

Thought for the Week: Monday, December 6th, 2010

Breaking Tax News...

If Death and Taxes are the only two certainties in life, as Ben Franklin once opined, most tax-paying American citizens may be about to receive **a two year, temporary reprieve** in the form of President Obama's Dec 6th statement on (a framework for) Tax Cuts and Unemployment. This addressed the burning "will they; won't they" question of whether **the Bush Tax Cuts will be extended**.

Ignoring the political name calling and the fact there may be objections from both sides of the political fence before anything gets enacted, the real 'meat' of the communiqué was:

"... we have arrived at a framework for a bipartisan agreement. For the next two years, every American family will keep their tax cuts -- not just the Bush tax cuts, but those that have been put in place over the last couple of years..."

Specifically, this means both sides of the house have negotiated a settlement which should result in:

- The **retention of ALL 'Bush' Tax Cuts** announced in 2001 and 2003.
- Reinstatement of **Estate Tax at a reduced 35% rate** and an exemption level of \$5million. Except for the temporary repeal of the estate tax this year, the rate has not been less than 45 percent since 1931.
- An **adjustment in the Alternative Minimum Tax (AMT)** for 2011. More than 21 million taxpayers will win a reprieve from the Alternative Minimum Tax for both 2010 and 2011.
- A **reduction in Social Security payroll tax** from 6.2% to 4.2% with effect from 2011. If you make \$50,000 a year you will pay \$1,000 less. If you get paid twice a month, you will have an extra \$41.67 in your paycheck starting in January. Anyone who makes more than \$106,800 a year will receive the maximum savings of \$2,136.
- The retention of the Earned Income **Tax Credit**, Child tax Credit and American Opportunity Tax Credit.

President Obama made it clear he supports the extension of these tax cuts for the middle class only; he intends making the extensions **temporary for the wealthiest 2%** of Americans.

The economic effects of this announcement, as calculated by the Congressional Budget Office, are approximately:

- **Employment increasing** in the range of 200,000 to 600,000 jobs in 2011 and 300,000 to 1,000,000 in 2012
- **GDP growing** by between 0.3% to 0.9% in 2011 and 0.3% to 1.1% in 2012.

The cost of these measures will be met by increasing government debt. Current **estimates put the cost at \$900 billion over the next two years**.

Our Thoughts

We hope Democrats and Republicans work together to quickly enact the above statement and believe that 'behind-the-scenes' deals to this end have already been struck.

Middle class families will be protected from tax increases at a time they can least afford them; **unemployment benefits will be extended** for those who are out of work and incentives will be provided for **businesses to create jobs**.

This is clearly **designed to stimulate growth and improve employment**, which recently and unexpectedly rose to 9.8%, as we predicted a month ago. Neither side can be caught voting against these two goals for too long.

Should the pronouncements pass into law, we expect:

- **Equities to continue their steady recovery**, although we may see a small correction as many prices are starting to look a little 'exuberant' (getting a little ahead of themselves without support from improved earnings and prospects).
- Bonds should continue their low yield, high price holding pattern for the coming months; however, we are **now more concerned about the long-term price prospects for bonds**, especially longer duration.
- The commitment of additional funds to stimulate growth deepens the debt hole the government will have to climb out of, but it also creates growth which may lead to better places for investors to invest. Why park money in Treasuries when riskier, **higher yielding (but traditionally more volatile) assets look increasingly attractive** from a credit default standpoint?
- The **increased debt levels required to finance this initiative** will require the government to issue more Treasuries, thereby increasing supply and potentially causing prices to fall. To put this into context, the government spent about \$25billion bailing out the auto industry and \$700billion on TARP (the banking bailout) – extending the Bush Tax Cuts is a meaningful expense.
- **Inflation should rise** with improving economic prospects and confidence; an imminent double-dip recession now seems improbable in the foreseeable future.
- The 'worse-than-expected' employment numbers suggest the government will continue to pump money into the economy. Just as QE2 leaves the shipyard and sails into the distance, **QE3 is on the drawing board**.

Should the pronouncements not pass into law, we expect: ...a short-term, knee-jerk sell off!

- **Failure to pass these measures is unconscionable** and it's clear both sides have a lot to gain and lose. Whoever gets tagged with stopping this stimulus will get tagged with all the ills of the economy, employment, housing and so on.
- For those of us who were watching the TV screens as our political leaders voted on TARP, we all know a political stand-off is not beyond Capitol Hill. Should this happen, active value-based investors like ourselves will most likely see **an opportunity for bargain hunting**.

Where the **Machiavellian machinations of the political machine** are concerned, never say never!