“The Long and Short of It”

Quarterly Newsletter from

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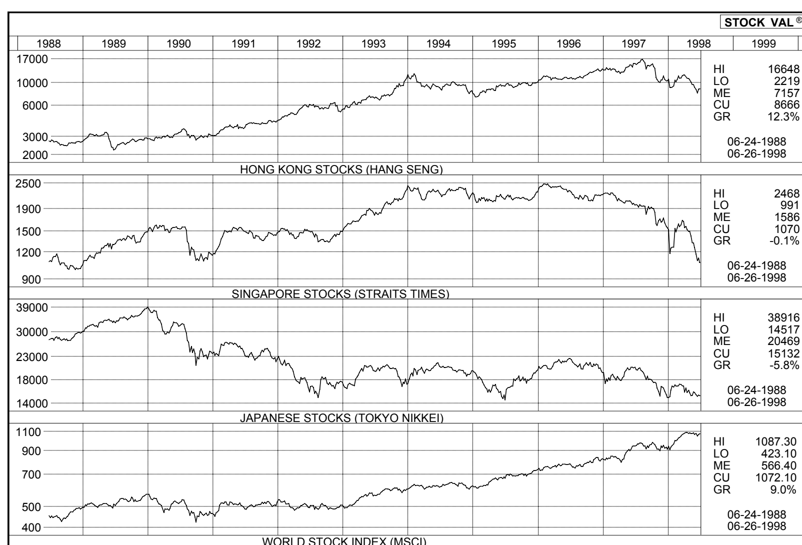
Second Quarter, 1998

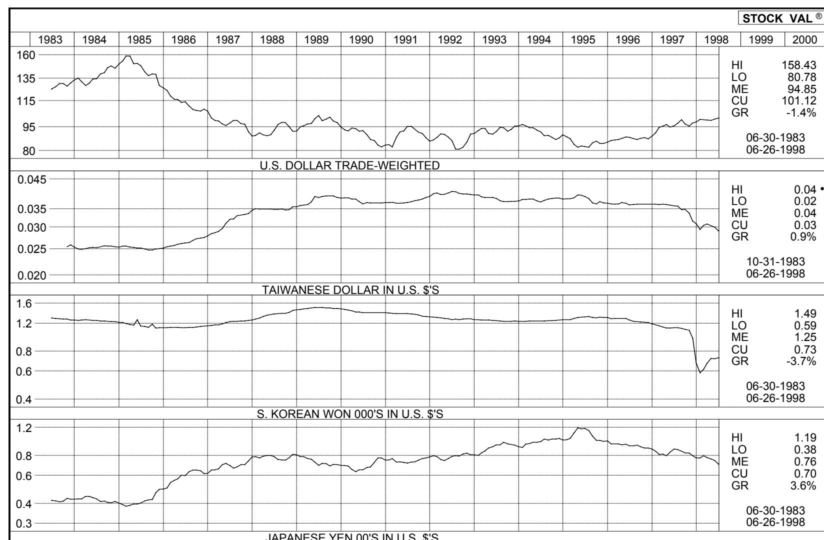
Asia Does Matter

Debate runs hot among economists these days about whether or not Asia has enough size to matter. Will Asia’s decline merely offer a valuable buffer to our robust economy? Or will it be enough to send much of the economies of the developed world into a recession?

Sitting on top of the longest economic expansion in peacetime history, as well as the best stock market performance since 1925, we believe the probabilities are high that the economic difficulties in Asia are a catalyst that will change the macroeconomic trends from expansion to contraction.



From a demographic point of view, a slowdown should have begun a year ago. In early 1997, the growth rate of the U.S. labor force, which in the long run is very closely tied to both GDP and interest rates, turned sharply downward. However, the benefits of productivity gains, excessive money supply growth, declining oil prices, and strong consumer spending due to a continuing sense of security and wealth derived from a healthy stock market, have accommodated a



continuing expansion. In other words, long term the U.S. economy needed to slow down but there was no economic event to give it a tangible reason for the good times to end. Now there is. Asia does matter.

