TrendMacrolytics

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

POLITICAL PULSE

Tax Wars

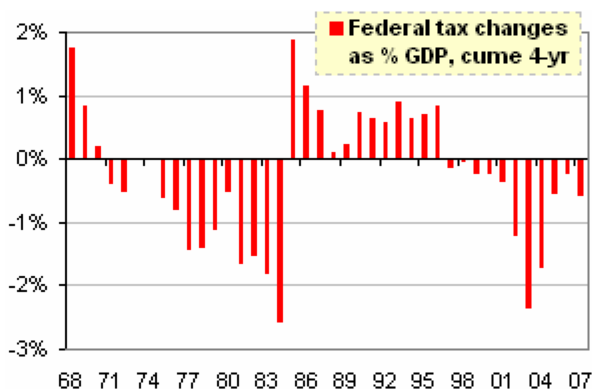
Monday, January 22, 2007

Donald Luskin

The era of tax cuts is over, and a new era of tax risk has begun.

Last Thursday the House of Representatives voted to pass a bill that would raise taxes on the energy industry by $8 billion in the name of "energy independence." It was showpiece legislation, part of the "first 100 hours" of the new Democratic majority. Our congressional sources indicate that it will quietly die in the Senate, where there is key bipartisan opposition. Even if enacted, in the grand scheme of things for the industry, this legislation is like a small flea on a big dog. For energy stocks on Thursday, it was overshadowed by a much more impactful development -- crude oil's panic bottom below $50 in the futures markets.

Yet in a larger context the House's vote Thursday has real significance: it marked the first time in more than 13 years that congress voted to raise taxes. It highlights the long-term risk to the economy and the markets that the resurgent Democratic majority could undo the pro-growth work of the deposed Republican majority. The stark reality is that the Democrats don't need to actually do anything to achieve that, either. Under current law, today's low rates on individual incomes, dividends and capital gains are scheduled to "sunset" after the 2010 tax year, reverting to the higher levels that prevailed under the Clinton administration. It's a long time off, but it would be a blow to growth. And from here it's difficult to visualize many high-probability paths that would avoid it (it would seem that a minimum requirement is the election of a Republican president in 2008). We don't sense that markets are especially focusing on this now, so there is the risk of a negative sentiment change



Update to strategic view

US MACRO: Tax rates on individual incomes, dividends and capital gains are set by current law to rise automatically after the 2010 tax year -- a long-term threat overhanging growth prospects. Near-term, absent new legislation, in the 2007 tax year the AMT exclusion will revert to 2001 levels, imposing $40 billion in additional taxes on at least 4 million individuals. The coming congressional battle over AMT relief will be a nerve-wracking preview of tax wars to come, and may significantly impact long-term expectations.

US STOCKS: Tax risk is another reason for intermediate-term caution on equities as they make new highs in the near term. Risk of political rupture over taxes in this year's budget process could come in a similar timeframe to a definitive shift in Fed expectations from ease to tightening.

[see Investment Strategy Dashboard]

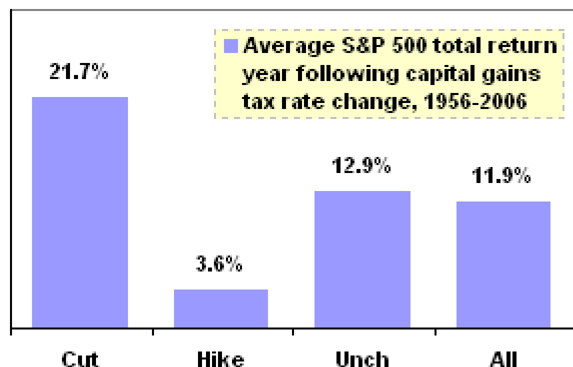
http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 552 3625

Copyright 2007 Trend Macrolytics LLC. All rights reserved. This document is not to be forwarded to individuals or organizations not authorized by Trend Macrolytics LLC to receive it. For information purposes only; not to be deemed to be recommendations for buying or selling specific securities or to constitute personalized investment advice. Derived from sources deemed to be reliable, but no warranty is made as to accuracy.

when some event forces it into consciousness. That said, perhaps the likely prospect of higher tax rates in the future explains the persistent relative undervaluation of equities expressed in the elevated equity risk premium.



