THE DELTA GROUP

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Overview:

"It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so." **Mark Twain**

Last year, in an effort to reduce its budget deficit, Oregon voters raised its personal income tax rate to 11% from 9% on income in excess of $250k, with a penciled in revenue gain of $180M from high achievers. The equalizing tax was intended to avoid public sector layoffs and maintain existing levels of government service, a worthy goal for a noble society.

One problem. $60M of the tax take never arrived while 25% of "rich" tax filers have vanished. Their whereabouts remain a mystery. Wary sleuths suggest the neighboring state to the north as the villain. Like other no-income tax states, Washington State is a draw for tax payers wishing to keep more of what they earn. Backstroke across the Columbia River, dry off and pick up twenty grand a year tax bonus. This fact misses the local politico's intellect. Tax dodging Oregonians are newly relocated and prospering Washingtonians.

Tax hikes are a simple solution to red ink. The green shade pulls up his spreadsheet, inserts 11 where there was a 9, and presto. Problem solved. Get to keep my job. But reality heads in a different direction. Make enough, tax enough, and Jed Clampet will pick up and go. No income tax states are welcome wagons for the agitated.

Oregon, like many other states, finds itself with chronic deficits, unemployment and a faltering economy. The experiment to expand the public sector via haircutting the private sector is a predictable failure. Hasn't worked here in California where tax free Nevada cozies up closer and closer. If it were that easy, there'd be no deficits.

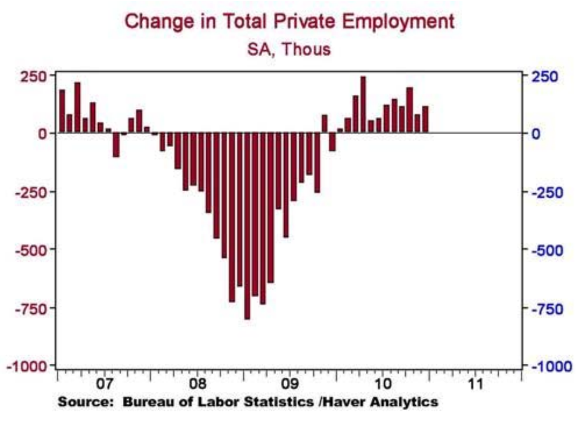
On a grander trillion dollar scale, our Federal Government makes the states look like pikers. Unlike the states, the Federal Reserve owns the currency. Pull out a dollar bill and take a look. **FEDERAL RESERVE NOTE** is the claim across the top. Printing presses fashion straw into currency, a la Rumpelstiltskin, to backfill the Treasury's yawning money pit. Officially, this was called QE II, or Quantitative Easing. Unofficially, we are buying our own debt via money creation – and dilution.

On a surely unrelated note, the price of gold continued on its 10 year bull run, touching a record $1,400 per oz. in December. Many have called the gold's run-up a bubble given the shiny metal has no intrinsic value. Bullion though has outlasted all other Fed enabled bubbles – real state/credit/commodities – which came before it. Wise observers suggest gold is simply the antithesis of Fed policy of money creation. Gold is tangible and stores value while your dollar bill is paper with dwindling worth.

Economic

Although last week's payroll report continued on a positive trend adding 100k jobs last month, US employment remains seven million workers shy of peak employment in 2007. Although economists suggest a thriving economy should create ~300,000 jobs per month, our current run rate will leave many years until we attain full employment.

The unemployment report reflected similar upbeat news declining to 9.4% from the previous rate of 9.8% in November. Good news as well, although a closer look identifies that the job counters eliminated 260 thousand job seekers from the rolls, either from lost unemployment benefits or being categorized as non-job seekers. In our own back yard, Santa Clara County payroll sits 100k+ below the internet bloated peak of 2000.



Some economists were surprised the economy has lacked vigor after the severe downturn in '08. Historically, the strength of the rebound has matched the severity of the downturn. Others suggest the magnitude of the credit crisis will require 4-6 years to normalize. 2011 puts us in the middle of that process.

In the past, real estate has led our economy out of recession stimulated by the demand for homes via falling interest rates. With excessive inventory and foreclosures, real estate remains in its own recession. About 44 million citizens – about one-fourth of potential homebuyers – have credit scores which preclude them from mortgage qualification, a significant note on the demand side of the equation.

On the international front, China's export driven economy fueled by their exchange rate manipulation, has long given them an (unfair) competitive advantage to spur the growth of their exports, at the expense of their trading partners (us.) This will remain a fundamental annoyance in the political process. China will do what's best for their economy, as we would do for ours.

Europe too, has its own spending/debt problems with its PIIGS – Portugal, Ireland, Italy, Greece, Spain. Austerity measures have been met with riots and a populous unwilling to sacrifice their inflated wage and pension benefits.

The size of government has a limit related to the taxpayer's ability to fund it. Adjusted for inflation and population gain, the US government has ***doubled*** in size over the past 30 years. Federal spending is taking ~25% of our national output, 5% above historic levels. With tax collections at 17% of GDP, the difference is the one point something trillion dollar deficit.

Overall positives/negatives for the economy:

Tailwind:

- Rising stock market
- Bush tax rate extension
- Accommodating Fed
- Retail/auto sales/service sector rebound
- Recovery gaining momentum
- Potential for corporate tax rate reduction

Headwind:

- European debt crisis
- Home price rebound faltering
- Rising interest rates
- Rising commodity prices/inflation
- Chronic unemployment
- Trillion dollar Federal deficits
- Billion dollar State deficits

Investment

Portfolio's broadly diversified and exposed to risk assets fared well in 2010, as they did in 2009. The Fed's attempt to pump the money supply and inflate financial assets was successful. Although investors should pause after a 90% rebound from the March 2009 crash lows, the majority remain bullish for 2011. Given our crisis-prone environment, looking past next month is foolish. Longer term requires similar caution since many economic and market underpinnings are supported by artificial and unsustainable government programs.

In the meantime, fearing higher rates, investors may continue to bail on the safety of their bond positions and head directly into equities, keeping the markets buoyant. A ~10% correction wouldn't surprise, nor would any number of events that would temporarily dent our portfolios. Our immediate focus is on the downside while longer term we can let the market upside take care of itself.

As noted previously, the Fed's willingness to buy Treasury debt to finance deficits does have a consequence. Aside from gold rising beyond orbit, it's a matter of time when faith is again lost in our financial system. We will look back and find great irony in the Fed's willingness to resolve our debt crisis with…even more debt.

Conclusion

The Fed will continue to be our friend in the short term providing unlimited funding to absorb State and Federal overspending. Their #1 priority is to move the economy and financial markets forward. Longer term, the grim reaper awaits, and we should be prepared to take cover.

In the meantime, the Giants win the World Series, and all is well.