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Fiscal Update: Tax Risk in 2009 Still Hard To Price

In 2009 and 2010, the new President's policies on the dollar and taxes will be key issues in U.S. economic performance. We think the tax risks are already having a negative impact on equities.

- By avoiding discussion of the dollar at the just-ended G8 meeting, the Bush administration isn't showing any inclination to shift away from its policy of encouraging a super-weak dollar. We think the 2009 dollar policy, the key investment issue in our view, depends on Fed dovishness, and on presidential candidates if they take a view. If Washington expresses a preference for a stronger dollar (rather than the decided preference for a weak dollar implied in its current stance), we think it would have very positive implications for investments in the U.S. and would cause a major shift away from commodity companies and countries.
- Tax policy will be almost as important to economic performance as dollar policy in 2009 and 2010. The U.S. is in a unique (and dangerous) situation. The 2003 Bush tax rates on labor, dividends and capital gains are set to revert to higher levels automatically (unusual in itself); and Senate budget procedures lower the vote hurdle for tax increases to 50 votes (from 60) when the President and Congress are of the same party.

Tax Hikes are Already in Law

<u>Tax legislation</u>	<u>Rate through 2010</u>	<u>Rate after 2010</u>
Tax rates on dividends	15%	up to 39.6%
Tax rates on capital gains	15%	20%
Individual income tax rates	10%	15%
	15%	15%
	25%	28%
	28%	31%
	33%	36%
	35%	39.6%
Estate taxes	top rate falls from 45% currently to 0% in 2010	55%

Tax-Writing Procedures and Timetable

In about September 2008, we expect Congress to approve another inflation patch for the alternative minimum tax. The “no offset” precedent set in 2007 will probably extend to 2008, so there won’t be a repeat of the 2007 discussion of the taxation of private equity and other revenue “raisers” until 2009.

In January 2009, President Bush has the option of submitting a budget. If so, it would become part of the historical record, but wouldn’t impact legislation. The new President will submit his own FY2010 budget in March or April 2009, which will then be examined by the budget committees.

- The House and Senate Budget Committees will write a budget in April or May 2009 and work to get a joint House-Senate resolution. The joint budget resolution isn’t signed or approved by the president, though he may be consulted on it.
- Regardless of who wins the presidency, the FY2010 congressional budget will likely propose many tax increases. One set of tax increases will be in the form of “offsets” for the increasingly large alternative minimum tax patch. (Since the AMT is not indexed for inflation, each year the patch is bigger. Congress assumes there would be no economic cost from bracket creep, so the offsets from the assumed revenue loss grow almost exponentially. There’s a 2-27-07 WSJ article on this in our website library at EncimaGlobal.com.)
- Another set of tax increases will be offsets for tax cut proposals – for example, a cut in the corporate tax rate might be offset by loophole closers in other parts of the tax code; similarly, a middle-class tax cut might be offset by tax increases on high incomes.
- Under Congressional procedures, there’s no consideration of the overall economic impact of the tax changes, so an anti-growth tax change (like higher marginal tax rates on small businesses) is not penalized in the scoring process.

In the summer of 2009, the tax-writing committees (Finance and Ways & Means) will write major tax legislation. At a minimum, this will include legislation to patch the AMT and revise the inheritance tax system (otherwise some might be placed on life-support systems to extend their life into 2010 to benefit from the current-law 0% estate tax rate.)

- If Senator McCain is president, the committees would have to work some with the Administration to avoid a veto (which would take two-thirds of the House and Senate to override.)
- If Senator Obama is president, the tax-writing committees would have broad flexibility under the budget to work on Administration and Congressional tax priorities as long as they were scored as increasing government revenues (again, with the proviso that the economic impact of the tax increases is not considered in the scoring and budgeting process.) If provisions meet the budget requirements, they can be approved by 50 yes votes (plus the vice president in the event of a tie) rather than the normal Senate requirement of 60 votes to avoid filibuster.

Market Implications

If Senator Obama is president, we expect major tax changes in 2009 (to take advantage of the honeymoon.) He would likely work with the budget committees and then the tax-writing committees to meet his tax goals, with the critical constraint (a low hurdle) probably being the need for a simple majority in the Senate Finance Committee.

- The Obama Administration and Congress would have broad latitude in the style and timing of various tax changes. In order to meet the budget requirement of increasing tax revenues (reducing the deficit), the tax changes would have to offset the cost of maintaining any part of the 2003 Bush tax cuts (for example, wide-ranging tax increases elsewhere if the decision is made to keep the dividend rate, currently 15%, from reverting to ordinary income.)
- However, on the assumption that the November election pulls Senator Obama toward the middle in rhetoric and commitments, the broad range of possible outcomes from the mid-2009 tax-writing process argues that markets will have trouble pricing their impact until May 2009 or later when the new Administration's intentions are clearer.