Considering the clarity of intuition about the effect of tax rates and tax burdens on growth and on equity returns, it's surprisingly difficult to find broad-brush historical evidence of it. The subtleties of particular tax regime changes, the expectations and lags involved, and the role of non-tax factors create apparent contradictions -- such as the superior equity performance during the generally rising tax environment of the 1990s. One key to understanding the seemingly anomalous '90s is the capital gains tax cut of 1997. Indeed, the record is clear that *changes* in capital gains tax rates have important and immediate effects on equities. As the chart above illustrates, over the last half century capital gains tax cuts have been followed by sharply superior equity returns, and hikes have been followed by sharply inferior returns. Sadly, of all of the 2003 tax cuts, the low rate on capital gains is the one most directly centered in the Democrats' cross-hairs.

We'll learn a lot about the prospects for the future as congress turns shortly to the 2008 budget. President Bush will no doubt call for making the 2003 tax cuts permanent, and the Democratic majority in congress will no doubt call for immediately repealing them. But this year the primary battle will be fought over extending for another year a "patch" to the Alternative Minimum Tax exclusion. Without the patch, the exclusion will revert to 2001 levels, and something like 4 million upper middle class taxpayers will find themselves on the AMT tax schedule for the first time, facing on average a $10,000 higher tax burden than last year. In the budget process the extension of patch will be treated as "cost" to the government of about $40 billion. Under new "pay-as-you-go" rules just enacted in the House, that cost would have to be offset with some combination of spending cuts and tax increases totaling $40 billion. It is highly unlikely that spending cuts will be countenanced, so offsetting tax hikes will be necessary. The Democrats will surely propose repealing or reducing the 2003 tax cuts as the offset. The GOP is highly unlikely to support this offset, and the Democrats' thin majority in the Senate will not be sufficient to overcome Republican opposition. Besides, the Democrats are in a poor bargaining position. The AMT most strongly affects taxpayers in states with high state and local taxes, and such states are predominantly Democratic. Thus there is a strong incentive for Democrats to find offsets acceptable to Republicans, such as repealing various corporate "tax breaks" or promising more vigorous "enforcement." But the GOP may well opt to blockade the patch entirely. Last year, after the 2003 tax cuts were extended, our congressional sources told us that the GOP would be prepared to let the patch expire this year, to let the chips fall where they may, and let the resulting ruckus give them the opportunity to run in 2008 as the party most likely to reform the tax code in the future.

Failing to extend the patch would be a bad thing for growth. But the worst-case scenario would be for the GOP to agree to trade today's low rates on capital gains for it. There is a non-zero risk of that happening, if the GOP will interpret its defeat last November as a signal from the electorate to abandon its commitment to low taxes for "the rich." The "growth wing" of the GOP is in a state of high agitation about this risk, its operatives planting rumors in the press that the Bush administration has made a secret deal to hike the payroll tax on wealthier earners to reform Social Security, and that Bush intends to announce in his State of the Union address that he supports a "carbon tax" to combat global warming. Such rumors are planted specifically to

elicit denials that will put the administration on record, and happily those denials have come. In fact it turns out that Bush will use the SOTU to announce a new tax *cut* -- a personal deduction for health insurance expenses.

BOTTOM LINE: At the very least, the era of tax-*cutting* is over. The only question is whether and when there will be tax *hikes*. In the near term, we expect that the Democrats and the GOP will find a way to extend the AMT patch for another year without disastrous offsets. But the risk of a political rupture -- in which the GOP either blockades the patch or caves by agreeing to anti-growth offsets -- is non-trivial. This risk gives us another reason to temper our short-term optimism about equities. For the moment, reaccelerating growth is good for the forward earnings that are driving stocks higher. But by March or April, ugly tax warfare will be out in the open. In a similar timeframe, faster growth and persistent inflation will have continued to shift Fed expectations from easing to tightening. We're not prepared to call the top here and now, but there is a good case for taking a little off the table here with the long-term in mind. But for investors who want to play it a little closer to the edge, we would be buyers of near-term weakness. We are likely to get another chance to sell into strength. TM