WEDGE WATCH

A newsletter published quarterly by WEDGE Capital Management L.L.P. • October 2008

Behind the Curve

"Economic truth is a lever that can move governments, move history…"
– Ronald Reagan

Third Quarter 2008
Financial Statistics

DJIA: 10850.70

S&P 500: 1166.36

90-Day T-Bill: .90%

30-Yr. T-Bond: 4.31%

Despite life's varied complexities and challenges, a simple logic-based approach to much we are confronted with is often best. In 1992, James Carville, Bill Clinton's famously combative campaign manager, boiled down the Presidential campaign to one very basic and straightforward slogan – "it's the economy, stupid," and, of course, the rest is history. As this is written, our country stands poised on the cusp of another Presidential election, the outcome of which may, once again, turn on some such unassailable "one-liner" or message. However, no matter who wins the White House (or who controls Congress) **the stakes for our economy appear to be very high**. A little history will shed light on what we mean.

During an unprecedented two-decade tenure that spanned the administrations of four different Presidents, the relatively ubiquitous Alan Greenspan, Chairman of the Federal Reserve, was the de-facto head of the global economy. His years at the helm of the Fed, the majority of which appear to have been a success, were marked by an often aggressive "stop-and-go" approach to monetary policy (in response to, among other things, exogenous shocks such as "Black Monday" and the tragic events of 9/11). During the latter stages of his remarkably long run, Greenspan was roundly lauded as "The Maestro" for his "…behind the curtain" Oz-like maneuvers to tweak and calibrate the economy as needed. However, that long-duration era of Fed dominance and perceived control (of the economy) appears to have now largely run its course. The extreme unintended consequences increasingly associated with Greenspan's protracted loose money policy (i.e., the housing and mortgage debacle), along with the still historically low nominal and real fed funds rate underpinning our economy, *suggest a Fed with a growing credibility deficit and far fewer arrows in its quiver* to bluntly "prime the pump" to help jumpstart an economic and equity-market recovery.

Assuming our assessment of the Fed is more or less on target, where do we go from here? This is where politics and governing come to the fore. Like it or not, Congress and the next President must step up their respective games to help carry a much bigger piece of the economic load, at least for a while. The intensely partisan bickering and gridlock that so blatantly stained Washington in recent years, hence the record low approval rating of our elected representatives, won't likely cut it going forward in the face of accelerating economic malaise here in the U.S. A bold and decisive move away from our government's all too prevalent "quick fix," instant gratification approach to monetary and fiscal policy, which has damaged the dollar and threatens to stoke inflation, appears very much in order. More specifically, **the implementation of permanent enhancements to the economy's incentive structure seems increasingly imperative** against the backdrop of a hyper-stressed consumer, a financial system pushed perilously close to the brink, and profligate out-of-control spending in Washington. In other words, it appears past time for at least one "tried-and-true" maneuver whose logic seems compelling.

Continued on inside…

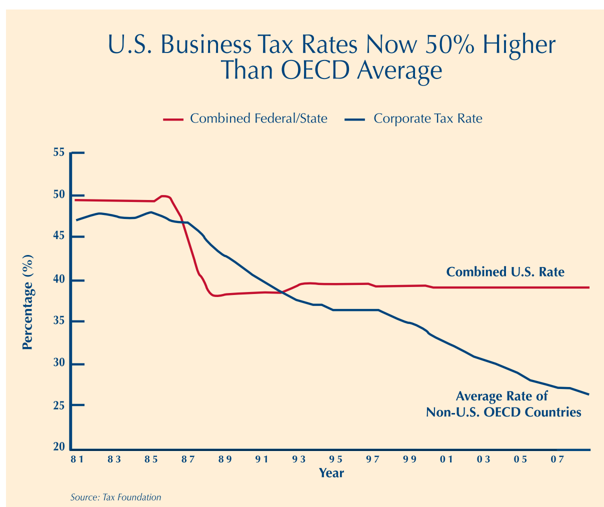
...Curve

"Does anyone really know what time it is? Does anybody really care?"
– Song lyrics from Chicago's debut album: The Chicago Transit Authority (circa 1969)

Amidst the "mean season" that is the slugfest of Presidential politics, the candidates and their respective parties have highlighted, among other things, their future plans for individual and capital gains tax rates; a deliberation of paramount interest and importance to investors. However, in the realm of taxation, there is something that might be of equal if not greater import.