This is not to say that Asia's troubles single handedly will ruin the party and spoil the success of the U.S. economy. Demographically speaking, we never should have had it this good in the first place. Asia will merely provide a catalyst to drive economic growth down to the levels normally seen with slow labor force growth and very low inflation. There is no historic precedent for expecting the labor force growth and inflation rates to remain virtually non-existent while the economy grows at 4% to 5% annually. Today's labor force growth rate was determined some 25 years ago, when today's new workers were born. That growth rate can be projected to continue to slow and eventually turn negative after 2010. Thus, it is fairly safe to say that over the long run interest rates and economic growth rates must also fall.

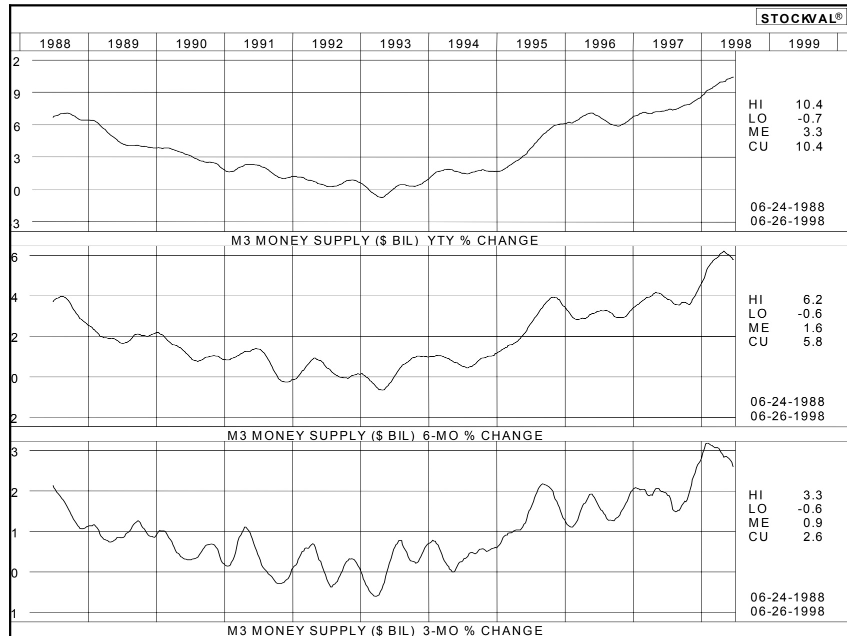
History indicates that when significant segments of the world economy suffer a downturn, the rest of the world usually joins in. No country's economy has ever been an island, unaffected by the surrounding world. This does not mean that our economy will suffer to the same extent as Asia. However, history does suggest that the U. S economy might not sustain the strong growth rates of the last seven years and as such will not be able to maintain today's premium valuations on earnings and cash flows for many stocks in the market.

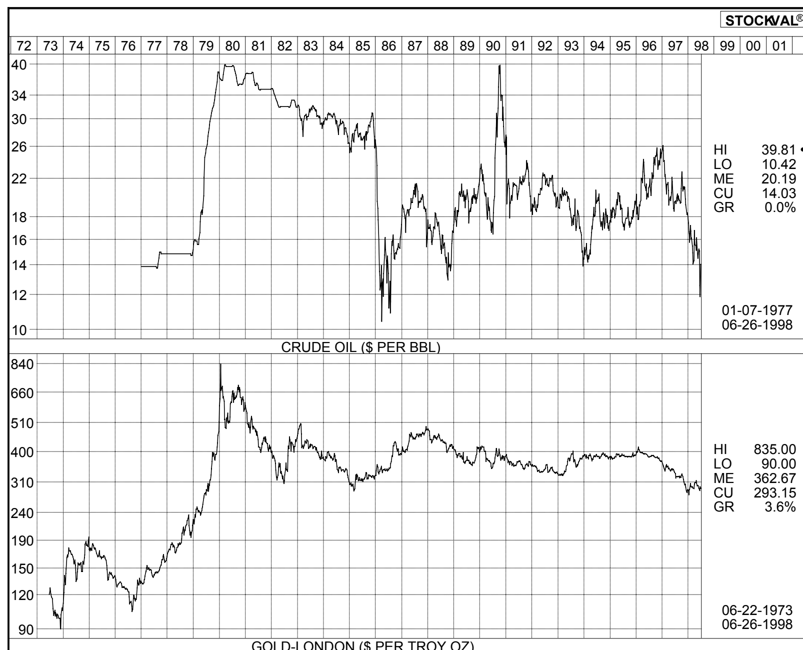
There are several pieces of supporting evidence that an economic slowdown is quickly approaching.

