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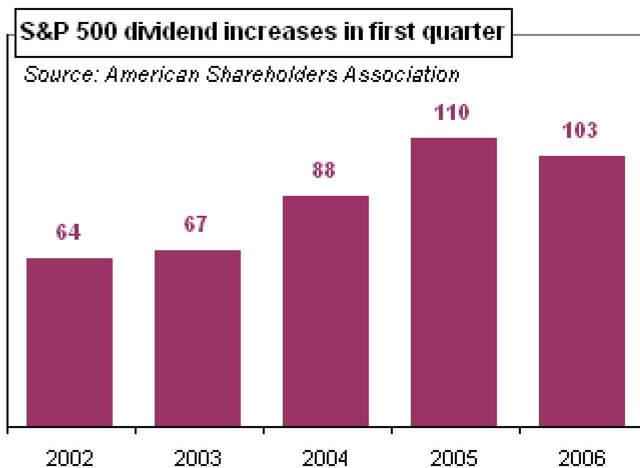
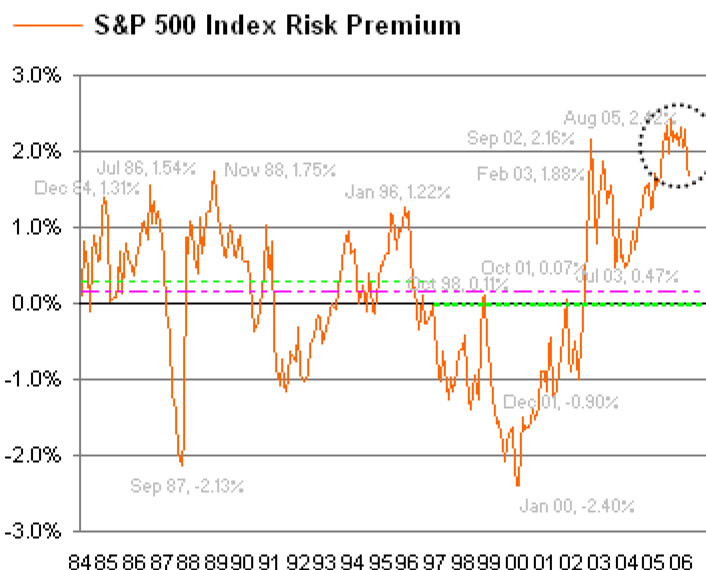
Stocks face the risk that if the 2003 tax cuts aren't extended now, they never will be.

We continue to believe that **Congress** will enact 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."** All it takes is for **House Ways and Means Committee chair Bill Thomas** and **Senate Finance Committee chair Chuck Grassley** to agree on exactly which portions of a complex tax bill will be embodied in the **filibuster-proof reconciliation process**, and which are popular enough to risk moving as a separate bill. We've already reported on the blame game being played by both men -- with Senate sources complaining to us that Thomas had commandeered the process and wouldn't compromise on trivial points (see "Two to Tangle the Tax Cuts" April 10, 2006), and House sources telling us that Thomas had agreed to all of Grassley's terms, but that Grassley aborted negotiations in a fit of personal pique (see "Tax Cut Rashomon" April 11, 2006). Sources tell us such things for a reason, and they've all since been repeated in the media. They are calculated to make it clear that both men want to see the dividend and capital gains rates and the AMT "patch" extended, and that both men see their **pre-recess negotiating positions** as a stable frame for the next step.



Though the process is still very much alive, it is nevertheless at risk -- and we're seeing the first signs of changing **economic behavior** in response. The number of **S&P 500 companies** that increased their dividends fell in the first quarter of 2006, compared to the prior year first quarter, for the first time in four years. This drop comes after two years of large increases that immediately followed enactment of the 2003 tax cuts. With **trailing 12-month earnings** up 9.5% versus a year ago at the end of the first quarter -- and with **consensus forward earnings** up even more steeply at 15.8% -- it's not because corporations can't afford higher dividends. Instead, managers are losing confidence in the duration of today's low 15% maximum rates on both dividends and capital gains, and see increasing risk that they will revert to their higher pre-2003 levels. If today's rates are not renewed, after 2008 the top tax rate on dividends will more than double from 15% to 35% (and further to 39.6% after 2010, if the **2003 personal income tax rates** are allowed to expire). At the same time, the top rate on capital gains will only rise by a third, from 15% to 20%. Because dividend increases are regarded by investors as effectively permanent, and because this shift in **relative tax rates** is quite large, even a small increase in uncertainty makes committing to larger dividends an unattractive way to return **shareholder capital**.