Unbeknownst to most, including investors, the United States holds a very dubious (and counterintuitive) distinction. According to the latest international tax rankings, the world's 2nd highest corporate tax rate resides right here in the good ole' U.S.A. (39.3% based on the average combined federal and state rates). Only Japan imposes a higher rate, and that is by a very thin margin. In fact, **for the first time, the U.S. statutory corporate tax rate is now nearly 50% higher than the average of our international competitors** in the *Organization for Economic Co-operation and Development* or *OECD* (see **Chart 1**). This embarrassing anomaly (even socialist Sweden and welfare-states France and Germany now have lower corporate tax rates) continues a long-term trend that has seen much of the rest of the world (including China, Kuwait and other developing countries across Asia and beyond) push their respective corporate tax rates far lower than the U.S.

Chart 1



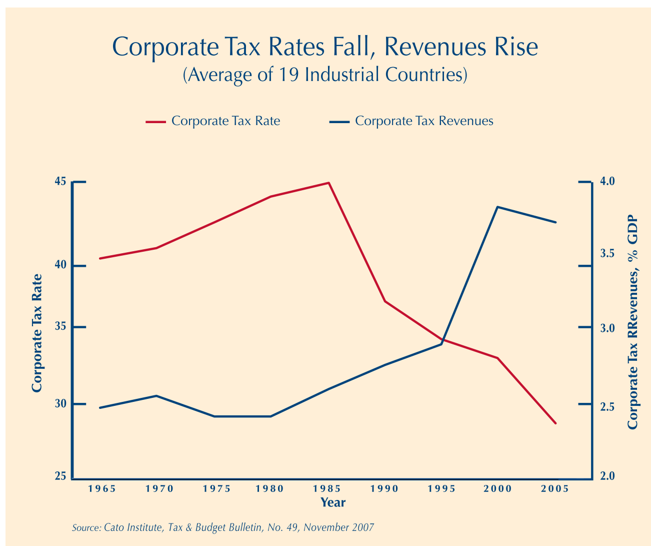
As highlighted in working papers from *The Tax Foundation*, a non-partisan tax research group based in Washington, D.C., it was not always this way. "The Tax Reform Act of 1986," **which was passed by a Democratic House and Republican Senate,** "reduced the U.S. corporate income tax rate from 46 percent to 34 percent, *the largest reduction since the tax was enacted in 1909*. That change, along with an earlier move in the United Kingdom, started a wave of corporate income tax reduction worldwide" which saw every major nation eventually lower its rate. However, since then, our statutory corporate tax rate has remained relatively flat, while the average rate of the rest of the developed world has moved decisively from "back of the pack" to a position far ahead on a relative basis (with the gap widening dramatically in the past decade or so). Though *effective marginal tax rates* in the U.S., a more comprehensive measure of the corporate tax burden, reside well below the statutory rate, they too have remained relatively flat, since the early 1980's, while falling nearly 30 percent overseas.

Highlighting the importance of corporate tax rates and how flat-footed the U.S. appears to have been over the past two decades, *The Wall Street Journal* recently reported that "the average European nation has tax rates on corporate income 10 percentage points lower than the U.S." However, despite this sizable differential, "those countries on average raise 50% more revenue as a share of GDP in corporate taxes than" we do here at home. So much for the oft-publicized argument that big tax cuts would further exacerbate an already huge and increasingly unwieldy budget deficit (note: U.S. corporate taxes, which generated $370 billion in 2007, accounted for only 14% of federal revenue). Remarkably, again according to *The Wall Street Journal*, "Ireland with its 12.5% rate captures a higher share of its GDP (3.4%) in corporate taxes than the U.S. does (2.5%) with its" outsized "39.3% rate."

