John Dessauer Investments, Inc.

John Dessauer's Outlook

June 2013

Dow 15,000, a Very Nice Resting Place

Pessimists are hard at work trying to make a case that stocks are too high and headed for a fall. One pessimistic pundit says to take note of the steep fall in Japanese stocks - that is what is coming next in the USA. (Japanese stocks fell 7% one day last month and then fell 5% recently.) Another says stocks are way too high, trading at 23 times earnings. However, a closer look at the pessimists' claims says stocks are not overvalued, and while due for a rest, are not especially vulnerable.

Robert Shiller is a professor at Yale University. He studies stock markets and has published extensive research papers on stock market patterns. Unfortunately, his work can be misused to support pessimistic points of view. For example, in a recent (May 29, 2013) edition of *The Wall Street Journal* there was an article titled: "Is This the Best Time for Investors? Don't Bet On It." The author focused on Robert Shiller's study of the ten-year average inflation adjusted earnings for the S&P 500 stock index. Looking back over ten years ending in 2013, stocks in the S&P 500 Index are trading at 23 times the ten-year inflation adjusted average earnings. You really don't need to do much research to conclude that 23 times earnings is quite high. The author of *The Wall Street Journal* article goes on to conclude that history is warning us of a coming steep fall in stock prices because the long term average P/E, based on the Shiller ten-year average, is 16. Stocks would have to fall 30% to get down to a 16 P/E. He didn't mention the other way the P/E could come down. Earnings could go up.

(Note: The Dow Jones Industrial Average includes just 30 stocks. It is never the less very popular and has a long history. Some researchers prefer the S&P Index because it covers 500 stocks.)

The author of *The Wall Street Journal* article is statistically correct. Robert Shiller's calculations are based on ten-year, inflation-adjusted earnings for the S&P 500. The mean P/E is 16.47, the high is 44.20 and the current reading is just above 23. However, looking back at stock market performance, the Shiller ten-year P/E calculations show that stocks have fallen from various P/E levels. For example, the P/E peak in 1987 was 16. It was from that low level that stocks plunged in the fall of '87. The P/E peak was 17.4 before stocks collapsed in the1970s. Looking at the P/E from another perspective we can see that it stayed above 25 for several years between 2004 and 2008. The bottom line is that the Shiller ten-year, inflation adjusted P/E research is very well done, but must be used carefully and with a full view of history. There is no "magic" in the current Shiller P/E.

Shiller's research does not stop with the P/E. He also calculates price to book value. The long term mean price to book value is 2.77 and the high is 5.06. The stocks in the S&P 500 Index are currently trading at 2.49 times book value, below the mean and an indication that stocks are undervalued.

When authors or analysts want to use Robert Shiller's P/E work they must consider all the facts. In this case the basic question is: are the last ten years typical when it comes to earnings and stock price performance? The obvious answer is no, they are not. How many financial crises have we had like 2008? How many times has global finance shut down as it did in late 2008 and early 2009? What about the role of China? Over the last ten years the global economy has been transformed. Asia recovered from a currency meltdown. China emerged as an economic powerhouse, displacing several developed economies including Japan to become the world's second largest economy. And, we have had a brand new currency, the euro in full bloom, for better and for worse. These new features of the financial landscape are not insignificant. Quite the opposite, they have been enormous forces in shaping the features of the last ten years. Robert Shiller's work is important and enlightening, but not a simple, easy stock market forecasting tool. We still are well served by focusing on current earnings and current stock prices.

The concept of "earnings" is neither simple nor straightforward.

For example, accounting standards have changed dramatically over the years. Reported earnings from the 1940s or 1950s would be very different if today's accounting standards were applied. But, what choice do researchers like Shiller have? It would be impossible to go back and bring reported earnings for the 500 companies up to date. Even though bundling 2013 reported earnings with reported earnings for prior decades is in some ways comparing apples to oranges,

there is no choice. Robert Shiller's research and data are what they are, and not to be twisted to satisfy an urge to draw conclusions about today's earnings and stock prices versus markets in the 1920s, 1970s or 1980s.

Earnings are an accounting phenomenon. Companies cannot pay their bills with earnings - they need cash.