If Senator McCain becomes president, most of the 2009 tax legislation would probably deal with the inheritance tax and the AMT.

- The broader issues raised by the expiration of the 2003 Bush tax cuts, the desire to lower the corporate tax rate, and the deep flaws in congressional scoring procedures would be put off until 2010 along with the market impact.

Tax rates are a major driver of the equity market because they impact the expected after-tax return to taxable investors, which is embedded in equity valuations. After-tax returns depend directly on the corporate tax rate and both the dividend and capital gains rates. They also depend some on the individual tax rate because employees have to be paid more if their personal tax rates go up.

- The 2003 tax cut lowered tax rates and therefore increased expected after-tax returns, adding trillions of dollars to U.S. equity market capitalization as the tax cut was negotiated (our June 2, 2003 piece on this was called Tax Cut Gains \$750 Billion, ROI Already 150%.) Congress's rules prevented these gains (and the future tax receipts they generated) from being considered in the scoring of the 2003 tax rate cut, so it was criticized as a tax cut even though it raised hundreds of billions in additional revenue through growth and asset appreciation.

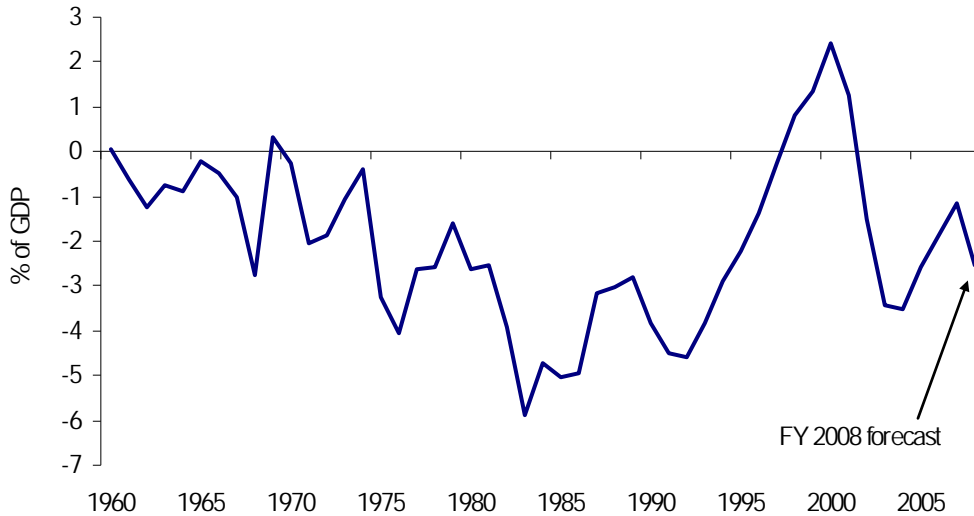
Weekly S&P 500 Equity Price Index (last obs. July 4, 2008)



Debt and Deficit Update

With the economic slowdown and write-offs in the financial industry, we expect the budget deficit to increase to \$365 billion (was \$380B) in FY 2008 (ending in September 2008), up from \$162B in FY07 and \$248B in FY06.

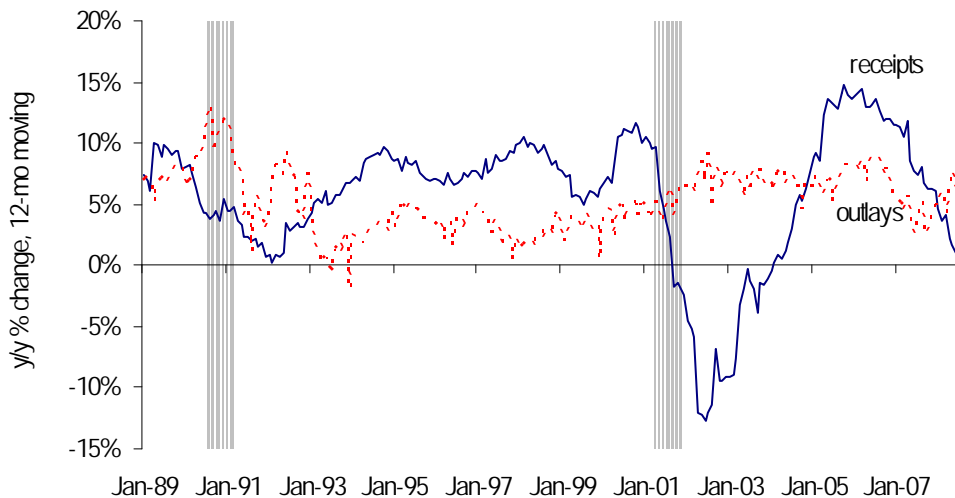
Federal Government Deficit as a % of GDP



Source: Haver; Encima Global

- Growth in tax receipts soared during the expansion, but has slowed sharply with the economic slowdown. June data on tax receipts showed an estimated 2% decline in corporate tax receipts from June 2007. Taxes withheld for income and social security rose an estimated 5% year-over-year, confirming the year-over-year gain in employment showing up in the household employment survey (see our July 3 employment graph in the EncimaGlobal library.)