One of these is the flatness of the yield curve, which relates to the duration of economic expansions. In the past, the yield curve has been an excellent predictor of future economic growth rates. Currently the spread between the ten-year U.S. Treasury Bond rate and the three-month U.S. Treasury Bill rate is the

smallest it has been since 1989. In fact, the combined yield curve for the U.S., Germany, the U.K., and Japan is the flattest it has been in the last six years. This indicates that economic growth is likely falling worldwide.

Another economic indicator offering evidence of a slowdown is the money supply (M3) growth rate. M3 growth rate is now at the high end of its historic range indicating that it is unlikely to continue increasing. In fact, looking at the shorter-term growth rates for M3, i.e. the six-month and three-month time frames, one can see clearly that the rate of growth has actually begun to turn down. Less new money available means less fuel for both the economy and the stock market.

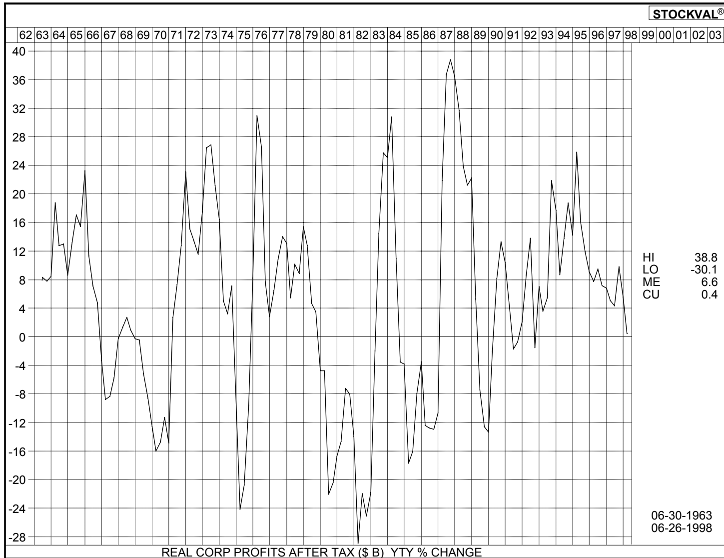




In addition, while declining oil prices have been perceived to be good for the economy, we believe they reflect more than just excess supply of petroleum. More importantly, we see a lack of global growth in demand for energy as an indication of a slowing global economy.

Finally, investor sentiment is perfectly positioned for a peak in the stock market. Small investors want to "click and invest" in anything that moves on the Internet. Institutional investors are holding the lowest cash levels, i.e., the heaviest equity positions, since 1972. Moreover, corporate merger mania has struck yet again.

Merger mania is particularly troublesome. When a company cannot grow its business through increased revenues, its only option is to create synergies or economies of scale by merging with another company. However, mergers usually do not turn out as well as expected. Short-term benefits are usually realized quickly; however, most long-term efficiencies are never realized and after two to three years the company is once again searching for revenue growth. Watch out when merger mania ends.

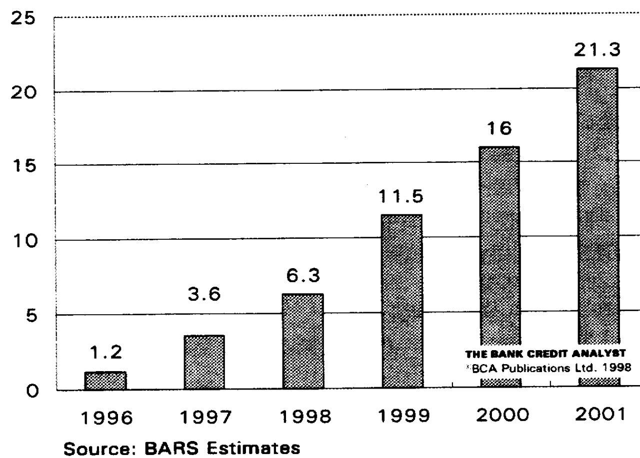


The adjacent chart of Real Corporate Profits caught our attention recently. It reflects the difficult environment in which managers are now working and confirms our view that mergers, thus far, have led to minimal if any improvement in real corporate profitability.

