Weekly Market Commentary

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A Taxing Issue for Investors

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Highlights

Perhaps surprisingly, it appears that the tax rate changes have played little or no direct role in stock or bond market performance.

The most likely reason is that the effects on after-tax returns were deemed negligible relative to the macroeconomic and geopolitical drivers.

The far bigger impact is an indirect one determined by the magnitude and direction of overall fiscal policy taken (or not taken) in 2013 to put the United States back on a path to financial stability.

This Tuesday, April 17, is tax day—and it may never be the same. The 2012 elections hold major consequences; one of them is tax policy. While there is much that we could present regarding the potential changes, we will constrain our comments to how tax changes may directly affect investors in the stock and bond markets.

Already written into law for 2013 are big changes including the expiration of the Bush tax cuts and the payroll tax cut and the new Medicare tax on investment income, not to mention the impact of the increasingly costly annual fix to the alternative minimum tax. However, this default option may instead be replaced by something else.

- President Obama has devoted a lot of his recent campaigning to highlighting his preference for the so-called "Buffet rule," which places a top minimum tax rate on capital gains of 30% and, combined with other changes, produces a top rate of 43.4% on dividends and interest income.
- Alternatively, included in the Mitt Romney supported House Republicans' proposal is a cut to the top income tax rate that would apply to interest income to 25% and maintain the 15% rate on dividends and capital gains.

The outcome is likely to be somewhere in the middle of the wide range between these two proposals. Given the scale of the changes, it may be surprising to note that we do not expect major direct impacts of tax changes on the stock or bond market. The far bigger impact is an indirect one determined by the magnitude and direction of overall fiscal policy taken (or not taken) in 2013 to put the United States back on a path to financial stability.

Bond Market Tax Rate Impacts

Historically, changes in income tax rates that apply to interest income appear to have had little, if any, direct impact on government bond yields. Yields rose with inflation in the 1970s and fell as inflation fears receded over the vast majority of the last 30 years regardless of tax code changes or their impact on the deficit.

Over the past 30 years, municipal bond yields traditionally traded at a discount to taxable bond yields. However, in recent years credit fears driven by macroeconomic events have resulted in a breakdown of the historic spread between taxable and non-taxable municipal bonds. Municipal bonds now trade at yields in line or above those of their taxable Treasury

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counterparts. The potential for higher income tax rates applied to interest income is likely to make municipal bonds even more attractive to investors as credit fears fade.

Stock Market Tax Rate Impacts

Tax changes have also had minimal effects on stock market performance. To illustrate, we can look at the two most important drivers of stock market return: earnings growth and valuations.

Generally, higher taxes mean less of an incentive for individuals to work, invest, take risks to create value and become entrepreneurs. It can also mean less disposable income to spend on goods and services. However, income tax changes have not had much measurable effect on earnings growth.

Earnings growth is very cyclical — it falls sharply during recessions and rebounds early in expansions to average about a 7% growth rate over the full cycle. This has been consistent regardless of the prevailing tax rates. In fact, the growth rate of earnings from the peak of one business cycle to the next has consistently been about 7% over the six major earnings cycles spanning the past 50 years, despite average top marginal income tax rates that ranged from 91% at the beginning of the period to the current 35% and corporate tax rates that ranged from 52.8% to 34%.

Earnings and Taxes: Tax Rates and Earnings Cycles for S&P 500 Companies

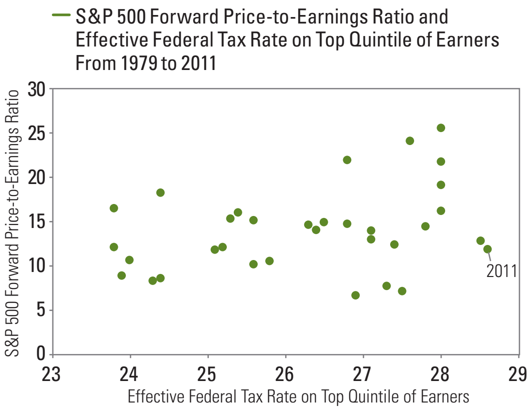
Earnings Cycle Peak	Annualized Earnings Growth from Prior Cycle Peak in %	Top Marginal Income Tax Rate (Cycle Average) in %	Top Marginal Corporate Tax Rate (Cycle Average) in %
Sep-69	5.4	80	50
Sep-74	9.1	70	49
Dec-81	7.5	70	47
Jun-89	7.4	48	43
Sep-00	7.2	36	35
Jun-07	7.2	36	35

