TrendMacrolytics

Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

POLITICAL PULSE

Tax Cut Extension: The Deal Takes Shape

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Donald Luskin

While partisans are distracted by immigration, tax reconciliation is quietly moving forward.

Yesterday afternoon, as the **S&P 500** moved to new highs, the story started circulating that **House/Senate negotiators** had hammered out an actionable compromise for finishing **2006 tax reconciliation.** The first steps toward actual voting could occur as early as this week. The compromise is reported to include a **two-year extension of the 2003 tax cuts on dividends and capital gains**, and a **one-year extension of the alternative minimum tax "patch."** We hear that **John Boehner** (the new **majority leader** in the House) and **Trent Lott** (who would like to return as majority leader in the Senate) were the MVP's in lining up support for a package that will work.

Sources tell us that progress has been possible because extending the 2003 tax cuts has become less politically controversial. It has been overshadowed in **Congress** by the divisive battle for **immigration reform**, and has been crowded out at the **White House** by a new focus on **health care reform** (nothing would have been worse for extending the 2003 tax cuts than to have an **unpopular president** push for it). And key Senate swing vote **John McCain** (see "The McCain Mutiny" September 23, 2005) is probably going to have to vote for extension, as he continues to reach out aggressively to the **conservative base** in his drive for the presidency. If he can mend fences with **Jerry Falwell**, he can vote to extend the tax cuts that he voted against in 2003.

We continue to believe that the strong performance of **equities** over the last several weeks -- in the face of rising **long-term interest rates** and heightened expectations for continued **Fed rate hikes** -- is due in part to the increasingly likelihood of tax cut extension (see "Extending Visibility" February 17, 2006 and "Why Rates Can't Clock Stocks" March 23, 2006). Now, as the story appears to be developing, there are two particularly positive angles for stocks. First, it seems that extension of the 2003 tax cuts will be for two years, to 2010 -- not just one year, to 2009, as had been widely floated as a potential compromise. Obviously, the longer the tax cuts can be extended, the longer the horizon over which **equity valuations** can assume with near certainty that the **after-tax returns to capital** will be augmented by lower dividend and capital gains tax rates.

Second, it seems that the AMT "patch" will be included within the reconciliation bill, rather than handled in a separate companion bill. This is disappointing in the sense that the AMT "patch" takes up $30 billion of the $70 billion **static revenue cost** of the bill, crowding out other **tax breaks** and opening the door to potentially pernicious **revenue raising measures.** But integrating the two provisions within reconciliation lowers the risk of **deadlock** between **Democrats** and **"moderate" Republicans** who favor the AMT "patch," and **pro-growth Republicans** who favor extending the 2003 tax cuts -- which might have led to the catastrophic result of *neither* measure being enacted (see "Tax Bill Game Theory, and Why It Matters"

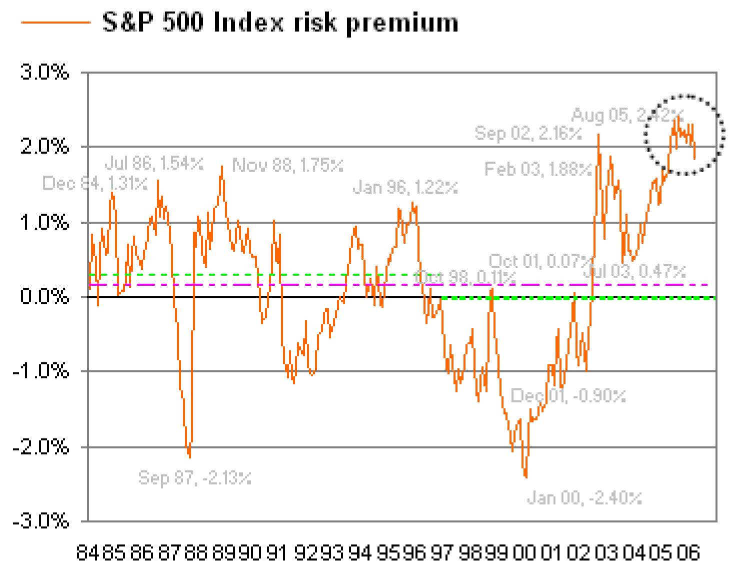
http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 544 6900

December 8, 2005). Thus integration lowers the maximum potential pro-growth impact of this legislation, but at the same time reduces the worst-case risk of failure.

Third, the compromise on the table now has the interesting election year property of luring Democrats into the position of voting against a bill that contains the popular AMT "patch" -- which otherwise would have expired for this tax year -- in order to maintain solidarity against **GOP** initiatives. For the GOP, delivery of extension of the 2003 tax cuts, which is a signature issue for voters in the **growth wing** of the party, will be an important step down the road to retention of **majority status** in November. Potential loss of that status has to be regarded as one of the major risk overhangs for stocks (see "Election Risk: It's Back" January 26, 2006).



BOTTOM LINE: As the probability has increased for two-year extension of the 2003 tax cuts on dividends and capital gains -- with lower risk of a legislative meltdown in which the AMT "patch" fails to be extended -- the **equity risk premium** has fallen to its lowest level in almost a year. With interest rates rising and the **yield curve flat**, **stocks** have proven to be just what we said: **"the king of carry trades."** Since we first coined that expression last June (see "The King of Carry Trades" June 14, 2005), the S&P 500 total return has been 10.6% (versus only 0.3% for **long-term Treasuries**, and a loss of 0.9% for **10-year Treasuries**). Now, while less extreme that at any time in almost a year, the risk premium remains near historic high levels. This continues to suggest that the **cost of debt capital** is too low relative to the **cost of equity capital**. From the standpoint of an **issuer**, the play is to **borrow** rather than to issue equity (indeed, with **corporate America** awash in cash, borrowing can effectively take place at the Treasury rate). For a provider of capital -- i.e., an **investor** -- the smart play remains to avoid providing cheap debt capital (i.e., don't own bonds) and instead be a provider of expensive equity capital (i.e., own stocks). In other words, stocks remain the "the king of carry trades."TM