

# THE COMPASS



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## Important Financial Dates

### February 15

- 941 deposits due

### February 29

- Employers file W2/W3 forms & 1099 forms

### March 15

- 941 deposits due
- File Corporate returns or extensions

### April 15

- File Personal, Partnership, Trust/Estate returns or extensions
- Federal 1st quarter estimated taxes due

### April 30

- 1st quarter payroll tax returns due

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## Growing Optimism

2011 was a very volatile year for the stock market being up 8% in the first four months, then down 18% the next five months. October was up but November and December were down. But on December 8<sup>th</sup> the European Union reached a tentative agreement to bail Greece out. Since then the DJIA (Dow Jones Industrial Average) is up 7.3% to 12,874.

A lot of folks have heard of the recent article in Barron's predicting a 66% chance of a 15,000 DJIA by the end of next year. It also says there is a 50/50 chance of reaching 17,000 or more. Is this feasible? Yes, it is very possible.

According to Wharton School finance professor, Jeremy Siegel, author of "Stocks for the Long Run", over the last 141 years the stock market returns including dividends, have averaged 8.7% or 6.4% after inflation. At this rate of 6.4% compounding, \$1000 invested 141 years ago would be worth \$5.9 million.

Last year, EPS for the DJIA grew at 12%. Assuming an earnings slow down of 25% to a consensus of 9%, the DJIA could reach 15000 with a P/E of just 12.8 compared to the current P/E of 13.1. Over the last five calendar years, the market's average annual return was only marginally positive at .78% placing it in the lowest quartile of all five year periods. Professor Siegel's data shows an average of 9.8% annual return in the two years following a five year period in the lowest quartile.

Thus, most serious investors should be invested in the market. Remember it is time in the market, not trying to time the market. Last September after the Greek tragedy, Quest clients were at a 40%-50% cash position. During the fall we at Quest started to cautiously go back into the market on a very selective basis to end the year at a 22% cash position. Since the beginning of the year we have continued to put more money to work and are now at a 15% cash position. Normal full allocation would have an average 5% cash position. By default Quest will keep an approximate 10% dry powder position to take advantage of any market retrenchments.

At Quest Financial Services Inc. we are very aware of some investment storm clouds on the horizon such as European defaults, Iran/Israel nuclear concerns, Far East revolutions in Syria and other countries, and the American fiscal dysfunction. As a defensive tactic we will continue to engage trailing stop loss orders with tight collars to prevent any significant losses.

At Quest we are growing optimistic that the stock market will reach its 15000 goal. Many of you know that Apple just crossed \$500/share and effectively added more than \$100 billion in capital value since Steve Jobs' death last October. This is more than the value of Facebook has been valued at with all the hype of its IPO. If Apple was in the DJIA, it would probably be close to the 15000 value. But that is not the top performer. Apple has appreciated 31.7% since last September 30<sup>th</sup>, but Caterpillar is up 54.0% for the same period. So there is serious hope that we will make this 15000 goal. Patience is the key to joy.

## Smoke & Mirrors

On the first Friday of each month, the DOL (Department of Labor) announces the number of jobs created or laid off and the related unemployment rate. We all know it has been very unfavorable for the last few years in the 9%-10% range as a result of the deep recession the U.S. has been in from 2008-2009. It has not been a good metric for the current administration because no incumbent president has ever been re-elected with an unemployment rate over 8%.

Over the last couple of months it has been announced that over 200,000+ jobs were filled to bring the unemployment rate down to 8.3% from around 9.1% last summer. It is very good news that some companies are hiring additional workers, well over the 100,000 level of last year. This will only help the economy as more families will have more income to spend. On the surface this is starting to look good for the President. But if one reads the footnotes and does some basic analysis, the headline message is not as good as Washington would like you to believe. The footnote is that the DOL increased the civilian employment percentage of the population by .2% up to 58.5%. This added 620,000 people to the denominator. What is the impact? The larger denominator will help reduce the calculated unemployment rate.

If that is not enough, the DOL has two other adjustments it makes to both the numerator and denominator. We all know the 77 million baby boomers are approaching retirement with 10,000 turning 65 everyday. So how is this adjustment handled? The DOL is removing that number from the unemployed and workforce on a periodic basis. This adjustment has a much more significant effect on the smaller numerator resulting in a lower unemployment rate headline.

