INVESTMENT LETTER

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KATIE MELOY

One of our longest and best relationships has been with economist and presidential advisor, Dr. Arthur Laffer and his firm, A. B. Laffer Associates. In the 80's his aging aunt lived in the Venice area, where he visited with her during her last years. While here, and before he had become so prominent, he contacted the local bank trust department that I worked for to try to get us to subscribe to his economic services. We did and have kept a relationship going with him personally since then. He has visited here and been a popular featured speaker at several of the public affairs functions we have sponsored over the years.

We mention this now because one of Art's unique approaches to explaining complex theories on taxation and incentive-based economic ideas has been to talk in terms that everyone in the audience could understand. His often repeated example of the how the price of apples that a farmer receives is based on whether apples are in short supply or over supply is always well received and well understood. The words "supply" and "demand" are so overused that many non-academics simply turn off when any conversation heads in that direction, even though it deals with a matter that represents one of the very few "laws" that exists in the field of economic theory.

Over the years we have frequently used the term "mother economics," to equate to "mother nature," which is well-known to be, and always must be, a tough taskmaster. We are told over and over again how one cannot fool with mother nature, as in the law of physics that "for every action there is always an equal and opposite reaction." We learned these kinds of things in high school Physics 101.

Likewise, and although there are few who truly understand, the same reactions to actions taken exist in the field of economics, whether they be in fiscal policy—like setting tax rates—or in the monetary arena, when the Federal Reserve Board changes interest rates or influences the amount of money in circulation. Each time a decision is made, in the fiscal area by Congress and the President, or as a monetary policy change by the Fed, there are equal and opposite economic forces at work that often tend to offset what the change was intended to achieve.

Art Laffer has made a career of lecturing to all who will listen about the negative impact that an increased tax rate has on the revenues it is supposed to generate. The world famous *Laffer Curve*, first drawn on a cocktail napkin, clearly illustrates that there is always going to be an optimal tax rate that generates the most tax revenue, somewhere between a zero rate and a 100% rate, which would both produce no revenue. Political battles are still being fought over this today, with many lawmakers remaining of the opinion that tax cuts reduce revenues to the government and tax hikes produce more revenue. It is almost inexplicable that this would still be so, but in the mysterious world of politics, economic nonsense can still be repeated so long as it is couched in language that generates votes. Fortunately, and thanks largely to Art, academia is now heavily in the camp that understands his theory that tax rates do in fact matter.

Well, enough of all this jargon from us investment types. Instead, we now present to you a paper that was prepared by 11-year old Katie Meloy of Silver Springs, Maryland, who is home-schooled by her parents, Debbie and Bob. This came our way from one of our original and valued directors, Jack Meyerhoff, who along with his wife Margie are Katie's loving and proud grandparents. This paper explains, in terms that will confuse nobody, the economics of supply and demand, so we thought we would share that with you now. It does a much better job than we could ever do to explain how simple some complex things really are.

No matter what we may think, it is still pretty obvious, at least to this writer, that little Katie has a lot more ahead of her to offer to the world than she could ever realize now at her tender young age. And, most certainly, the world will be a better place because of those, who like Katie, study and come forward to lead all of us in years to come. Thanks, Katie.

A BRIEF NOTE: Supply and demand are heavily at work currently in the marketplace, including the recent sharp stock selloff since the Fed raised short rates again, somewhat unexpectedly. Most traders were assuming the steady Fed hikes were about over, which moved stock prices higher. The latest surprise increase, however, signaled that the Fed still has worries that price levels for basic materials will push costs higher (short supplies), forcing companies to raise their prices, which could slow consumer demand, causing an economic slowdown worldwide. Long rates, however, have hardly budged, which means real inflation fears are low (Laffer). Our take is that investors should use this pullback as an opportunity once again to add to positions in quality under-valued equities.

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CASE STUDY:

The Laws of Supply and Demand

The Laws of supply and demand are simply the concepts of how the quantity of an item available (supply) and the want or need for that item (demand) influences prices for that item.

Let us use an example to explain how supply and demand works. Let us say that Mrs. Greebs owns a small nursery, in which she raises plants to sell. She has one dozen chrysanthemum plants that she has raised from seed. Twenty people want chrysanthemums, and so fewer chrysanthemums are available than are needed. The demand, or number of people who want chrysanthemums, is greater than the supply, or the number of chrysanthemums available.

People will be willing to pay higher prices for these comparatively rare plants, simply because they have become harder to obtain. Mrs. Greebs will be able to raise the price of her chrysanthemums, or, in other words, the price of chrysanthemums will inflate.

Mrs. Greebs, seeing the increased value of chrysanthemums, will hurry to obtain more plants. Let us say that she obtains an additional thirty plants. There are still twenty people who want chrysanthemums. There are now more chrysanthemums than people who want chrysanthemums, or the supply of chrysanthemums is greater than the demand for chrysanthemums. All the people who want chrysanthemums will buy chrysanthemums, and Mrs. Greebs will have a surplus, or an excess supply, of chrysanthemums.

Mrs. Greebs will want to make at least some money on her remaining chrysanthemums, so she will lower her price. A lower price will tempt people who would be unwilling to buy chrysanthemums at the old, higher price into buying plants at the new, lower price. The demand, or people who want chrysanthemums now, will increase, and the supply will remain stable, so the demand for chrysanthemums will be greater than the supply of chrysanthemums. This will inflate the value of chrysanthemums, and Mrs. Greebs will be able to raise her prices. At the higher prices, she may want to buy more chrysanthemums to sell, and there will once more be a surplus of chrysanthemums. You can see how this is a circular cycle. This cycle is probably a very beneficial one, as it keeps our economy fairly stable, and prevents vast or permanent inflation in short periods of time.

There are still other aspects of supply and demand. If the same amount of people want chrysanthemums, or any other product, as there are chrysanthemums, the cycle will slow. Natural rarity of products or resources can also make them more valuable. For instance, gold does not, in itself, possess any particular qualities that would make it so very pricey and sought after. However, gold is a lot rarer, or harder to come by, than wood or rock, for instance. Basically the less there is of something, the more people want it, and the more valuable it becomes.

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