In brief, we believe the rest of this year could present a difficult environment for equities, so we continue to be somewhat cautious.

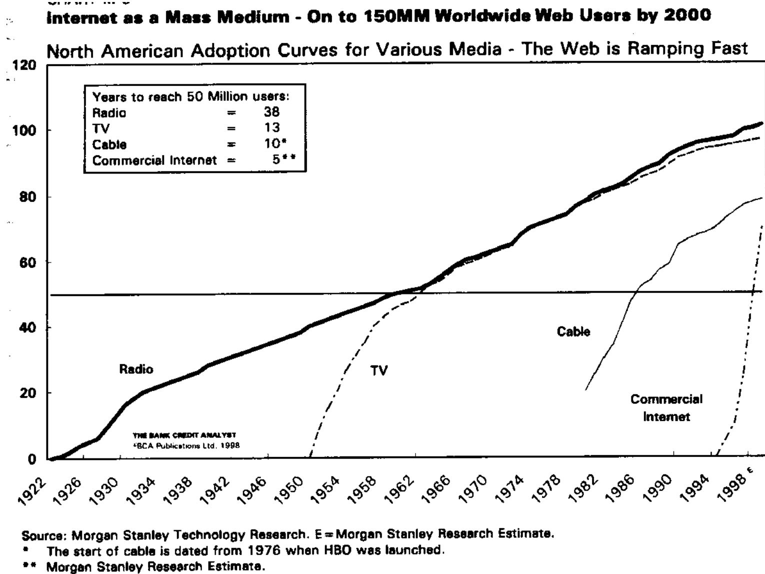
Internet Rising

Another interesting phenomenon we have heard much about this quarter is the Internet. According to an article by John C. Levinson of Westway Capital, L.L.C., in the *Bank Credit Analyst*, "the Internet will be the central nervous system of the world economy." He provides powerful support for his position in the form of data on the increasing number of buyers and revenues generated on the Web.



Due to the significant growth of Internet commerce, its impact on the equities markets is something we are watching very closely. In Levinson's example of how one company's use of the Internet is changing the way its business is conducted, two things are very clear.

First, the cost per transaction is dropping dramatically. If such results are consistently achieved, they should have a significant deflationary impact on the economy, assuming competitors are able to freely enter the market and drive down prices in an attempt to gain market share. Second, until competition materializes, the companies who successfully utilize this new medium for doing business should be very profitable in the short run.



However, remember that excess profits rapidly attract competition. If a company sees its competitor begin to do business on the Internet, the only barriers to entry are a $2,000 computer and a small amount of programming once its web sight has been designed. While we believe the Internet will lead to great gains in efficiency, some wealth creation, we are not sure it will create as much wealth as initial profit margins might indicate. As with all economic revolutions, there will be winners and losers. We will be watching this phenomenon closely as some of the companies we currently own are aggressively pursuing business on the Internet. While they do not have names like Amazon.com, they are nonetheless earning money from other, more proven businesses.

Roth IRA or Regular IRA: Tax Simplification at its Finest?

On January 1, 1998, the Roth IRA was officially launched. It has generated considerable enthusiasm among investors and IRA sponsors alike. Nevertheless, with typical congressional style, the law is so confusing we are frequently asked questions about it. Hopefully, the following summary will help you decide whether the Roth IRA is right for you.

A Roth IRA is a new tax-favored savings vehicle created by the Taxpayer Relief Act of 1997. Contributions to the account are nondeductible. However, as long as investment earnings are not distributed within five taxable years of establishing the account, they can be distributed from the account *tax- and penalty-free.*

After five years, investment earnings may be distributed under the following circumstances:

a) the account owner is at least age 59½ at the time of distribution,

b) the account owner is disabled at the time of distribution,
c) the distribution is made to a deceased account owner's estate or beneficiary,
d) the distribution is a "qualified special purpose distribution" (relating to a first-time home purchase, with a lifetime limit of $10,000).