Finally, the DOL removes the number of people who drop out of the workforce. (If they dropout, they are not looking for a job. Where are they getting income to live off? Are they just lying on a beach drinking beer purchased with food stamps or some other government dole?) Any way, this adjustment just reduces the numerator resulting in a lower unemployment rate calculation.

It is a given that the current administration has the highest percentage of the population on some form of subsidy and over 50% do not pay any income taxes. It is also given that the current administration wants to get re-elected and take back Congress. Therefore the unemployment rate must improve and come down in this election year. Is the DOL using smoke and mirrors? Things may not be as they appear. Can one really trust the calculations and announcements? With just a little manipulation it is possible to make statistics support whatever argument you want. Political silliness!!!

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## Do Nothing Administration

Ever since the highly visible dysfunctional theater of the US government hit last August, we have been on total grid lock. This is really adding to the future confidence of our fiscal environment. Despite the current reduction of the unemployment rate to 8.3% (see Smoke & Mirrors) both small and large businesses could be hiring significantly more employees to grow our GDP. Yet the current administration is content to sit back and do nothing constructive to help the economy grow. Maybe the President has a game plan for this election year of doing nothing, but succeeding with grid lock because he is afraid to engage his adversaries.

The President just submitted his 2013 budget which shows a fifth year of a deficit over \$1.0 trillion. Is he arrogant and a damn fool? No. He is as sly as a fox. Why? If he does nothing, the fiscal deficit will significantly improve through no action of his.

The Bush tax cuts expire in January 2013 which will increase income tax revenue 31% from 2012 to 2014. This will add 3.7% revenue and bring it to 20% of GDP. The following is a list of the major tax changes.

- Tax rates will increase from
  - 10-15%
  - 25-28%
  - 8-31%
  - 33-36%
  - 35-39.5%

## **Do Nothing Administration (cont.)**

- There will be reduction in the tax break for married couples with 2 incomes.
- Capital gains will increase from 15%-20%.
- Dividends will change from 15% to ordinary income rates.
- Reduction in credits for childcare and college.
- Temporary AMT reductions will disappear adding \$90 billion.
- Business deductions for machinery and equipment will be greatly reduced.
- The 2% Social Security reductions will expire on 12/31/12.
- 3.8% Obamacare health care tax will start.

On the spending side Congress will be in grid lock. It is true that there will be an increase of \$200 billion in Social Security, Medicare, and Medicaid. This will be an offset by the mandatory sequestered \$1.2 trillion cuts in everything else including defense. Medicare will actually take a cut in payments made to doctors and hospitals. Government interest payments will stay low into 2014 before the deluge begins when they increase by \$400 billion.

So we have a U.S. government that is totally inept. We have political polarization and all kinds of tricks that create a blur of irresponsibility at all levels. Maybe this is the administrations game plan for this election year. Is this the leadership we deserve?

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## **Tax Changes for 2012**

Legislation passed in 2010 extended many tax provisions through 2011 and others through 2012. The result is a confusing patchwork of tax rates, deductions and credits. As a quick overview, the same six rates will continue through 2012. Next year the 10% rate will disappear and all the rates greater than 15% will revert back to their 2001 levels.

The Long Term Capital gains currently taxed at 15% will increase to 20% next year. Those in a 15% or lower tax rate that now pay a 0% LTCG will have it increased to 10%. Qualifying ordinary dividends now taxed at 15% will revert to ordinary income subject to the new 2013 tax rates. Even included in Obama's 2013 budget submission is a proposal to double the tax on dividends to 30%.

Next year there are two new taxes being implemented under Obamacare on the majority of middle class families. There will be a .09% increase on Medicare tax and a 3.8% income tax on all investment income above the following income levels.

- Married Filing Joint            $\geq$  \$250,000
- Married Filing Separate       $\geq$  \$125,000
- Single                            $\geq$  \$100,000

Small businesses do not escape. Last year each business could fully expense all asset purchases up to \$500,000. For this year the limit drops to 50% to a maximum of \$139,000. Next year all bonus depreciation is eliminated and Sec. 179 depreciation is reduced to just \$25,000.

Unless extended by Congressional action, these items will not be available for 2012. Other provisions are scheduled to expire at the end of 2012. What will happen going forward? What provisions might be in effect and how is uncertain.