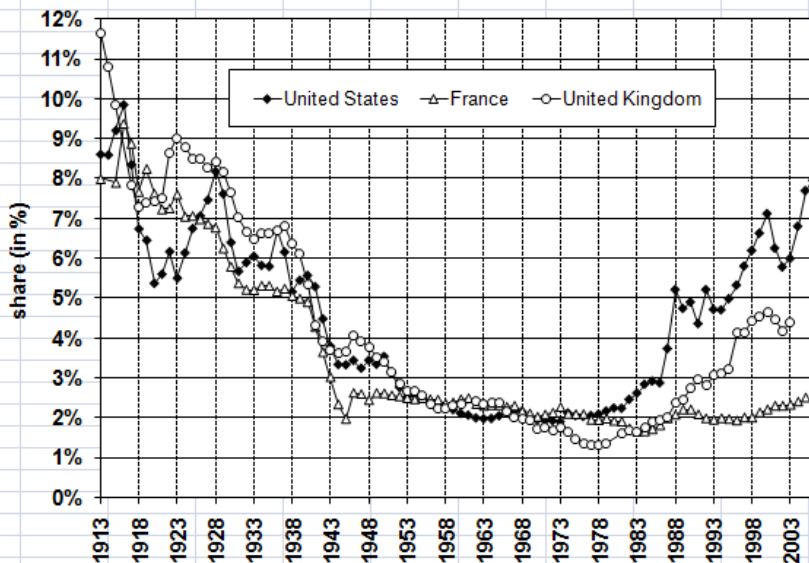
Considering the contribution the U.S. consumer makes toward both the domestic economy and other major developed and developing economies it is essential to understand who he really is. What I have tried to demonstrate is that there is no one “consumer”. At the very least there are two, the few very wealthy and all others. The small group of very wealthy, the outliers, have a black-swan type impact on many aspects of the economy and for whom causation and outcome must be viewed very differently than when looking at the average. And who is average anyway? On average, the typical human being has one breast and one testicle! By looking at aggregates one gets a drastically deformed picture and one has to dig further:

- In **aggregate**, the US consumer is extremely wealthy and holds considerable **net** worth but in fact the **majority** of households have very little accumulated wealth.
- The “wealthy” and the “majority” have radically different savings behaviors. During periods of rising asset prices it has been the top wealth earners that have had a negative savings rate. The majority has actually been increasing its pace of savings.
- The current account deficit is a natural phenomenon of wealth disparity that can be in part explained by the negative savings rate of the top earners. It is probably not a sign of national excessive consumption.
- The large share of discretionary spending from the top percentiles and their lower sensitivity to moderate economic downturns is supportive for aggregate consumption trends and does not necessarily reflect the consumption trend of the majority.
- Assets are very unevenly distributed; stocks and bonds ownership in particular, is extremely concentrated amongst the wealthiest who benefit from a diversified portfolio and who are therefore less exposed to any individual asset class. This has many implications that I will come to in following letters.



I hope to have offered a new perspective on some popular beliefs. Whether it be the sustainability of current account deficits, the lack of savings or the who's who in consumption and why he constantly fails to follow the path provided by the world's intelligentsia. This analysis not only applies to the US but also to most other Anglo-Saxon countries. More egalitarian countries like France, Switzerland and Japan, where wealth disparity is lower and remarkably stable, happen to be those with the exact opposite characteristics: high savings, current account surpluses and weak consumption growth.

*“There are a number of fundamentals that may change the trend in disparity we have witnessed for so long. I believe that we are seeing some of these changes slowly taking place. I am thinking of the change in the tax system, a red hot subject these days, which is a significant threat to the current state of income disparity.”*



**FIGURE 12**

**Top 0.1% Income Shares in the U.S., France, and the U.K., 1913-2007**

Source: Thomas Piketty and Emmanuel Saez of February 2003 “Income Inequality in the United States, 1913-1998” *Quarterly Journal of Economics* (tables and figures updated to 2007 in Excel format, August 2009)

Next month, the subject of my monthly letter shall be on the recent exponential growth in government debt and we shall see that the uninterrupted growth in income disparity for over three decades may contribute in understanding what may lie ahead.

## Make a buck on a reversal?

I personally believe that the current situation offers a good investment opportunity that I shall be implementing for myself as you receive this letter. I am writing this letter to share my thoughts and provoke a discussion; it is only if this exercise naturally leads me to make a trade that I will share that trade with you. The investment ideas I share in this letter are based on the conviction that people believe they know more than they actually do. I always start with the view that I know close to nothing, which is always true, but that attractive risk/reward opportunities might lie here and there when behavioral biases or valuations reach extremes. At least the odds are on my side.

Those who have invested in companies that benefited from the rising trend in income disparity have witnessed unparalleled growth, exceptional fundamentals, and have also enjoyed exceptional outperformance since 1995. The turn in events of the financial crisis has however put, at the very least, a pause on this trade. No fundamentals are ever written in stone. There is no “free lunch” as we have learnt the hard way. There are a number of fundamentals that may change the trend in disparity we have witnessed for so long. I believe that we are seeing some of these changes slowly taking place.

I am thinking of the change in the tax system, a red hot subject these days, which is a significant threat to the current state of income disparity. It is extremely difficult if not impossible to determine to what extent and who shall be impacted by a rise in taxation. Will it be the middle class as usual or shall it be the wealthiest Americans who in practice enjoy an average tax rate of 15%, nearly half the rate of the middle class. It is not clear how the threats of capital mobility, outsourcing, and fiscal competition will interact with the apparent will of governments to finance their fiscal deficits by raising tax rates.

