<u>SPEECH TO FMG CORPORATION</u>
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Introduction:

Whether 2013 brings us President Obama or President Romney, the significant issues, and their narrow ranges of possible solution, will essentially be the same. There will be few, or no, new initiatives in either administration; since there is no money either President will be engulfed by required remedial actions to contain the damage of past policies and practices. A President's political destiny is much decided by what's in the inherited pipeline, good or bad, on January 20th.

The underlying worldwide theme is deleveraging, and this will take a decade. There will be enormous pressures on governments, economies and civil society itself throughout the world, as the universal culturally ingrained post-war growth model is fundamentally challenged.

Budget and Taxation:

The United States cannot continue to run annual multi-trillion dollar budget deficits. While our control over the world's monetary printing press has given us substantial flexibility, the danger of a catastrophic accident increases. Historically low interest rates temporarily mask the true magnitude of financing our deficits. World financial markets will someday impose sudden unilateral discipline on runaway American debt levels, if our political leadership does not take responsible action to self-correct.

Both political parties recognize the unsustainability of United States debt levels and the debate is about means to address the problem. Irrespective of who is elected President, the realities of budget and taxation issues will be addressed in 2013. The harmonic political convergence of an end to a hard fought election, sunset of all Bush era tax cuts, sequestration with huge automatic cuts to the defense budget, and a need to raise the debt ceiling, present a rare fertile patch for a grand compromise in an otherwise barren political landscape. The election of both legislative chambers and a President should add significant political momentum to one point of view or another, and set the stage for a compromise between the legislative and executive branches of government.

President Obama probably made a mistake by not getting solidly behind a solution to the budget issue, within the general framework set by his appointed bi-partisan Simpson Bowles Commission; he thereby ceded the "fiscal responsibility" political terrain entirely to the Republicans. However, the grim facts, the President's recent statements in support of Simpson Bowles and the Democratic Party's moves to position itself in the Senate for compromise, make a 2013 fiscal deal likely.

A comprehensive solution is vital. It must include increased taxes; tax reform focused on deductions; adjustments in social security, Medicare and Medicaid and genuine caps on spending. It is probable that any grand bargain would phase in changes, so as not to deflate the currently weak economy. If there is such an omnibus solution, it will add certainty to decision-makers, from industrialists to ordinary consumers, and should help trigger stronger investment, purchases of consumer goods, and stock prices.

During his first campaign President Obama called for a 20% tax on capital gains and dividends. Only recently did he raise the stakes by campaigning for a 39.6% tax on dividends and 30% capital gains levy. The Democratic Senate, however, recently ignored the higher Obama tax aspiration and called for 23.8% rates on both. This stance positions them closer to the Republican call for keeping a 15% rate and should allow for a compromise somewhere in between.

There could be a blend of higher individual tax rates on "the wealthy" and fewer deductions. This would keep the rate from going to 39.6% demanded by the Democrats and leaning more toward "tax reforms" called for by Republicans. There will probably be a much higher threshold in defining "wealthy" than at $250,000. A gasoline tax might also be included. "Reforms" will even be harder to come by, as one man's reform is another man's necessity. Nevertheless, oil and agricultural subsidies, some form of worldwide corporate tax, eliminating the carried interest concept which allows for 15% tax rate on private equity firms and mortgages on second homes are among likely targets. Some increase in Estate taxes is also likely, but not to pre Bush levels. A total rewrite of the tax code would be most desirable, but is less likely.

These tax changes would have to be accompanied by adjusting the social security retirement ages modestly upward from 66 over time, capping inflation adjustments and increasing FICA payments by beneficiaries and employers. Significant reforms of Medicaid and Medicare must be made to insure their long term solvency, as these necessary entitlements are swallowing an increasingly uncontrollable percentage of the GDP. Some further cuts, in discretionary expenditures, which include defense, education and environmental protection might be possible, but more symbolically to demonstrate shared sacrifice than material, since $800 billion was cut from this area last year.

State and Municipal Government Crisis:

Greece is a Canary in the coal mine for much of Europe, as well as for many American states and localities.

1) Revenues restrained by slow growth economy and migrating or reincarnating industries.

2) Federal government flat lining or reducing support to get control of its own budget. However, state and city mandates stay in place, with many having built in escalator clauses embedded in local legislation.

3) Pension obligations rising as retirees and layoffs increase; pension fund assumptions unrealistic and shortfalls must be annually funded from current account, thereby depleting revenues available for service delivery.

4) Proposals for minimum federal tax payments on income, or limited deductions of state and local income taxes, threaten the highest tax rate jurisdictions and thereby weaken their ability to resort to tax increases to balance the budget, since less federal deductibility will accelerate business and population flight.

5) Narrowing and more expensive debt markets for weaker municipal entities are temporarily masked by overall low interest rates; markets will inevitably differentiate more sharply among strong and weak credits, money will be absolutely and relatively rationed by cost of funds.

Europe:

A European Union with a multiplicity of political decision-making and regulatory jurisdictions, plus radically different life perspectives and work ethics, wrapped tightly within a single currency, is very hard to sustain. A simple example is that Greek wages rose 40% during the same time period that German wages rose only 18%, and they are supposed to compete economically in the same currency. Add to this that government entitlements at the national and municipal levels were largely sustained on borrowed money.

The ECB decision to recapitalize the banks and purchase government bonds is a temporary stop gap in a very serious situation. However, it will not cure the fundamental economic disparities within the common currency: massive differences in national wage and productivity levels; dramatic differences in current account balances, national and municipal indebtedness; revenue raising via tax collections; and government indebtedness. While many call for Eurobonds and massive repurchases and forgiveness of government debts in 2013, so-called "mutualizations," are unlikely to happen. They are politically unfeasible, as Northern Europeans do not want to give an unlimited entitlement to Southern Europeans. This does not mean that 2013 will not see conditional temporary support mechanisms in exchange for more disciplined centralized regulatory control.

The most likely scenario is a massive devaluation of the Euro, perhaps 20-30% from current levels. Such a steep devaluation should be effective in making Italian, Spanish and Greek products more competitive in worldwide trade. However, it will also make all Europeans

poorer, since they import almost all their raw materials and many finished goods in dollar denominated contracts. And a devaluation is only a temporary remedy, since the underlying competitive positions must be fixed to remain sustainable.

It is unlikely that the political and cultural situations will permit Greece to make the extraordinary adjustments it will take long term to remain within the Euro. There is a strong possibility that Greece will leave the common currency in 2013.

Italy and Spain are more difficult cases for the European Community. Much of northern Europe's prosperity is built on internal European Union exports and this helps account for full employment in Germany, for example. If Italy and Spain were to leave the Euro, they could not afford to import German goods, thereby impacting German employment. These countries are also heavily indebted to northern European banks and the latter governments are more likely to extend themselves to prevent defaults, which will rock their banking systems further. 2013 is likely to show greater ECB involvement in trying to right Spain and Italy; they have been good at accepting conditionality and adjusting internally to it, but these populations are highly tentative in their support. For example, it might take a 9% loss of Spanish GDP just to avoid insolvency.

Food:

The drought in the United States will likely result in 4% food price increases. When this is added to unusually high and increasing unemployment throughout the world, the ability of families to just sustain themselves will be challenged. Hundreds of millions of people were elevated in their diets, even in the poorest nations, and it is unlikely that they will passively return, or even be able to return, to rural subsistence living. Therefore, in 2013 there is likely to be significant urban unrest over food and governments will be tested for solutions. Civil disorder will be a growing challenge as the world deleverages and economies experience slower growth.