Contribution limits
You can contribute up to the lesser of a) $2,000 ($4,000 for married couples filing jointly) or b) *earned* income annually to a Roth IRA, provided your income level does not exceed certain thresholds. However, the $2,000 ($4,000) annual limits apply to *all* IRA contributions (other than Education IRAs); therefore, Roth IRA contributions are reduced dollar-for-dollar by any contributions made to "traditional" IRAs.

The full $2,000/$4,000 contribution allowance is available if you are single and your modified adjusted gross income (MAGI) does not exceed $95,000, or if you are married filing jointly with MAGI of $150,000 or less. The contribution allowance phases out at MAGI of $95,000-$110,000 for single individuals and $150,000-$160,000 for married couples filing jointly.

Who is eligible?
Anyone can establish a Roth IRA, provided they have earned income (or the account is established for a "non-working spouse") and do not exceed the relevant MAGI limitations.

Distributions
Distributions from the account are considered withdrawals of your nondeductible contributions, i.e., principal. Thus, you can always withdraw contributions tax-free. These distributions may be used to fund a college education or meet other obligations. Once total distributions exceed your aggregate contributions, you begin to distribute investment earnings. Distributions of investment earnings within five years of establishing the account (or that otherwise do *not* meet the other requirements for "qualified distribution" treatment) are subject to federal income tax as well as the 10 percent early withdrawal penalty—unless exceptions to the penalty apply.

There are no minimum distribution rules for a Roth IRA during the life of the account owner. This means that your account can stay intact for as long as you live, allowing investment earnings to grow on a tax-free basis. In addition, if you're married, your spouse—if named beneficiary of the account—can "step into your shoes" (e.g., by establishing a Roth IRA rollover account) and continue to defer distributions during the remainder of his or her lifetime.

Following your death (or the death of your surviving spouse if he or she were named account beneficiary and rolled over the account after your death), the "normal" postmortem minimum distribution rules apply. The schedule of required distributions is determined by the identity of your "designated beneficiary" at the time of your death. The general rule requires a complete distribution of the account by December 31 in the year containing the fifth anniversary of your death. An exception is available for a designated beneficiary (e.g., your child or grandchild), who can receive distributions over

his or her remaining life expectancy, so long as the first minimum required distribution is made by December 31 in the year following the year of your death.

Converting an Existing IRA into a Roth IRA
All or part of an existing IRA can be rolled over into a Roth IRA, if you are single or married filing jointly and your MAGI or the combined MAGI of you and your spouse does not exceed $100,000 in the year of conversion. The income inclusion resulting from a Roth IRA conversion does not count in determining whether your MAGI exceeds the $100,000 conversion threshold, but it is included in determining your eligibility to make regular contributions to a Roth IRA for that year. The conversion is treated like a taxable distribution from the existing IRA, but the 10 percent penalty that normally applies to IRA distributions before age 59½ does not apply to the conversion transaction. For all conversions occurring in 1998, the income attributable to conversion must be included ratably over the four-year period beginning in 1998 on your annual income tax filings.

If you use funds in your existing IRA to pay the conversion-related taxes, you'll be subject to the 10 percent early withdrawal tax on the amount used to pay those taxes—unless one of the exceptions to the penalty applies (e.g., you are over age 59½). Under current law, you could make a post-conversion withdrawal from the Roth IRA to pay those taxes without penalty. However, provisions in the pending Technical Corrections Bill would severely restrict such withdrawals by imposing a) a 10 percent early withdrawal penalty (subject to normal exceptions) and, for 1998 conversions only, b) an additional 10 percent penalty on the amount of the withdrawal—regardless of your age. Therefore, conversions become less attractive and seem to make less economic sense unless you use non-IRA funds to pay the taxes on the conversion.

Whether to convert can be a perplexing issue, which depends on many factors:
a) Your income tax bracket at the time of conversion,
b) Your income tax bracket at the time of the withdrawal,
c) The investment's rate of return,
d) Your age and life expectancy,
e) Availability of funds outside your IRA for paying the taxes attributable to the conversion,
f) Your expected spending rate/draw down on your IRA during your retirement.

We will be happy to help you analyze your situation and determine if a new Roth or converting your existing IRA is right for you.