"An economy hampered by restrictive tax rates will never produce enough revenue to balance our budget, just as it will never produce enough jobs or enough profits."
– John F. Kennedy

The *Laffer Curve*, an economic theory made famous three decades ago by supply-side economist Arthur Laffer, asserts that above a certain tax rate, a decrease in that rate results in an eventual increase in tax revenues. In other words, if government wants to maximize tax revenues it should, under most reasonable circumstances, lower rather than raise rates. Adding credence to this view, according to *The Cato Institute*, the Washington D.C.-based free-market think tank, **"In most countries, corporate (tax) rate cuts have coincided with rising tax revenues."** Using data going back to 1965 for a group of 19 advanced economies, a graph constructed by *Cato's* Tax Policy Department (see

Chart 2



Source: Cato Institute, Tax & Budget Bulletin, No. 49, November 2007

Chart 2), shows that "the average rate in the 19 countries fell from 45 percent in 1985 to 29 percent by 2005." During the same period, corporate tax revenues markedly grew from 2.6 percent to 3.7 percent of GDP.

Academic critics of the *Laffer Curve*, and there are many, typically attribute such gains in tax revenues to varied alternative explanations. However, a relatively recent body of research, not to mention plain old-fashioned common sense, seems to validate Laffer's theory. Of particular note is a study published last year by the *American Enterprise Institute (AEI)*, a non-partisan, not-for-profit public policy think tank in Washington, D.C., that makes the case that **corporate tax cuts can actually be self-financing** (over time).

AEI economists Kevin Hassett and Alex Brill, replicating and building on the closely-related work of economist Kim Clausing (2007), studied the impact of corporate tax rates on tax revenue in industrialized countries from 1980 to 2005, a time frame during which average corporate tax rates experienced steady declines. Their research pointed to *strong statistical evidence of a Laffer Curve*, even when significant potential outlier countries, such as Ireland, Switzerland and Norway, were excluded from the sample. In addition, they found that the revenue-maximizing corporate tax rate, which was about 34 percent in the late 1980s, had declined steadily to about 26 percent for the most recent period measured (2000-2005). Of special note, this decline was accompanied by a steepening in the curve, which would seem to suggest the revenue penalty for being above the peak of the Laffer Curve, where the U.S. precariously resides now, has increased sharply over time. Hassett and Brill attribute this to enhanced capital mobility in an increasingly global economy, a view likely shared by fans of Thomas L. Friedman's widely-read 2005 best-seller on globalization, *The World is Flat: A Brief History of the Twenty-First Century*. Like the highly contentious global warming debate, it might prove a dangerous "high stakes" gamble by Congress to do nothing and then wait to see if the drag from this needless governor on growth, jobs and wages eventually triggers serious economic consequences. Lawmakers beware: by the time the answer is known, **the damage, which could be significant, may have already been done.**

In addition to a very high statutory corporate tax rate, it's not a secret that the U.S. tax code is needlessly complex (and loaded with loopholes, many of which effectively disincent business investment at home). According to U.S. Treasury Secretary Hank Paulson, writing in a July 2007 *Wall Street Journal* op-ed, "the current tax code distorts capital flows, hurts productivity, job creation and our global competitiveness." Among other specifics, he cites an estimated cost of tax compliance for U.S. businesses at approximately $40 billion annually; a serious burden that damages our country's ability to compete in an increasingly profit-seeking world. Although U.S. companies have become quite adept at utilizing tax avoidance schemes (i.e., off-shore tax havens), a 2006 study, conducted by Canada's *C.D. Howe Institute*, showed that the effective tax rate on capital investments for U.S. multinationals, relative to non-U.S. peers in other advanced economies, was, along with Germany, the highest in the world. In addition, according to the World Economic Forum's 2005-2006 *Global Competitiveness Report*, the U.S. was tied for 107th out of 117 nations in terms of tax efficiency, while also earning the rather dubious distinction of having crafted the world's fifth longest business tax code among the 175 nations measured *(per a 2006 World Bank/Price WaterhouseCoopers study)*. Needless to say, among industrialized economies, **our corporate tax regime appears increasingly and unambiguously punitive**.

Despite the glaring problems with our corporate tax code, political proposals to cut the tax rate are unlikely to be greeted with open arms by a skeptical electorate and Congress; especially with many prominent U.S.-based companies reporting multi-billion dollar profits and budget deficits in Washington remaining blatantly unchecked. However, **the reality is that this is a *populist* issue which has very "real world" impact on jobs and wages for the average American family**. In a globalized world where capital, in seeking out the least punitive tax treatment, is increasingly mobile but workers are not, labor bears the brunt of onerous corporate tax rates (as capital flees, and job and wage growth slow). In fact, according to an August 2006 *Congressional Budget Office* report, 70 percent of the burden of corporate taxes falls on domestic workers through, among other things, lower real wages and higher prices, while the remaining 30 percent falls on company shareholders. In addition, a recently released study by the Paris-based *OECD* found that **corporate taxes are the single most harmful tax to GDP growth – more so even than personal income taxes or consumption taxes**.