*“But when the fruits of society’s labor become maldistributed, when the rich get richer and the middle and lower classes struggle to keep their heads above water as is clearly the case today, then the system ultimately breaks down; boats do not rise equally with the tide; the center cannot hold.”*

— Bill Gross, PIMCO  
Investment Outlook,  
August 2007

Income disparity has its limits, it must be at some point elastic, and although “consuming” has been genetically and forcefully embedded in our culture, there comes a time when the acceptance of this disparity by the general public reaches its limit. To add insult to injury, the mirage of somehow participating in this wealth creation has abruptly come to an end with the fall in housing prices that was artificially fueled by record low long term rates. The middle class has sustained its spending by leveraging its balance sheet on the back of rising asset prices. Many of these households will not be able to borrow against their homes for years because their mortgages are higher than the value of their homes. The “I will make it also” factor is losing its appeal and its fairness is questioned. I expect the political involvement to grow and that the pressure will be mounting for those who have most benefited in the past to now pay the price for finding a new equilibrium.

Currently, the upper 5 percentile of tax units pay about 60.6% of income taxes. The upper 10 percentile pay 71.2% of income taxes. The middle class, which is strangely not considered as the 40-60 percentile but more like the 6-25 percentile (income between USD 75’000 and USD 200’000) pay 30.8% of taxes and represent 19% of the tax unit population. It has historically been this unfortunate group that bears the fiscal adjustment, as the upper 5 percentile may have the means to consider a move to a more hospitable taxation environment, which would put in peril over 60% of income tax receipts. A large majority of the bottom 50 percentile of tax units have zero federal income tax liability to speak of, so this group is almost not relevant, as a group, they only represent a share of 13.4% of total income taxes paid. Unless you wish to create social havoc, generally not a political aspiration, you avoid infuriating that group. But this time might be different, “One Man, One Vote”. The risk is to infuriate the very large majority and cause a social breakdown. It appears that there is no other solution than to increase the tax rate of the most wealthy. An increase in the tax rate imposed to the top 5 percentile has an impact on over half of income taxes collected. Talk about a small change, which impacts very few voters but makes a big difference to the fiscal situation.

*“This shift should be accentuated by the demographics. Most of the wealth is concentrated on baby boomers for which the median age is now 53. One should expect them to say goodbye to capital appreciation and focus on income strategies and capital preservation. This shall be an unprecedented shift in asset allocation after six decades of risk taking.”*

If so, then a trade that would consist of being short the companies that benefited most from discretionary spending and long those that are the least cyclical makes sense. Otherwise, considering that the US consumer is over two thirds of the US economy a simpler trade is simply to be short the US market as a whole and keep the same second leg of the trade. We are only in the early innings of the deleveraging process and the general economy will suffer both a rise in taxes, and subdued credit demand. There has been a torrent of credit card cancelations to the tune of 11% last year alone. It is very likely that a secular shift away from equity markets will soon be underway, similar to the shift that occurred in Japan where it has been lasting for almost two decades now. Wealthy households have been burnt twice in the last decade, first from the dotcom bubble and now by the housing bubble. This shift could be accentuated by wealth demographics. Most of the wealth is concentrated on baby boomers for which the median age is now 53. One should expect them to say goodbye to capital appreciation and focus on income strategies and capital preservation given the absence of any performance this past decade. This shall be an unprecedented shift in asset allocation after six decades of risk taking.

As for the long leg, I believe the utility sector offers a good defensive position. If the market pulls back as I expect the boring and low beta utilities sector shall outperform. The sector provides close to a 4% dividend yield which is higher than across most of the Treasury curve. As market participants reach for income and throw the towel on the equity market, this should be one of the very few sectors to stand out.

You might ask why not short the luxury retail space? Luxury benefits from many more aspects other than income and wealth disparity. First of all there is incredible pricing power when you target a product for the wealthiest 1 percent. You could actually argue that for some luxury goods, demand actually increases with price as the “uniqueness effect” takes hold. Also, the margins of some companies in the luxury space are rarely witnessed, at least with legal businesses. Demand for luxury goods shall only expand with the wealth created in the developing economies, which is confirmed by the recent results of many luxury good companies that are witnessing record shares of growth derived from their operations in emerging countries. Given these supportive factors, I would currently avoid shorting the very high end retail sector.

In my letters, I will avoid to offer any recommendations on any individual stocks. I have a proven record of having no edge whatsoever in the selection of individual equities. Unfortunately, I have rarely come across anyone who has had any sustained edge in that field. There must be. However, I suspect that it would be terribly difficult to prove that the “edge” is not the statistical confirmation of the absence of this same edge. What I mean, is that there will always be a successful stock picker with a 10 year track record. Statistically, as proven in “A Random Walk Down Wall Street” by professor Burton Malkiel, with a sufficiently large population, there will always be one individual (or one monkey for that matter) using the analytical tool of selecting stocks by throwing darts on the stock prices of the Financial Times that will achieve that track. But how do you define whether the outstanding track is the result of talent or luck. I can’t. So I will not list any specific stock. At most, and in the absence of an ETF, I will propose a basket of stocks.

Luckily, for the subject at hand there are two ETF’s available, the Utilities Select Sector SPDR (XLU) and the Consumer Discretionary Select Sector SPDR (XLY). Their list of holdings can be found on their websites. Crisis breeds behavioral change, and we are not out of the woods of this one. I would not be surprised if we witness a correlation breakdown between the boring utilities and consumer related equities.

*My portfolio*

LONG 1 UNIT OF XLU @ 30.24 (closing price April 9, 2010)

SHORT 1 UNIT OF XLY @ 33.97 (closing price April 9, 2010)

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Yours truly,

Stuart Staines

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