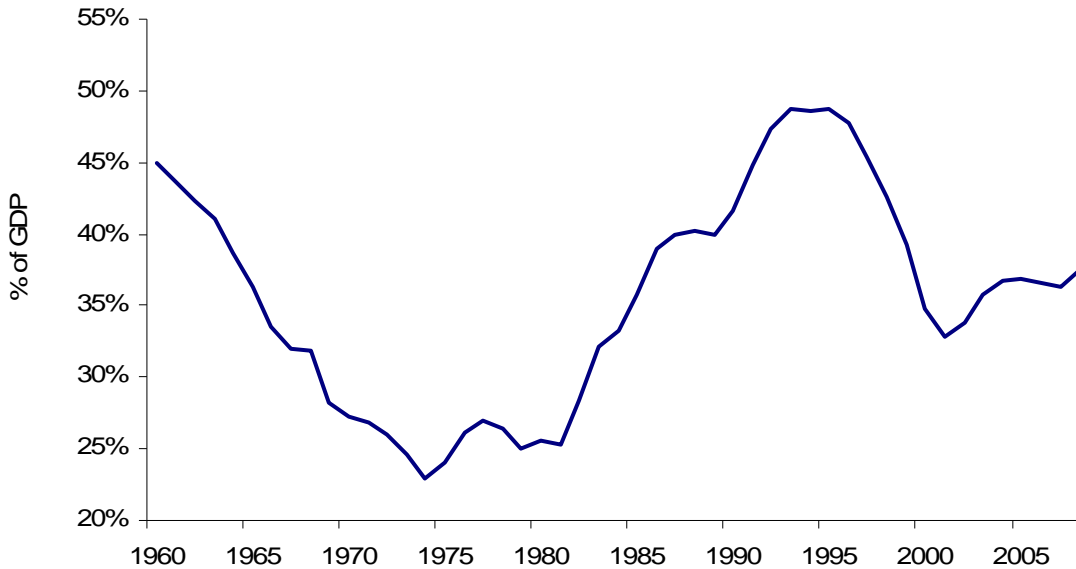
Growth of Tax Receipts and Outlays (last obs. May 2008, est June)



Source: Haver; Encima Global

- In terms of the marketable debt to GDP ratio, it has been rising gradually during the Bush administration.

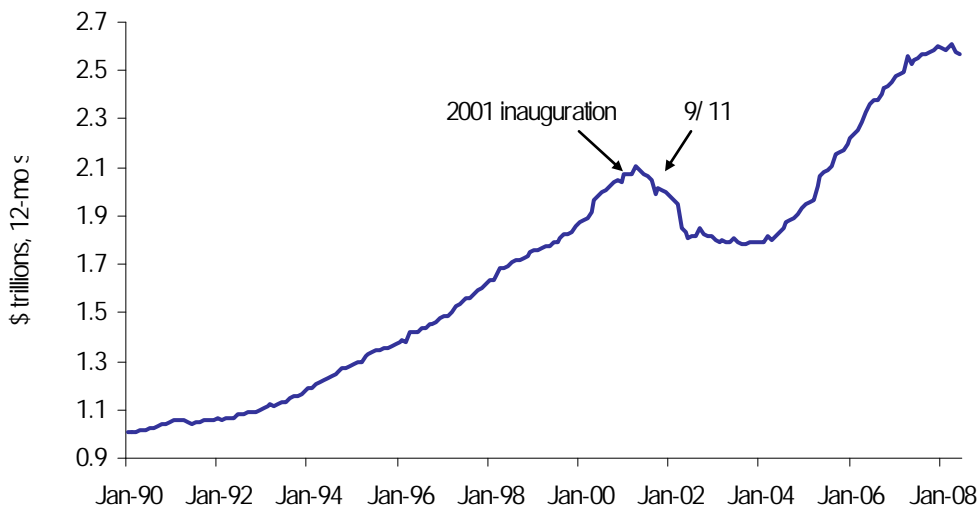
Federal Government Debt as % of GDP (last obs. FY2007, est 2008)



Source: Haver; Encima Global

- In dollar terms, tax *receipts* tend to go up except during recessions, but the issue for growth and equity markets in 2009 is which tax *rates* go up and by how much. The 2003 tax cut had a dramatically positive impact on equity performance. Tax policy may be equally influential in economic and market performance in the next decade.

Federal Tax Revenues \$ trillions (Last obs. May 2008, est June)



Source: Haver; Encima Global

Notes

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