Using the just referenced *Congressional Budget Office* findings as a backdrop, *Tax Foundation* economists Andrew Chamberlain and Gerald Prante completed work in 2007 measuring the burden of the U.S. corporate tax on American households. Their findings were eye-opening, and seem especially relevant now amidst the on-going political debate about how best to lend a real "helping hand" to ordinary working Americans. According to the analysis, low income households, the bottom quintile, shoulder an inordinately large share of the corporate tax burden (when compared to personal income tax paid) via the pass-through of lower wages, higher prices for goods and services, etc. More importantly, according to the same study, *low- and middle-income Americans would appear to be the prime beneficiaries of a drop in the corporate income tax;* with the estimated 40 million Americans who already accrue little or no personal income tax liability (under the existing tax code) benefitting most.

Adding to the attraction of a corporate tax rate reduction, recent research by *AEI* has shown that wages are highly sensitive to corporate tax rates, so it is likely that low- and middle-income workers would ultimately see their gross wages rise as well. According to the report, which examined 72 nations over 22 years, if the U.S. were to cut its *federal* corporate tax rate from 35% to 30%, American manufacturing workers would gain nearly a 10% pay raise dividend within five years (the equivalent of roughly a $3,500 per year pay boost). Needless to say, **this would be a powerful "one-two" punch (a true win-win) for the all-important, and underappreciated, working class constituents of both Democrats and Republicans**.

"If elected, I shall see to it that every man has a square deal, no less and no more."
– Teddy Roosevelt

No discussion on taxes, corporate or otherwise, would be complete without addressing the proverbial "elephant in the room." The ***budget deficit*** is one of the most publicized topics of conversation in the realm of politics and finance, and rightfully so (though economies can accommodate sustained deficits if GDP outgrows debt over time). That said, out-of-control spending and excessive leverage, among other things, are what doomed the residential housing market here in the U.S., and a sustained repeat of such unrestrained consumption (fiscal malfeasance) would appear to pose a similar, though much more pernicious threat to our economy long term. Though tax cuts, such as the corporate cuts highlighted here, would likely increase the deficit in the short run, *history shows that such targeted cuts can be quite stimulative over time*. In fact, one only has to look back a decade or so (to the late 1990s) to see actual budget surpluses in Washington; a by-product of Congressionally-mandated spending cuts and a capital gains tax rate cut that was signed into law by the President.

According to noted economist R. Glenn Hubbard, Dean of Columbia University Business School and former Chairman of the President's Council of Economic Advisers, *"balancing the federal budget without a tax increase is possible, but will require strong fiscal restraint*. To achieve full-employment budget balance by the end of the next President's term, federal non-defense spending growth needs to be restrained to 2% per year instead of the currently projected 4.5%." Within such spending restraint, targeted cuts in existing business subsidies, which are estimated at well north of $100 billion per annum, could potentially offset, on a near dollar-for-dollar basis, a bold and dramatic cut in the U.S. corporate tax rate. Such a long overdue fiscal boost could go a long way toward helping reverse the stealthy and accelerating erosion of our hard-earned, long-held relative competitive advantage versus the rest of the world.

"Nor should the argument seem strange that taxation may be so high as to defeat its object, and that, given sufficient time to gather the fruits, a reduction of taxation will run a better chance than an increase of balancing the budget."
– John Maynard Keynes, British economist (1883-1946)

Against the backdrop articulated here, where time is surely of the essence as the globe's competitive paradigm morphs with increasing velocity, history tells a cautionary tale for those betting decisively on positive change. In other words, *nothing is ever easy in Washington,* especially when bad blood courses through the halls of Congress. However, on very select occasions in the past, when the going really got tough, our elected representatives mustered up just enough collective good judgment and non-partisan wherewithal to "do the right thing" and put in place the appropriate incentives to help solidify jobs and drive our economy forward (by unlocking the vast creative power of capital).

