
Todd's Perspective

Spring 2008

The Financial Crisis Drags On

What the World is going through, and has been going through the last nine months, are truly extraordinary, and described by many as the worst in 50 years."

Excerpts, testimony by Tim Geithner, president of the New York Federal Reserve, at a senate hearing April 3, 2008 about the collapse of Bear Stearns.



In this letter we discuss three topics. First, we suggest the current financial crisis will last another year. Second, we forecast tax increases are coming in 2009. But we also cite a study which demonstrates raising marginal tax rates do not lift tax revenues as a percent of GDP. Finally, we agree with Goldman Sachs which predicts we will see \$200 oil in 2009.

ELEVENTH CRISIS IS 40 YEARS

It is impressive that the Dow Industrial Average is only down 3% since the onset of the credit crisis last July. Our country faces a period of debt retrenchment and, thus, we expect a shallow recovery from the alleged recession we are now experiencing. There are some signs of improvement in the credit markets, but it is too soon to assume the worse of the bad news is past. The housing market continues to weaken. Stock prices may have bottomed in January, but we are somewhat neutral at this point until there are more convincing signs of sustained easing in the financial strains.

We are in the midst of the 11th financial crisis we have experienced over the last 40 years. As Jamie Dimon, chairman of JP Morgan Chase, said in his recent annual report "the turbulence that began in the second half of 2007 continues to wreak havoc on the financial markets today. We do not know when the cycle will end or the extent of the damage it will cause."

BEAR STEARNS "BAIL OUT" WAS NECESSARY

The Federal Reserve "bail out" of Bear Stearns in March was an historic event in the midst of this crisis. The Federal Reserve was prompted to initiate "major innovations" in its conduct of monetary policy culminating in the dramatic steps taken on Sunday, March 16th to prevent a run by counterparties to investment banks. Bear Stearns had revealed to the SEC and the New York Fed on the previous Thursday that it intended to declare bankruptcy. Fearing that such a declaration would prompt a run on investment banks, the Fed, the SEC, and JP Morgan engineered a decent burial which included a \$2 per share price for Bears' stock, a transfer of \$30 billion in Bear Stearns mortgage-backed securities onto the balance sheet of the Federal Reserve, and the unprecedented opening of the Fed's discount window facility to investment banks. Subsequently Morgan upped the share price for Bear's stock to \$10 in an effort to retain valuable Bear Stearns employees. The result was a major expansion of the Fed's exposure to credit risk. However, a major financial panic was avoided.

STOCK MARKET HAS PERFORMED WELL

The stock market, excluding financial stocks, has performed fairly well. We believe stocks offer better value today than treasury bonds. Investors are generally driven into stocks when interest rates are this low. Our Price/Intrinsic Value research analysis

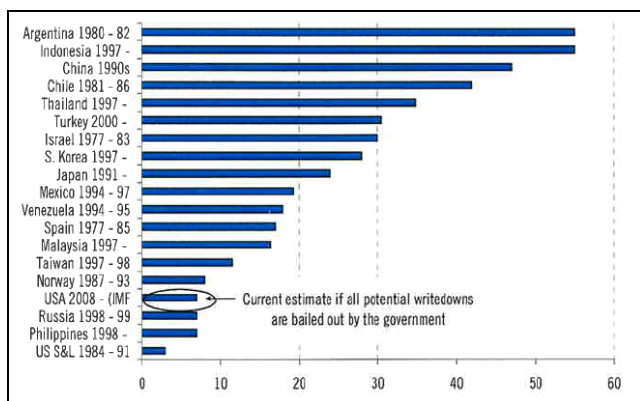
suggests that the S & P 500 stock index is selling almost 30% below what one would consider its "fair" value, the cheapest in 30 years.

However, consumers feel constrained now that their spending on essential items, which consumes 56% of disposable income, is up from its normal 50%. Oil prices have doubled over the past year. Other commodity prices, such as grains have also risen sharply. There was one small piece of good news regarding employment data. Lay-off announcements have not spiked in line with past recessions, which suggests the labor market may yet avoid a significant hit.