The **stock market** has responded to heightened uncertainty, too. Just as we forecasted, the S&P 500 has been stuck ever since House/Senate tax negotiations broke down two weeks ago (see "On the Tax and Budget Breakdowns" April 7, 2006). Nevertheless, we continue to believe that stocks this year have at least partially discounted that extension of the 2003 tax cuts and the AMT "patch" will indeed be enacted (see Extending Visibility" February 17, 2006). This may explain why, in the face of **rising interest rates**, **energy prices**, **domestic political risk** and and **geopolitical tensions**, stocks have done as well as they have (see "Why Rates Can't Clock Stocks" March 23, 2006).



In fact, with all these risks in the background, the **equity risk premium** (as measured by comparing the **consensus forward earnings yield** of stocks with the **30-year Treasury bond yield**) has **contracted** markedly over the last several weeks as the outlines of a tax bill compromise have taken shape. The risk premium hit **21-year highs** on October 21, 2005 -- with stocks even more **relatively undervalued** then than they were at the **panic bottoms** of October 2002 or March 2003. The contraction of the risk premium since then can be partly explained by rising interest rates, but that effect has been almost entirely offset by rising expected earnings. What has contracted the risk premium is, primarily, simply that stock prices have gone up. In the almost exactly six months since the risk premium hit its record high, stocks have returned 12.0%, while 30-year bonds have lost 0.7%. While it may not feel like this has been an exciting period to own stocks, the reality is that they've returned twice the long-term historical average for six-month periods. The spread in total returns between stocks and bonds -- i.e., the extent to which stocks have outperformed bonds -- has been almost four times greater than the long-term historical average. Stocks have proven to be, as we've said so often over the last year, the **king of carry trades** (see "The King of Carry Trades" June 14, 2005).

Though the equity risk premium is not as ultra-elevated as it was six months ago (or as it was, within a tight range, for most of the last year), it is still elevated. Our model shows that stocks would have to rise by another 28.7% from here to bring the risk premium back down to its **long-term norm**. While some of this considerable room on the upside is no doubt attributable to uncertainty about when **the Fed** will really be done raising interest rates, some of it is surely attributable to the remaining uncertainty about extending the tax cuts. If the **Republican majority** fails to make this happen now, it will never happen. The **GOP** doesn't need a single **Democratic** vote -- only the internal coherence to deliver on a critical mandate from the Republican **pro-growth base**. Failure would be a sure prescription for loss of the House in November, as the **GOP electorate** throws up its hands in disappointment and disgust. And if that happens, the 2003 tax cuts will **sunset** away after 2008 -- because if a Republican majority can't enact extension, a Republican minority certainly won't either. The stock market and **the economy** won't wait for 2008 before reacting. The first quarter's slowdown in dividend growth is only a small foreshock of the large quake potentially to come.

BOTTOM LINE: The matrix of risks, returns and probabilities is complex. First, we believe that the probabilities favor success in extension of the tax cuts. But the economic consequences of

success or failure are not symmetrical. Success only preserves the status quo, consisting of very favorable -- but nevertheless temporary -- tax rates on capital, and a fragile political consensus that is only marginally pro-growth (mostly to the extent that it is not overtly anti-growth). Failure leads directly to loss of the Republican majority in the House in November, which would foreclose any possibility of pro-growth policy for at least two years -- and sets the economy up for the virtual inevitability of higher tax rates across the board, as the 2003 tax cuts on dividends and capital gains automatically roll off after 2008 and the tax cuts on personal income roll off after 2010. For all that, the equity risk premium remains elevated, though not at the extreme levels of most of the last year. So stocks come into this time of risk already deeply undervalued, suggesting a valuation cushion that would somewhat dampen the worst effects of failure -- and room on the upside in the event of success. We predict that extension will succeed, probably within the next four weeks. As the path to that conclusion becomes clearer, stocks should break out of the **trading range** in which they've been confined while **Congress** has been in recess. If we are wrong, we would strongly **downgrade** the optimistic view of stocks and the economy that we have held for more than three years -- and our only comfort would be knowing that we enter a difficult time from a position of undervaluation. TM