Analysts have long struggled with reported earnings in evaluating a company's stock. Reported earnings can include one-time capital gains and all sorts of confusing accounting issues. In an effort to cut through the accounting fog, many analysts use "earnings from continuing operations" as their standard.

Argus Research's June 2013 monthly update has this headline: "Rally Likely Won't Top Out at Current Valuations." This is the opposite of the *Wall Street Journal's* May 19 conclusion: "These are more dangerous times than many investors realize. …..they are basically betting on a steady boom with rising prosperity and no inflation---a best-case, and rare, scenario."

First, the Argus point of view: "In assessing the bull's health, stagnation in EPS (earnings per share) would be the first red flag and P/E expansion would be a second. So far, there are no red flags."

Argus has a 2013 forecast for earnings from continuing operations of $110.80 for the S&P 500. They see a 10% rise to $122.50 in 2014. The S&P 500 Index closed May at 1,630.74, 14.7 times the Argus 2013 forecast and 13.3 times the 2014 forecast. Both are below the long term mean of 15.49. Argus researchers looked back at seven bull markets and found the average P/E when they ended was 20.9. Even if Argus is too optimistic on earnings, the S&P 500 Index is a long way from a peak.

The Dow Jones Industrial Average fell 208 points on the last day of May. Still, May was an up month for stocks, the seventh up month in a row. As if in answer to *The Wall Street Journal's* article, the media said the final Friday in May plunge was due to fear the Federal Reserve might start easing back on the $85 billion monthly bond buying program. Why? Because of good news on housing, business activity and consumer confidence, which rose in May to the highest level in almost six months. It seems investors are not betting on a nonexistent economic boom, but on a weak economy and easy Fed monetary policy.

The pessimists have shifted gears. Instead of arguing that Fed policy will fail and result in high inflation rather than a strong economy, they now say that an improving economy will mean an end to easy money and, therefore, higher interest rates. They claim rising interest rates will be very bad for stock prices. They are wrong. Rising interest rates will be bad for *bond* prices, but under today's economic circumstances they will be good for the economy, corporate profits and therefore stock prices. Rising interest rates would be bad for stock prices if the economy was in danger of overheating and inflation was a real threat. Today's economy is the opposite. It is growing too slowly, unemployment is too high and there is no sign of inflation - in fact there are real concerns about deflation. The news that preceded the May 31 stock slump was that housing is doing better, business activity is increasing and consumer confidence is at the highest level in almost six months. This is truly good news. Hopefully it will continue, and in time we will see short term interest rates back at 3%-4%. When that happens, we will all breathe easier and stock prices will be a good deal higher. For now the best case is for stocks to hold their gains while earnings continue to grow. When another quarter or two confirms the Argus earnings estimates, stocks will have fundamental support to move higher.

Two researchers at the New York Federal Reserve Bank did a study of stocks and the risk premium. They used 29 different computer models and applied them over 50 years. They found the current risk premium to be in line with stocks at their bottom in the 1970s and in 2009. This means it would take a dramatic increase in interest rates or a huge upward surge in stock prices to make stocks look expensive relative to government securities. Neither is likely.

Japanese stocks

Japan has a new prime minister – well, not entirely new. Shinzo Abe was prime minister several years ago. He resigned in September 2007, because of chronic illness and a dismal record. He is back, in good health and armed with an aggressive program to end Japan's decades of economic stagnation. He has begun to implement his plan, the yen is down and the money supply is growing. It will take time to see if his plan works. The Japanese stock market did not wait. It shot higher in anticipation of economic growth and rising corporate profits. At one point the Nikkei Dow was up 80%. It should not have been a surprise when Japanese stocks suddenly fell 7% in a single day. Nor should a second, more recent 5% fall be a surprise. When stocks soar in anticipation of future earnings they become vulnerable. The outlook for the Japanese economy and the Japanese stock market has improved under Abe, but stocks need fundamental support from profits

and economic growth. With the yen down and the bank of Japan finally applying a more aggressive monetary policy, odds favor a better economy and eventually higher stock prices. Japanese stocks are attractive as a long term investment. Trading on the NYSE is an iShare tied to the MSCI Japanese stock index. The symbol is EWJ. I rate this iShare a buy below $10.50. It closed at $10.84 on May 31.

