

TRENDMACRO LIVE!

On the Tax and Budget Breakdowns

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House/Senate negotiations to hammer out a final **tax reconciliation bill** -- which would extend the **2003 tax cuts on dividends and capital gains** by two years, and the **alternative minimum tax "patch"** by one year -- broke down yesterday afternoon. This is a disappointing reversal after signals late Wednesday that a compromise between widely divergent House and Senate versions was near (see ["Tax Cut Extension: The Deal Takes Shape"](#) April 7, 2006).

The breakdown on tax cuts took place at the same time as the **2007 budget process** in the **House of Representatives** fell apart in bitter disagreement over **spending** levels between **conservative** and **moderate Republicans**.

Apparently the tax cut extension breakdown was triggered by a dispute between **Senate Finance Committee chair Chuck Grassley** and **House Ways and Means Committee chair Bill Thomas** over a relatively trivial element of the AMT "patch." Grassley wants a more generous version which would raise the **AMT exemption** to a level such that no more **taxpayers** would be hit by AMT in 2006 than had been in 2005; Thomas wants a less generous version that would only **inflation-index** the exemption, and would result in a few hundred thousand new taxpayers being hit by AMT in 2006.

If this is really the only sticking point, we would expect that a compromise will get worked out after the two-week **Easter recess**. And the hope that actual floor votes could have been completed before the recess (and the symbolic April 17 **tax filing deadline**) was always a stretch. But surely it isn't a positive development for negotiators to be in a position where they can't even announce the substance of their compromise. At the least, now waiting adds to uncertainty.

BOTTOM LINE: We are delighted to see **stocks** well behaved this morning despite this disappointing news (and a strong and **bond-unfriendly jobs report**). But we have been saying that rising stock prices have been, in part, gradually discounting extension of the **growth-critical** extension of the 2003 tax cuts and the AMT "patch" (see, for example, ["Extending Visibility"](#) February 17, 2006) -- so this setback could usher in a short period of **retrenchment** or **consolidation**. Looking further out, the GOP's seemingly irreconcilable internal divisions on spending present a greater risk to **equities**. Failure to produce a 2007 budget could frame the **GOP**, in a dangerous **election year**, as a party both without a consistent governing philosophy and unable to get things done. If, after the recess, the GOP can't come back and pull together to both deliver a 2007 budget and complete last year's unfinished business of extending the 2003 tax cuts and the AMT "patch" -- then we would probably have to downgrade our outlook for stocks. Yes, we see stocks as deeply **undervalued**, and thus priced to be fairly robust to a great deal of bad news. But the upside potential in stocks won't be unlocked if yesterday's breakdowns presage a broad and long-lived breakdown in the **pro-growth** policy potential embodied in a viable **GOP congressional majority**. **TM**