



November 9, 2012

Dow: 12,770

THE BROKEN WINDOW

Since hurricane Sandy tragically devastated vast parts of the northeast corridor, some investors have been searching for investment opportunities amidst the destruction. If that sounds insensitive, it probably is. Nevertheless, there will certainly be obvious beneficiaries of this disaster. Construction may be the most obvious choice as thousands of houses being rebuilt all along the Eastern sea board will need lumber, carpeting, furniture and appliances. Many analysts are noting that the event will stimulate the economy in a broader sense and turn what has been a lackluster economic recovery into a roaring one.

But hold on a minute. In 1850 Frederic Bastiat, a French economist, introduced his parable of the broken window or “*That Which is Seen and That Which is Unseen.*” His conclusion was that money spent to recover from destruction is actually not a net-benefit to society. He further demonstrated how opportunity costs as well as the law of unintended consequences affect economic activity in ways that are unseen or entirely ignored. The parable involves a shop keeper whose son accidentally breaks one of his father’s shop windows. The seen part of the parable is that the window needs to be replaced and the glazier will be paid six francs to repair it. So the glazier now has six francs to spend on shoes, clothing or other items. Therefore, one could initially conclude that it is good to break windows in order to stimulate the economy. What is not seen according to Bastiat is that the shopkeeper now has six less francs to spend on shoes, clothing or whatever. So if we bring this parable into hurricane Sandy terms the seen will be all the rebuilding and replacement of household goods. The unseen is the loss of funds needed by homeowners to pay for replacing their houses – money that cannot be spent elsewhere. Even if insurance covers much of the replacement costs, insurance companies will probably have to raise rates for all homeowners thus cutting more money out of the economy. Yes, there will be seen beneficiaries from this disaster, but don’t let the unseen consequences cloud your judgment as to the potential growth effect for the overall economy.

The Fiscal Cliff: America spoke last Tuesday and voted to give the President four more years. The most pressing problem confronting our country today is the fiscal cliff. The fiscal cliff simply put is the massive tax increases and spending cuts due to take place at the end of this year. Congress has kicked this can down the road for over a year, but the magnitude of this event can no longer be ignored. Starting on January 1, 2013 Americans will face a tax increase of \$450 - \$600 billion (economists estimate). The previous administration’s tax cuts will expire and new taxes will be added. The top marginal income tax rate will rise from 35% to 39.6%. The child tax credit will be halved to \$500 per child. The capital gains tax rate will also increase from 15% to 20%. Dividends will be taxed as ordinary income, with the top tax rate rising to 39.6%. The payroll tax cut will expire, which effectively results in a tax hike almost exclusively on middle and low-income families. The 10% tax bracket will also move to 15%. The Medicare

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payroll tax will rise from 2.9% to 3.8% on all wages and self-employment profits for married couples earning more than \$250,000 (\$200,000 for singles). Lastly, ObamaCare will introduce at least twenty new (or higher) taxes. There is more, but you get the picture. Then there are the spending cuts estimated to be over \$1 trillion. These cuts will come from social programs and from cuts in defense spending. If this sounds dire, it could be if the President and Congress can't somehow learn to work together. These problems *can be* resolved and the President has a golden opportunity to create a lasting legacy for himself. Republicans, Democrats and Independents should all be rooting for a positive resolution to this problem. If we hope to maintain our leadership position in the world, we must get a grip on our financial house.

The United Kingdom is now in a double dip recession. Japan thinks they have entered another recession and our own CBO (Congressional Budget Office) believes that if we go over the fiscal cliff, it would reverse the current slow recovery and lead to a recession as early as next year. China, as well as the Asian Tigers, are having fiscal problems of their own. The weight is on our shoulders to pull not only ourselves up, but the rest of the world as well.

This promises to be a stressful Thanksgiving for millions of Americans who weathered the devastation caused by hurricane Sandy only to have it followed by a ferocious nor'easter that left tens of thousands without electricity and essential utilities, freezing in their houses, if they were fortunate enough to still have one. Jeff Bridges played an alien trying to get back to his spaceship in the movie "Starman." The woman helping him asked, "What is the one thing that you like about humans?" Bridges replied that when things are at their worst you people are at your best. This Republic conceived by men at their best has withstood many national disasters over the years, both natural and manmade. We believe that America has it within herself to overcome the potential fiscal cliff and the aftermath left by Sandy. It is in our DNA to lend a helping hand. While the government can do a few things to help, it is the love and compassion of relatives, friends and neighbors that will maintain most Americans through the holiday season.

***Happy Thanksgiving to all who are snug in their houses
and our prayers go out to those struggling through this season.***

Random Thought for November 2012: "In America anyone can become president. That's one of the risks you take."

Adlai Stevenson Jr.

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