Source: LPL Financial, Thomson Financial, Center for Tax Policy 04/16/12

With no discernible effect on earnings growth, what about the impact of tax rates on valuations? Certainly, tax rates have the ability to directly impact the value investors place on the stock market. In theory, stocks are valued by investors based on expected total return, net of applicable taxes. For example, if dividend and capital gains taxes were each set at 100%, stocks would have little value to a taxable investor. It is reasonable to believe that the lower the tax rate, the more a taxable investor would value stocks up to that of a non-taxable investor.

However, over the past 30 years, higher effective federal income tax rates for the top 20% of earners (who tend to make up the majority of individual investors) have not resulted in lower stock market valuations, measured by

1 Valuation and Taxes



Source: LPL Financial, Thomson Financial, Congressional Budget Office 04/16/12

the price-to-earnings ratio for the S&P 500 index. Counter-intuitively, periods of higher valuations occurred during periods of higher effective tax rates and lower valuations occurred when tax rates were lower. Much of this can be explained by cyclical factors. For example, in the late 1990s, stock market valuations rose to record highs despite relatively high marginal and effective tax rates.

Based on our analysis of the tax debate in Washington, we place the highest probability on the dividend and capital gains tax rates both rising to 20–30%. However, a reversion to the much higher rates that preceded the Bush tax cuts or a one-year extension of all current tax rates of 15% are also possible outcomes.

Investor Tax Changes: Interest, Dividend and Capital Gains Taxes

	Pre-Bush Tax Cut Rates	2012	Current Law 2013*	Obama Proposal 2013**	Romney supported House GOP Proposal 2013
Top Rate on Interest	39.6%	35%	43.4%	43.4%	25%
Top Rate on Dividends	39.6%	15%	43.4%	43.4%	15%
Top Rate on Capital Gains	20%	15%	23.8%	30%	15%

* Includes the new 3.8% percent tax on interest, dividends and capital gains.

** Includes "Buffet tax"

One reason the direct impact of tax rate changes may be muted is that it appears that stocks may already reflect the return of higher tax rates. One way we can see this is to look back at prior periods with similar tax rates and what it may imply for 2013. If we average the historical top dividend and capital gains tax rates together, we find that during the post-WWII period a 25–30% combined investor tax rate was in effect only during 1991–92 and 1997–2002. During the later period, stock market valuation was at record highs well above current levels and do not serve as a good comparison due to the impact of the internet bubble distorting the overall market value. However, 1991–92 may offer a comparable period for analysis. During this period, the macroeconomic and geopolitical backdrop included the aftermath of the S&L crisis, sluggish U.S. economic growth, a European recession, the geopolitical risks surrounding the first Gulf War, and pessimistic consumers.

During this 1991–92 period, the average top dividend and capital gains tax rate was between 25% and 30%, and stock market valuation, measured by the price-to-earnings ratio on the next twelve months expected earnings for the S&P 500 companies, was about 15. This figure is above the current forward price-to-earnings ratio of about 13. What this suggests is that while there are many factors that affect stock market valuation, the direct impact of the potential for higher tax rates on dividends and capital gains may already be discounted by the market.

Investor Tax Rate Changes

It seems that the bond and stock markets have adjusted to different tax rates without any apparent long-term direct effects on performance. But what about during short-term periods when those rates were changed, did markets have abrupt adjustments to the changes in rates? The answer is no; history shows that the markets took the changes in stride.