Europe’s unsolved employment problem

According to a recent study by the OECD (Organization for Economic Cooperation and Development), between 60% and 80% of employment in the euro region is by small and medium size businesses. These crucial employers do not have access to the capital markets. They are dependent on bank borrowing. The problem is a shortfall of deposits among euro region banks. The shortfall is largest in the most troubled peripheral countries such as Spain and Portugal, where the shortfall can be as much as 40%. This is in sharp contrast with banks in Asia where deposits far exceed loans. Here in the United States our banking system has been through a transition. Today our banks are well funded, and deposits exceed loans. European banks fill the deposit gap by borrowing in the capital markets where interest rates are much higher than those set by the euro central bank. In practice this means the euro central bank does not have the same degree of control over borrowing costs as other central banks. The euro economies, especially those in the most fiscal trouble, are still burdened by high interest rates. Combine that with tighter credit requirements and it is easy to understand why Europe is still suffering high unemployment and slow to no economic growth. On the positive side, the euro central bank is making progress dealing with government borrowing and bank liquidity. It will take time, but odds are confidence will improve and there will be deposit growth at Europe’s banks.

China

One day last month the Dow Jones Industrial Average fell about 100 points after this headline: “IMF Cuts China Growth Forecast.” The IMF (International Monetary Fund) explained the cut by pointing to China’s expansion of credit, and complained about the quality of investment and the ability of borrowers to repay loans. There is nothing new here. There have been similar complaints about China’s economy since the launch of the Pudong project in1990. Pudong is a large area near Shanghai. After the government built scores of high rise office buildings in Pudong, there was a plunge in the value of Shanghai real estate values and many office buildings in Pudong remained vacant for a year or more. Critics pounced,

declaring Pudong a disaster that would bring the Chinese economy down. They were wrong. It took only a few years. Today Pudong is a thriving economic area with a high speed train, new airport and deep water port.

The IMF's new forecast may be right because there is no dramatic, pessimistic declaration in their revised growth estimate. The IMF now says the Chinese economy will grow at a 7.75% rate this year. That is still better than the government's target of 7.5%. Clearly the stock market overreacted to the IMF's revision. That became very clear when, a few days later, there was news that manufacturing accelerated in China in May.

Stocks and our portfolios…It's all about the future

As one money manager pointed out, P/Es were quite reasonable in 2007, just before one of the worst stock market plunges since the 1920s. High prices are just one way stocks become vulnerable. In fact, that seldom happens because it is obvious to all. Take today as an example. Stocks are up, so just about everyone is concerned. No one knows the future. There are always pessimists coming up with scary forecasts. When one turns up right, he or she gets credit for having seen the future. Truth is - in all cases things can go either way. What if Lehman Brothers had been saved, like Bear Sterns, AIG and the others? We now know that allowing Lehman Brothers to fall was a huge mistake. Saving Lehman Brothers might have prevented the housing collapse and the deep recession. Is there another financial crisis lurking around the corner? Not that we can see. Could something unforeseen come along and push stocks down? Yes, that is a possibility. However, after the devastation done by the fall of Lehman Brothers and the 2008 financial crisis, the odds favor a long period of recovery. The best strategy is to stay invested in stocks in financially strong companies.

NEWS AND VIEWS ON OUR COMPANIES

Aetna, NYSE, AET, $59.00. Like other health insurance companies, Aetna faces a challenge from Obamacare. In nine short months insurers will begin paying their share of an $8 billion tax on the industry; the tax rises to $14.3 billion in 2018 and then will be indexed to growth in medical costs. Each insurance company will pay based on market share. In addition, there are new underwriting restrictions. Because of all the uncertainties, Wall Street rates Aetna as a hold. However, Obamacare challenges did not hold Aetna back in the opening quarter of this year. Aetna earned $1.50 a share, excluding special items. Analysts were expecting $1.38. Management has raised earnings guidance for this year to $5.50-

$5.60 a share. That may be conservative, thanks to the expected contribution for recently acquired Coventry Health Care (the deal still needs Justice Department approval). In interviews after the earnings release CEO Mark Bertolini talked about “train wreck” comments from leading Democrats in Congress. Bertolini said that there are problems with the Obamacare legislation as it stands. He expects it will take several years and several amendments before Obamacare can be fully implemented. When that happens, the reality may be quite different from the current headline descriptions. In other words, Obamacare may not be the threat to insurers that Wall Street now fears. The stock, at just over ten times this year’s guidance, is undervalued. Aetna is a buy.