To borrow a couple of well-worn clichés, *hope springs eternal,* especially in *the land of the free and the home of the brave*. That said, it's also worth a reminder that *it's always darkest before the dawn,* especially on Wall Street and in Washington, and this time may prove no different (especially if Congress and the President act, sooner rather than later). In the meantime, leave it to the "one and only" Warren Buffett, himself a staunch advocate of fiscal restraint, to help buoy the spirits of

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investors by striking an optimistic chord amidst the lingering *doom and gloom*:

"It has not paid to sell America short since 1776, and the time to start is not in 2008. People who think that America is not in the game are totally wrong."

On that emphatically upbeat note, from the man who wrote the book on staying "ahead of the curve," we'll close. But not before offering a little sage advice to both would-be and sitting political leaders in Washington: **it's the economy (again), stupid!** *Let's hope they get it this time.*

Index	09/30/08 Price	3rd Quarter Price Change*	Year-to-Date Price Change*
Dow Jones Industrials	10850.70	-4.4%	-18.2%
S&P 500	1166.36	-8.9	-20.6
Value Line Composite	339.67	-8.7	-22.8
American Exchange Comp.	1786.89	-19.9	-25.8
NASDAQ Composite	2091.88	-8.8	-21.1

*Does not include dividend income.

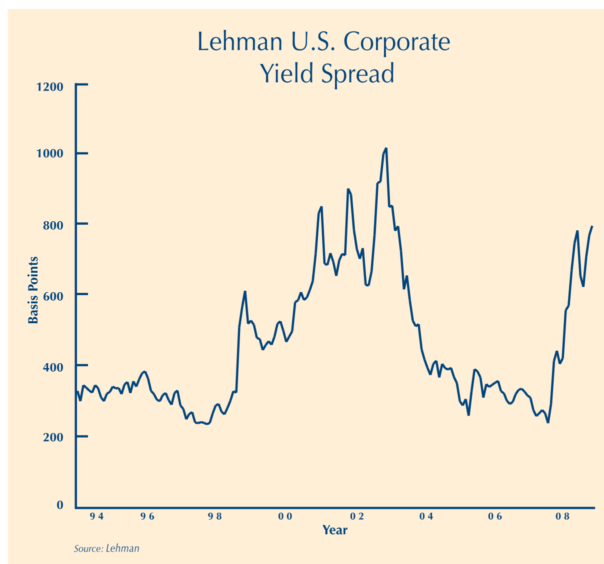
Fixed Income

Junkyard Dogs?

As the on-going credit debacle has evolved over the past year, investor and media focus has been directed predominantly toward housing, mortgages and financial institutions (and rightfully so). At the same time, at least on a relative basis, the **high-yield bond market** has escaped serious scrutiny. That said, close followers of the credit markets are distinctly aware that high-yield spreads are now far wider than the all-time lows set during the spring of 2007. With that in mind, let's revisit this asset class in an attempt to discern whether or not the dramatic spread widening off those record lows appears sufficient to compensate for the growing credit-cycle risk, *or whether the market is now merely a motley collection of angry and rabid "junkyard dogs."*

Chart 3 shows the yield spread of the *Lehman High-Yield Corporate Index* over time. As can be seen, the spread has increased sharply during the last year; though it has not yet scaled the heights seen during the last credit cycle (when it peaked in the fall of 2002). We note that during that credit downturn, spreads peaked well *after* the end of that cycle's recession in late 2001. As things stand today, despite many negative data points in recent months, it remains unclear as to whether or not the U.S. economy has actually moved into recession mode. Note also that in the last cycle, high-yield spreads began to widen well *before* the downturn in the economy. Like

Chart 3



then, it appears that the extraordinary high-yield spread widening of the past year or so was a good early warning signal that the economy would experience turbulence in the quarters ahead. Looking a little deeper into the quality components of the high-yield market gives us added cause for concern going forward. **Chart 4** shows the spread on the Caa-rated component of the *High-Yield*