FINANCIAL CRISIS MAY DRAG ON ANOTHER YEAR

It is somewhat comforting to put in perspective the fiscal cost of this banking crisis as a percent of GDP compared with that in other countries as shown below. Notice that the USA crisis should run no more than 7% of GDP, which is dwarfed by most of the other banking crisis shown in this graph. This problem, too, shall pass but it may drag on for as long as another 12 months. Recent actions by the Federal Reserve and massive monetary and fiscal stimulus programs should begin to provide some relief in the last half of this year, particularly since it is an election year.

Fiscal cost of Banking Crisis as a % of GDP



Source: World Bank (Caprio and Klingebiel), IMF, Citi Investment Research

TAX INCREASES LIE AHEAD

As pointed out in a recent memo by Jason Trennert of Strategas Research Partners, this may be the final year that can be considered a golden era for taxpayers. A net federal tax increase has not been enacted since 1993, according to Trennert. This has been the longest period without a federal tax increase going back to WWII. By this time next year a raging tax debate will take place in Washington as the new administration will be facing a \$500 billion budget deficit, a laundry list of tax cuts, spending promises to voters, and tax revenues subdued as a result of the sluggish economy.

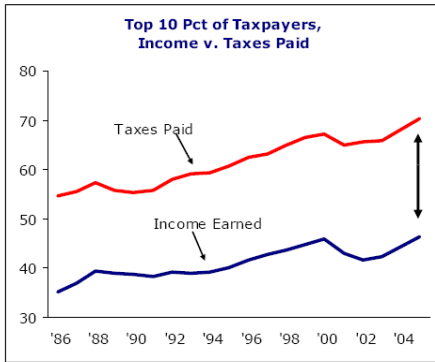
Currently Intrade.com places a 60% chance of Democrats taking the White House, although the situation remains very fluid. Regardless of who is elected Strategas believes that the bias is that tax rates will increase sometime in the middle of 2009 and they think the prime candidates for an increase will start at a top marginal income tax rates, capital gains and dividend tax rates, and the estate tax.

The record refutes some common tax cut myths. Since 1997 the federal government has cut taxes by \$2.8 trillion yet tax revenues, as a percent of GDP, today is above its long term average. The chart below shows the tax burden is actually shifted to the wealthy during this time with higher income tax payers bearing a greater share of the federal income tax burden than before the tax cuts went into place.

(2005)	Income	Taxes
Top 1%	21%	39%
Top 5%	36%	60%
Top 10%	46%	70%
Top 25%	68%	86%
Top 50%	87%	97%
Bot 50%	13%	3%

Source: Strategas Research

Taxes paid for higher income groups have been increasing faster than their share of income. The chart below looks at the top 10% of earners' income and taxes and shows this group earns 46% of the nation's income, but pays more than 70% of the federal income taxes.



Source: Strategas Research

Strategas estimates that some of President Bush's tax cuts will be repealed in 2009, specifically the 33% and 35% income tax rates as well as capital gains and dividend cuts with changes made to the estate tax. Below is a table of some of the changes they expect to see.

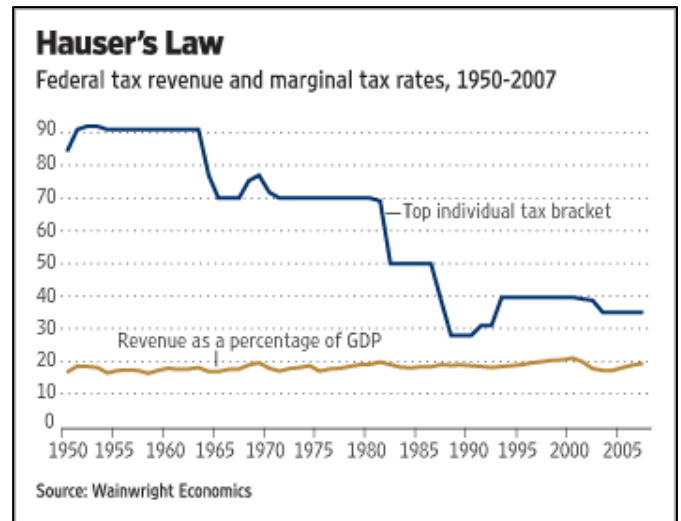
Income Tax	Top Two Tax Rates to 36 and 36.9 Pct W/ Additional 5% Surcharge
Cap Gains/Dividends	Absent Income Tax Surcharge Increase from 15-15 to 25-25 Pct
Estate Tax	45% Tax Rate With \$3.5 Mill Exemption
Corporate Tax	Double Taxing on Foreign Source of Profits May be Lower Corp Tax Rate
Other	Tobacco, Alcohol, and Other User Fees
Tax Reforms	Watching Proposals to Eliminate Corporate Tax and Replace with Value Added Tax