BP, NYSE, BP, $44.00, reported the sale of its Russian joint venture sooner than expected. BP will realize $15 billion on the sale. Earnings from operations came in at $1.32 a share, much better than the $1.23 analysts were expecting. BP will use $8 billion to buy back shares, reducing the share count by 5.7%. BP’s finances are recovering from the Gulf oil spill faster than expected. At the end of March, BP had $27 billion in cash and cash equivalents. Debt was reduced during the quarter from $28 billion to $18 billion. BP will realize another $3.5 billion from asset sales that are expected to be completed this year. The dividend at $2.16 a share provides a current yield of 4.9%. The final outcome of BP’s legal troubles won’t be known until later this year at the earliest. However, a final result of anything less than the $21 billion worst-case scenario will be good news for BP’s stock price. The stock rose after the first quarter report. Buy BP on any pullback to less than $40.

Cardinal Health, NYSE, CAH, $46.39, reported a drop in revenue, but a boost in profits for its third fiscal quarter. On April 12, before the third quarter report, Argus analyst David Toung wrote: “While the nonrenewal of the Walgreen contract will lower revenue for Buy-rated Cardinal Health, we believe that the exit from this low-margin business will lead to higher profitability.” The third quarter results confirm that analysis. Management has raised earnings guidance for the full year that ends June 30, 2013. The new guidance range is $3.67-$3.71 a share. The Argus estimate was $3.53 a share. The $1.10 annual dividend provides a current yield of 2.4%. The stock - at 12.5 times this year earnings guidance - is undervalued. For the new fiscal year that begins July 1, Argus has a $3.83 per share earnings estimate. That may be raised after the strong third quarter report. Cardinal Health is a buy. My twelve month stock price target is $55.

CareFusion, NYSE, CFN, $33.79, has two operating businesses: Medical Systems and Procedural Solutions. Medical Systems manufactures complicated,

technical equipment for hospitals. For example, CareFusion has a line of equipment and supplies for medication management. Procedural Solutions develops, manufactures and markets single-use skincare products and other patient-preparation products. In the third fiscal quarter, CareFusion reported excellent earnings per share, but somewhat disappointing revenues. Adjusted diluted earnings per share were $0.59 versus $0.49 a year ago and analysts' expectations of $0.53. Revenues were $901 million. Analysts were expecting $909 million. Hospitals have been under financial pressure and that is likely to be the case for the next twelve months. As a result, management's guidance for fiscal 2013 is for revenues to be flat or slightly down compared to fiscal 2012. Earnings guidance is for $2.11-$2.21 a share. Standard & Poor's says: "Still, we are encouraged by CFN's boost in R&D spending, its plans to penetrate emerging markets, and its intention to invest about $2 billion over the next three years on share buybacks and M&A (Mergers and Acquisitions). Given the aging populations of the U.S. and other developed economies, CareFusion has significant long term growth opportunities." The stock - at 15.3 times this fiscal year's guidance - is undervalued. CareFusion is a buy.

Cisco Systems, NASDAQ, CSCO, $23.80, reported third fiscal quarter profits that beat analysts' expectations, and for the first time in years, CEO John Chambers issued a positive outlook for coming quarters. Excluding items, Cisco earned $0.51 a share in the third quarter. Wall Street analysts were expecting $0.49 a share. Gross profit margins came in at 63% - better than management's guidance of 61%-62%. Commenting on the quarter CEO Chambers said: "We are starting to see some good signs in the U.S. and other parts of the world which are encouraging." Coming from Chambers, that is full blown optimism. Analysts are now somewhat confused. Cisco is doing better than some of the other large tech companies. Is the market improving or is Cisco better than the competition? Either way, Cisco's stock deserves more respect. Argus Research has a $1.99 estimate for the fiscal year that ends in June. That estimate will likely be raised to $2.00. For fiscal 2014 Argus has an estimate of $2.16 a share. The current dividend yield is 2.8%. Cisco will likely raise the dividend this year. The stock at 11 times the fiscal 2014 estimate is undervalued. Both Argus and Standard & Poor's have a stock price target of $26. My twelve month stock price target is $30. Cisco is a buy.