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Chart 4

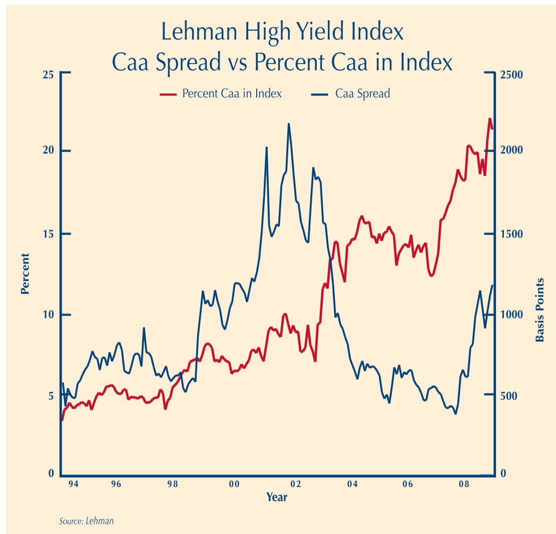
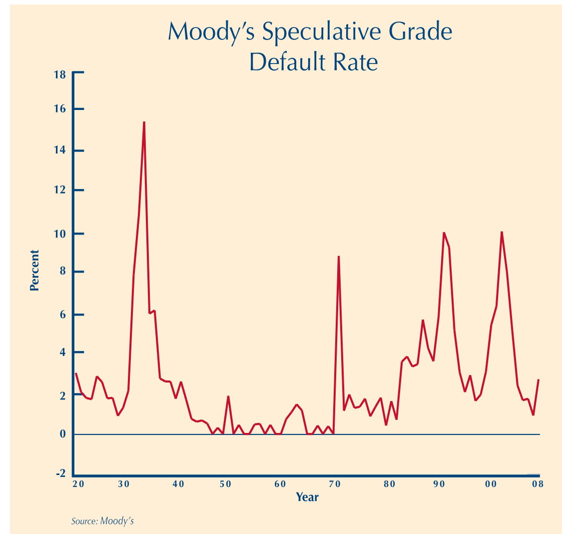


Chart 5



Index, as well as the percent of Caa-rated bonds in the index. Notice that over time, Caa's have increased as a percent of the index. Also note that the Caa spread is well below its previous peak during the 2001-2002 time frame. *Given that Caa-rated bonds are now a much larger component of the high-yield market and that current Caa spreads are meaningfully below the previous peak,* ***it seems quite possible (probable?) that high-yield spreads could eventually exceed levels seen during the last credit cycle downturn.***

Armed with the knowledge that Caa-rated issuers have historically defaulted at a much greater frequency than higher-rated issuers, it seems likely that default rates for the high-yield market could rise quickly in the current environment. **Chart 5** shows the *Moody's* long term annual default rate of high-yield (speculative grade) issuers. For illustrative purposes, we have added the default rate for August 2008 as well. As can be seen, at the current rate of 2.7%, defaults have already risen noticeably from the cyclical low default rate of 0.91% at the end of 2007. Of even greater concern, *Moody's* is now projecting the default rate to swell to 7.4% by August of next year! If all this wasn't disconcerting enough, we've actually only highlighted a little more than half of the high-yield debt market. Let us explain.

Since 2003, there has been enormous growth in the high-yield or **leveraged loan** market. Leveraged loans are bank loans made to speculative grade issuers which, in years past, were known as "HLT's" (highly leveraged transactions). Of special note, *they also rank senior to high-yield bonds in the capital structure of their respective issuer*. Although it is difficult to know the exact size of the market for these loans, a good proxy is to compare the amount of debt outstanding for the respective indexes of each. In that regard, *at the end of August 2008, the high-yield index had $672 billion outstanding, while the high-yield loan index, though smaller, showed a very sizeable $525 billion outstanding*. Ominously, in a recent report (June 2008), *Moody's* wrote that it "expects recovery rates on defaulted bonds to be below their historical averages." These low expected recovery rates "are due to the average outstanding bond now having more debt (i.e., loans) senior to it than has historically been the case," a nuance of more than modest relevance to holders of high-yield debt today.

As with any severe credit cycle, significant investment opportunities will very likely evolve in the months ahead. However, in peering cautiously over the fence into the junkyard, we do not yet see a relatively obvious safe path across to the other side. As a result, **we deem the odds of being bitten (and possibly mauled) by a "junkyard dog" simply too high, at least for now.** *Stay tuned.*

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