For example, the capital gains tax rate went from 20% to 28% for 1987 when the 1986 tax reform act was passed, and that did not stop a rally in stocks beginning as the act was passed that lasted for most of 1987 (until the unrelated October 1987 crash).

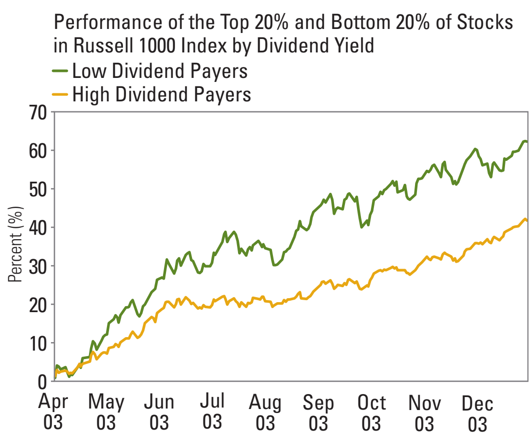
In addition, the market impact of the investor tax cuts in 2003 that lowered dividend and capital gains tax rates to 15% was difficult to discern, given the geopolitical and economic environment at the time, and the impact of the reversal of these provisions may be equally difficult to discern separately from their macro context. We can see this difficulty by looking back at the stock market's reactions to the news of the proposed investor tax cut and then the passage of those cuts:

- Initial details of the 2003 investor tax cuts began to appear in early December of 2002 with a statement from President Bush providing further insight into the package of tax cuts on January 7, 2003. Stocks slumped in December and January—even around the days details came to light—as investors were focused on the impending invasion of Iraq. The performance of both non-dividend paying and dividend-paying stocks was very similar, despite the prospects for a cut in the dividend tax rate.
- Attention returned to the tax cuts in April 2003, as competing bills with various provisions moved through both houses of Congress. There was much uncertainty as to what the final tax cut elements were to be and whether any investor tax cuts were going to be passed. The tax bill narrowly passed in mid-May with Vice President Cheney breaking the tie in the Senate. The package including the investor tax cuts was signed by the President on May 28, 2003. As you can see in Chart 2, in April and May (and over the rest of the year), the stocks of low or no dividend-paying companies outperformed high dividend payers as stocks rallied powerfully and the invasion of Iraq got underway.

During both of the above-referenced periods, U.S. and non-U.S. stocks also performed very similarly, with the world focused on Iraq. The impact of the investor tax cuts in the U.S. did not result in U.S. stock market outperformance. Also, low and non-dividend paying stocks outperformed the high-dividend payers that would benefit most from the lower dividend tax rate.

It appears that the tax rate changes have played little or no direct role in stock or bond market performance. Possible reasons may be that investors discounted the effect since changes were not made permanent or, more likely, that the effects on after-tax returns were deemed negligible relative to the macroeconomic and geopolitical drivers.

2 High Dividend Paying Stocks Underperformed When Dividend Tax Cut Passed



Source: LPL Financial, FactSet Research Systems 04/16/12

Past performance is no guarantee of future results.

We believe the heightened attention on taxes and the deficit is more of a concern than in prior episodes of tax rate change. The direction of the markets is dependent upon substantive action taken to address the debt ceiling, potential debt downgrades, and fiscal stability with any change in tax rates likely to be secondary to how successfully the challenges are addressed.

Year-End Effects

While history suggests otherwise, given that a lame duck session after the election is unlikely to result in enough time or cohesion to adjust tax rates before they change, investors might take action around year-end to take advantage of expiring low tax rates. As the year-end expiration of the 15% capital gains tax rate looms, investors might be prompted to sell to lock in the 15% rate. Also, a potential outcome of the year-end dividend rate tax hike could be a large number of public companies with a high concentration of family and closely held shares declaring and making a one-time, special dividend payment in the fourth quarter to be sure to take advantage of the 15% tax rate before it goes away. ■

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