Kohl's, NYSE, KSS, $51.20, reported first fiscal quarter (ended February 1) earnings that beat analysts' expectations and were $0.03 a share better than the opening quarter a year ago. In the first quarter of fiscal 2013 Kohl's earned $0.66 a share. The consensus estimate among analysts was $0.57 a share. In last year's opening quarter, Kohl's earned $0.63 a share. Sales, on the other hand, fell from

$154 million a year ago to $147 million this year. Same-store sales fell 1.9%, but gross profit margins rose 0.5 percentage points to 36.4 percent of sales. This indicates that Kohl's was not overly promotionally oriented in the opening quarter. Management says sales will improve this quarter. Earnings guidance for this quarter is $1.00-$1.08 a share. Argus Research has a $1.06 second quarter estimate and a $4.45 a share estimate for all of fiscal 2013. In sharp contrast to rival J.C. Penny, Kohl's changes in merchants, brands and promotion are working. The dividend at $1.40 a share provides and annual yield of 2.7%. The stock ran up nicely after the first quarter earnings report. Kohl's is an attractive long term investment. My advice is to buy Kohl's below $50.

Kraft Foods, NASDAQ, KRFT, $53.00, reported a strong first quarter. Adjusted earnings were $0.88 a share, well above the expected $0.65 a share. Sales grew 2.1%, also better than expected. Now that Kraft has been independent for six months, the full story of the future growth potential is becoming clearer. Kraft is focused on North America, where the foods business is well established and, by itself, is not a major growth opportunity. Kraft management is being quite vocal about the degree to which previous owners neglected the business. For example, some of Kraft's factories have not seen major investment since the 1950s. Management is now planning to correct that by investing in factories, systems, and other business essentials. In the first quarter, profit margins improved by an impressive 1.2%. Profit margins will benefit as factories and systems are modernized and upgraded. There is more to Kraft than a stodgy, mature North American foods business. Management says earnings this year will be $2.75 a share. At 19 times that guidance, the stock is not cheap. Other packaged foods stocks trade above 18-19 times forward earnings. The dividend yield is 3.8%, which is attractive in this low interest rate environment. However, my advice is to buy Kraft on dips below $50.

McGraw Hill Financial, NASDAQ, MHFI, $54.03, sold the education business for $2.5 billion in cash, changed the company's name and listed on the NASDAQ. The new listing became effective of May 14, 2013. These changes are the completion of a multi-year program designed to focus the company on the faster growing financial services business and the highly lucrative bond rating business. The federal government is suing McGraw Hill over ratings prior to the 2008 financial crisis. McGraw has responded with a motion asking the court to dismiss the entire complaint. The litigation has caused volatility in the stock price. That will likely continue for several more months. The balance sheet is strong and the company is highly profitable. Earnings this year are estimated to be $3.20 a share. Argus Research has a twelve month stock price target of $64 and rates the

stock a buy. Because of the uncertainty due to the litigation, my advice is to buy McGraw Hill below $50.

Mondelez, NASDAQ, MDLZ, $30.70, reported first quarter diluted earnings per share of $0.32, a significant increase over last year's $0.19 a share. However, net revenues rose only 0.9%. Organic (meaning underlying) revenues rose 3.8%. While better, that was below analysts' expectations. Irene Rosenfeld, CEO, explained: "Our first quarter results were in line with expectations we outlined earlier this year as we work through some near-term headwinds." One headwind was falling coffee prices. Coffee prices have a history of volatility. They will rise again. Management expects revenues to be stronger in the second half of this year. Mondelez is a strong, diversified company. There are nine brands that provide more than a billion dollars in annual revenue. Mondelez has a global business with production and sales in every major region including China and other emerging markets. Management has raised 2013 earnings guidance to $1.55-$1.60 a share. Analysts agree that Mondelez is a very attractive long-term investment. However, having been independent for only six months, there are lots of near-term challenges for management. For that reason the stock is judged to be trading at just about fair value. Standard & Poor's has a $31 stock price target. Morningstar says $29 is fair value. Argus says: "In short, we continue to believe that Mondelez will need three or four quarters to reach its full potential." There is a dividend. The current yield is 1.7%. My advice is to buy Mondelez on any dip below $29.

