Tea Leaf

…weekly since 1976

Your guide to understanding today's economy and financial markets

April 2, 2008

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The Dark Side

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As a long-time observer of the U.S. economy and financial markets, my writing and speaking have typically found me to err on the side of optimism… of seeing changes as providing new opportunities, as opposed to our being too fearful of change…of typically seeing the glass as half full rather than half empty…

In an effort to provide "balance" I present to you the long-term view of futurist Harry Dent

…I see it as being realistic and optimistic

I am frequently challenged and criticized for my optimism. Various people who receive the *Tea Leaf* have suggested I am too "Pollyanna" or too optimistic. One reader recently referred to me as a "sunshine pumper"…while others at times have been less kind…

…such is life in the dismal science of economics

Balance

In an effort to provide "balance"…I present to you the long-term view of futurist Harry Dent. Harry is a very successful writer and high-priced speaker whose views are greatly impacted by how movements of large generations through their life cycles (such as the Baby Boomers) have great impact on such critical factors as savings, stock prices, productivity, housing, retirement, inflation, etc.

You may recall two of Harry's successful books released in the late 1990s, *The Great Boom Ahead* and *The Roaring 2000s*. A more recent book, *The Next Great Bubble Boom: How to Profit from the Greatest Boom in History: 2005-2009,* was released in 2004.

In fairness, Harry has made some accurate forecasts during the past 20 years. He has also had some major blunders.

The period 2005-2009 has not exactly been the greatest boom in history…far from it. This period to date has been one of moderate economic growth during 2005 to 2007, followed by likely recession in 2008, and who knows what in 2009.

His 2004 book predicted the Dow Jones Industrial Average would rise to 40000 by 2009, with the NASDAQ index at 25000. Note: the Dow as of April 1, 2008 was 12654, while the NASDAQ was at 2363, or forecast misses of only 27346 and 22637 points, respectively. Needless to say, these forecasts would easily rank with some of the worst ever made.

Harry's Back

…and never really went away

…he suggests his next book, due out in mid-2009, will likely be entitled *The Great Crash of 2010*

…Harry now forecasts that the Dow Jones Industrial Average will hit 16000 to 20000 during the next year or two, followed by the next Great Depression. He sees some great stock market buying opportunities in late 2010 and late 2014

…moreover, he forecasts that the next Great Depression, beginning in 2010, will last until around 2020-2024, a period of 10 to 14 years

…Harry suggests that rising inflation pressures will lead interest rates higher between late 2008 and 2009, just before the increasing retirement moves of Baby Boomers will quickly lead to the greatest deflationary period since the 1930s

…Harry suggests that housing values will ultimately have to fall 40%-50% to be fairly valued, with the worst of the housing decline occurring between early 2010 and early 2015

…for the period described above, he suggests only two major places to put your money…high quality bonds and cash

It's more fun being optimistic.

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Cap Gains

Democratic Presidential candidate Barack Obama provided more details of his plans to raise taxes when and if he is sworn in as President next January. He talks of increasing the capital gains tax rate from the current level of 15%, as does Hillary Clinton.

He noted that he "certainly would not go above what existed under Bill Clinton, which was the 28% rate…and my guess would be it would be significantly lower than that." Most read that as a preference for a 28% rate, with the likelihood of a 20% to 24% rate in order to get both sides of the aisle to agree.

He talks of such an increase as a means of generating new tax revenue for new government programs…

…maybe a quick glimpse at reality might be of value

The Numbers

I would argue that just about any time the government raises a specific tax rate, total tax revenue actually declines in subsequent years. I would also argue the reverse: when the government reduces a tax rate, revenue usually climbs sharply.

Nowhere is this more clear than in regard to taxes on capital gains. The capital gains tax is one of very few taxes where the taxpayer can choose when and if to pay such a tax.

Investors have the ability to indefinitely hold stocks that might have substantial gains. Many such investors will wait for a more attractive (lower) capital gains tax rate before considering a sale.

The past few years are a great example. The capital gains tax rate was reduced from 20% to the current level of 15% as part of the Bush tax cuts of 2003. What happened to capital gains tax revenues in recent years?

…such revenues rose by 152% in four years!

Investors had a greater incentive to sell a stock and recognize a gain, i.e. a lower tax "penalty." Please note that we are not just talking about "the rich" as 79% of the tax returns reporting capital gains in 2005 were from filers with incomes of less than $100,000 a year *(Investor's Business Daily)*.

Obviously part of the reason that huge stock market gains were taken is because the stock market did well between 2003 and 2006. Note, however, that one reason the stock market did well was because capital gains tax rates were lower…people simply had a greater incentive to invest in stocks.

History Lesson

A great example also exists when the rate is increased. The capital gains tax rate was cut to 20% from 28% in the early 1980s as part of the Reagan tax cuts. Bowing to intense political pressure in his second term, President Reagan reluctantly agreed to a series of tax hikes. One of these was for the capital gains tax rate to be boosted back to 28% from the existing 20% rate, effective January 1, 1987.

Capital gains tax revenue was extremely high in 1986's final quarter. Tax revenue forecasters were gleeful as they prepared tax revenue projections for 1987.

The common wisdom in government, particularly at the state level, was "Wow! If we generated such high revenues in 1986's final few months at a 20% rate, just imagine the tax revenue that will arrive at a 28% rate!"

You guessed it. Capital gains tax revenue fell by two-thirds in 1987 from that of the prior year. The reason? People make rational decisions about their money in most cases. Maybe various political entities and politicians across the nation will someday figure that out.

Jeff

"TEA"ser

Economics is like red wine—you shouldn't smell it, but drink it. But if you drink too much on one occasion, there is a risk of dizziness.

—from our book, ***On the One Hand…The Economist's Joke Book***

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