Source: Strategas Research

YOU CAN'T SOAK THE RICH

David Ranson, Head of Research at HC Wainwright Economics, wrote a thought provoking essay in May 20, 2008, Wall Street Journal. He cites Kurt Hauser, a San Francisco economist who, 15 years ago published data about the federal tax system.

His findings implied that there are constraints on the ability of tax-rate increases to generate fresh revenues. His study reveals that during our post-war period tax revenues have remained close to 19.5% of GDP, no matter what our marginal tax rates have been. Mr. Hauser's horizontal straight line is a simple fact and an inconvenient truth for economists and politicians who believe otherwise. As Mr. Hauser said, "Raising taxes encourages taxpayers to shift, hide, and underreport income. Higher taxes reduce the incentives to work, produce, invest and save, thereby dampening overall economic activity and job creation." Politicians are likely to be disappointed if they expect raising marginal income tax rates will lift tax revenues as a percent of GDP. Instead they would be better advised to come up with plans for increasing GDP while ridding our tax system of its complexity.



GOLDMAN PREDICTS \$200 OIL IN 2009

Oil prices have doubled in the past year to \$129 a barrel. "We believe that the current energy crisis may be coming to a head, as a lack of adequate supply growth is becoming apparent" Goldman Sachs analyst Arjun Murti said in a recent note to clients. Murti said oil could reach \$200 a barrel next year. That translates into gasoline prices of more than \$6.00 a gallon.

In 1973, when the first energy crisis hit, we imported 33% of our oil; today we import 60% and this figure could rise to 70% by 2020. Our transportation system is still completely

dependant upon oil. Gideon Rachman recently observed in the Financial Times: “our politicians have, so far, responded to this problem only with a mixture of wishful thinking and anger. No leading politician is yet prepared to say our lifestyle will have to change and adjust to a world of permanently higher fuel prices.”

Competition for the world's oil supplies is intensifying. More than 50% of Saudi oil is now exported to Asia. The International Energy Agency predicts that in 2010 China will become the world's largest consumer of energy. The IEA also thinks that the world's energy needs will be 50% higher in 2030 than they are today – and that we are going to become more, not less, reliant on fossil fuels.

An article entitled “Tapped Out” in the June 2008 issue of the National Geographic made this observation. Saudi Arabia and other members of OPEC control 75% of the world's total oil reserves. Their output will peak substantially later than that of other oil regions, giving them even more power over prices and the world economy.

At present there are about 10 cars in China for 1,000 people. There are 480 cars per 1,000 people in the US. By 2015, China could be the world's largest market for new cars. Similar patterns are unfolding in India. If the Chinese and the Indians eventually eat and drive like Americans and Europeans, the current inflation in fuel and food prices could be just the beginning.

The only plausible routes to our energy security is right here at home – in the development of new technologies and a change of lifestyles, as Rachman observed: “We may have to drive smaller cars and drive them less but it will be a brave presidential candidate who says that.”

It's unusual that oil prices have maintained an upward momentum in the face of diminished US demand, which at 19.7 million gallons per day, is 5% below last years demand. The worlds diminished spare production capacity remains the strongest catalyst for high prices, according to Daniel Yergin of Cambridge Energy Research. He

estimates the safety cushion is only 2.3% of daily global demand and nearly all of it is in Saudi Arabia.

“Eighty five million barrels of oil a day is all the world can produce, and the demand is 87 million.” T. Boone Pickens said in an interview on May 20th with CNBC. “It's just that simple.”

He reiterated his belief that the world's oil output is about to peak, warning that oil prices would hit \$150 a barrel by the end of this year.



Source: Financial Times, May 12, 2008

Sources: Bank Credit Analyst, Financial Times, National Geographic, Stratargas Research, Citi Investment Research, Wainwright Economics, Goldman Sachs, JP Morgan Chase, Intrade.com

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