PepsiCo, NYSE, PEP, $82.83, has declared the 41st annual dividend increase. This time the quarterly dividend is being raised 5.6% to $0.5675 a share. That raises the annual dividend to $2.27 a share for a current yield of 2.7%. Buy PepsiCo on dips below $80.

Pfizer, NYSE, PFE, $28.96, reported first quarter profits, excluding gains on the sale of part of its Animal Health business, of $0.54 a share, down 5% from last year and $0.02 below analysts' expectations. The miss was due to patent expirations and generic competition. The stock fell on the news, but the miss really was more due to analysts' calculations than anything new at Pfizer. Pfizer is in transition, selling off non-core businesses and improving the new drug pipeline. The rest of the Animal Health business is expected to be sold or spun off to shareholders. The proceeds from Animal Health and a new debt issue will be used to buy back shares. Pfizer also plans to divide the company into two businesses, an innovative core, focused on neuroscience, oncology, inflammation, vaccines and pain; and a group featuring more mature, established products. Earnings estimates

for this year are $2.23 per share, rising to $2.35 in 2014. The dividend was recently raised to $0.96 a share and is expected to rise again to $1.04 a share in 2014. At 13 times this year's earnings estimate the stock is modestly undervalued. I rate Pfizer a buy, with a twelve month stock price target of $35.

SEI Investments, NASDAQ, SEIC, $31.15, has increased its semi-annual dividend by 25%, from $0.16 a share to $0.20. In addition, the board of directors has increased the stock buyback authorization by $100 million to $139 million. SEI is benefiting from its innovative approach to providing a wide range of services to banks, mutual funds and investment advisors at home and in Europe. The recovery in global stock prices is a major plus. SEI is a buy below $30.

Wal-Mart, NYSE, WMT, $77.40, had a more difficult opening quarter than management expected. Delayed tax refunds and bad weather were the primary causes of a 1.4% decline in U.S. sales. Sales outside the U.S. grew enough to lift total sales by 1%. First fiscal quarter (ended April 30) earnings per share were $1.14. Earnings in the first quarter a year ago were $1.09 a share. CEO Mike Duke said: "…the Wal-Mart U.S. business will deliver positive comps next quarter." The stock came down after the report, but it had run up prior, so the decline was not really a negative reaction to the news; just investors selling after a run up. One very positive piece of news was that e-commerce sales grew by more than 30%. Wal-Mart is gaining strength on the Internet. Wal-Mart is a strong retailer, with a global footprint and a solid balance sheet. The stock is trading at 14.4 times the Argus Research full fiscal year 2013 estimate of $5.40 a share. Argus rates the stock a hold because of price. The dividend yield is 2.4%. Next year's Argus estimate is $6.00 a share. If results improve this year, as management expects, then that 2014 estimate will look realistic and the stock could trade up to $90. My advice is to buy Wal-Mart below $75.

Walt Disney, NYSE, DIS, $67.25, reported a blockbuster fiscal second quarter. Diluted earnings per share were up 32% over the year ago quarter. Total revenue rose 10%. Revenue from Parks and Resorts was up 14%. CEO Robert Iger said the parks drew more visitors thanks to new attractions. Disney's new movies are also big hits at the box office. Argus research analyst Joseph Bonner has this to say about Disney: "We think Disney is in a long-term virtuous growth cycle, reaping strong returns from large strategic investments in both intellectual property and its Parks and Resorts division." For example, Disney's ventures in China are at the very beginning of development. The long-term growth in China alone makes Disney attractive. Add all the other Disney assets and the stock rates a buy rating. Standard & Poor's has a Strong Buy rating on the stock. Both Argus and Standard & Poor's have a $75 stock price target. Disney is a buy.

P.S. Disney's strong quarter is real, on-the-ground evidence that the U.S. economy is doing better than the media headlines indicate. Consumers have the money to travel to Disney Parks and fill up Disney's cruise ships.

CLOSING THOUGHTS

Health Care

Obamacare has been causing uncertainty and confusion ever since the legislation passed Congress during a late night pre-holiday session. Critics have been warning of the difficulty administering such a huge and radical change to our nation's health care system. One leading Democrat recently warned that Obamacare was looking more and more like a coming "train wreck." The most serious charge against Obamacare, however, is cost – specifically, affordability. Can the nation afford the costs? Can individuals afford the premiums?

Recently I spent a few days in Bermuda - a beautiful island about 700 miles off the coast of North Carolina. While closer to the United States than to the United Kingdom, Bermuda is beyond the reach of U.S. laws, including Obamacare. I was surprised to see this headline in the May 29 issue of *The Royal Gazette*, Bermuda's daily newspaper: "Health costs to soar by up to 20%." Bermuda has a problem. Looking at the details I recognized similarities to the United States. "The Island's ageing population is adding upward pressure on premiums, exacerbated by the departure of guest workers who had been paying into the system," said the editors of *The Royal Gazette*

There is more: Mr. Wright of the Bermuda Hospitals Board said, "The ageing population in Bermuda was magnified when many expat workers, largely in the 25 to 55 age bracket, left the island during the past several years."

This last statement struck me as important in explaining rising health insurance premiums in the United States. We also have an aging population because the baby boomers are getting older - passing age 65. We did not have an exodus of guest workers, but we have had a tidal wave of working Americans being laid off, unable to find new jobs, and leaving the workforce. From a financial perspective, it doesn't matter why the number of people contributing to the health care system costs declines. Discouraged workers dropping out or simply being unemployed has the same financial effect as Bermuda's loss of guest workers.

High unemployment, and jobs at wages well below those lost to the recession are pushing up health care insurance premiums for those who can pay the premiums.

The massive health care insurance expansion, called Obamacare, will arrive next year against an unfavorable economic background. Americans, like Bermudians, could soon face a rise of 20% or more in health care insurance premiums.

The size of government does matter.

Lost in the heated debates over austerity, cutting government spending, and fiscal challenges is a basic, simple fact: it is much easier for smaller governments to adjust to rough economic times than it is for large governments. On average, government in the euro region is about 40% of GDP. In the United States the ratio is about 20% - half of the euro region. Cutting government back to an affordable size, therefore, has to be more painful in Europe than in the United States.

At what point does government become too large? We know from the wide spread of Communism that government at 100% of GDP is not sustainable. It takes time, but the end result of total government is economic collapse and poverty. At the end of Mao's Communism, a billion Chinese were left stuck in a level of poverty that truly is beyond the ability of Americans to comprehend. Europe's Communism also ended in economic collapse, but the unraveling of the Soviet Union took place in a region surrounded by economically successful neighbors. Still in Europe, government at 100% of GDP ruined lives and resulted in pockets of extreme poverty.

At the other end of the spectrum we know that 0% government is also tragic. Countries with no effective government suffer chaos, violence, poverty, hunger and sickness. Somewhere between 0% and 100% lies the ideal sustainable level of government. Socialists argue that the sustainable level is 50% or even higher. Capitalists argue that the level is below 20%. Current experience, following the 2008 global financial crisis and deep recession, tends to support the capitalists more than the socialists. What is sustainable when economic growth runs at 4% or higher, is not sustainable when growth rates fall below 2%. To be successful, economies need effective government during rough times as well as good times. Prior to 2008, Europe and the United States suffered only short periods of recession and slow growth. It was easy to assume that would be the case for many more decades. The past five years have taught economists and politicians a hard

lesson. It was very wrong to assume we would never suffer a prolonged period of slow to no growth.

As we can see from political rhetoric in Europe and here at home, it is still difficult to accept the current harsh reality. Denial is common. Many politicians and even economists preach false hope that strong growth will soon return and last for decades. Some economies may see stronger growth, but the underlying assumption from now on has to be that the right size of government is what is affordable during long periods of slow growth.

Next issue: The July issue of John Dessauer's Outlook will be ready on Wednesday July 3, 2013.

Next weekly hotline: Wednesday June 12, 2013

All the best,

John Dessauer
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