



Weekly Market Commentary

July 26, 2010



Jeffrey Kleintop, CFA

Chief Market Strategist
LPL Financial

Highlights

While information on the economy, European bank stress tests, and corporate earnings helped to lift the markets last week, it may have been the hint that tax rates may not be going up as much as expected in 2011 that got investors the most excited.

The potential for much higher tax rates on dividends and capital gains appears to be discounted by the market, suggesting a potential relief rally as the tax uncertainty is resolved.

However, we do not expect Congress to act on taxes until after the November elections.

Tax Hike 2011

While information on the economy, European bank stress tests, and corporate earnings helped to lift the markets last week, it may have been the hint that tax rates may not be going up as much as expected in 2011 that got investors the most excited. Based on comments from last week, the party consensus among congressional Democrats on taxes seems to be eroding with some members increasingly in favor of extending the Bush tax cuts as the November elections loom.

Last week Senate Democrats Kent Conrad and Ben Nelson joined Senator Evan Bayh in saying they supported extending the Bush tax cuts for all earners—including those with the highest incomes. In addition, at least half a dozen House Democrats also have come out publicly in favor of postponing tax increases for higher earners. The comments from the senators represent a departure from what appeared to be an emerging unified Democratic stance on the Bush tax cuts, which held that those for the top earners should be allowed to expire and investor tax rates on dividends and capital gains should be lifted to 25%–28%.

The internal party debate increases the odds that Democrats will be unable to tackle the question of 2011 tax rates until after the November election. After the election they may choose to waive the PAYGO rules that require any tax cuts to be paid for through other tax hikes or spending cuts in order to amend tax rates in a lame duck session and avoid a 2011 tax hike back to pre-Bush levels.

The current S&P 500 price-to-earnings ratio on the next 12-month earnings expectations is around 12. This is well below the average of 15 and reflects not only the uncertainty of the transition in the global economy from recovery to sustainable growth, but also the transition in spending and tax policy.

Investor Tax Rate Changes

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. Looking at the post-WWII relationship between investor tax rates and stock market valuations based on trailing price-to-earnings ratios, we can see that stocks appear to have already priced in a return to much higher investor 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 25%. But we also acknowledge 20% or 30% rates are also potential outcomes as is a reversion to the 39.6% and 20% rates that preceded the 2003 cuts or a one year extension of all current tax rates of 15%.

Dividend and Capital Gains Tax Changes

	Pre-2003 Rates	Current Law 2010	Current Law 2011	Obama Proposal	Democrat Consensus
Top Dividend Rate	39.6%	15%	39.6%	20%	25-28%
Top Cap Gains Rate	20%	15%	20%	20%	25-28%

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 does 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 economic growth, the first Gulf War, pessimistic consumers, and a weakening dollar.

During the 1991-92 period, the average top dividend and capital gains tax rate was between 25%–30%, and stock market valuation, measured by the price-to-earnings ratio on the next 12 months expected earnings for the S&P 500 companies, was about 15. This figure is well above the current forward price-to-earnings ratio of about 12. While there are many factors that affect stock market valuation, the potential for higher tax rates on dividends and capital gains may already be fully discounted by the market. In fact, at 12 times forward earnings, stocks appear to be pricing in a return to when the average rate was around 35% suggesting a potential relief rally as the tax uncertainty is resolved.

Stock Market Impact of Investor Tax Changes

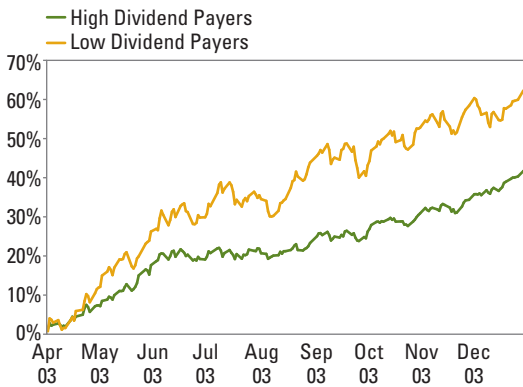
It is very difficult to determine how much of a market impact may be generated by the tax rate changes in the dividend and capital gains tax rates. It is hard to separate the impact of tax code changes from the economic backdrop for the stock market.

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

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



1 High Dividend Paying Stocks Underperformed When Dividend Tax Cut Passed
Performance of the Top 20% and Bottom 20% of Stocks in the Russell 1000 Index by Dividend Yield



Source: LPL Research, Factset Research Systems 7/23/10

The Russell 1000 Index is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

market's reactions to the news of a 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. 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 cuts played little or no role in stock market performance. Possible reasons may be that investors discounted the effect on future dividends since the cuts were not made permanent or that the effects on after-tax returns were deemed negligible relative to the macroeconomic and geopolitical drivers.

We believe the heightened attention on taxes and the deficit is more of a concern than in prior episodes of tax rate change. Consequently, we believe a positive impact of the resolution of uncertainty around tax rates is probable given that the outcome is likely to be better than what investors have priced in to the markets. However, it is difficult to predict the magnitude. One factor that could undermine the impact of any positive action on taxes is that the changes to the dividend and capital gains tax rates may not be permanent. A one year extension of current tax rates may not be as welcome as a resolution of the tax rate uncertainty.

As the year-end expiration of the 15% capital gains tax rate looms investors may be prompted to sell to lock in the 15% rate. However, there are not a lot of long-term capital gains to be taken in the stock market with the major averages still down sharply from their 2007 highs. The selling would most likely take place in sectors that have generated the largest long-term capital gains for those investors who bought stocks in the first half of 2009, such as Financials.

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.

Income Tax Changes

Historically, changes in income tax rates 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.

To see why this relationship is similar for the stock market we can look at the two most important drivers of stock market return: earnings growth and valuations.

Income Tax Changes

Income Ranges (Married Filing Jointly)	Pre-Bush Tax Rates	Current Law		Obama Proposal
	2000	2010	2011	2011
Over \$372,950	39.6	35	39.6	39.6
\$208,850 - \$372,950	36	33	36	36
\$137,050 - \$208,850	31	28	31	28
\$67,900 - \$137,500	28	25	28	25
\$16,700 - \$67,900	15	15	15	15
\$0 - \$16,700	-	10	-	10

Source: Internal Revenue Service, Obama Administration Budget

Impact of Income Tax Rates on Earnings Growth

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%.

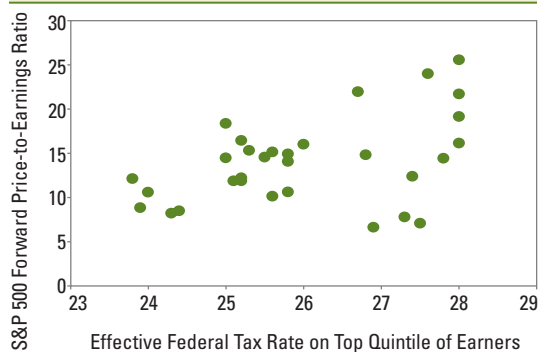
Earnings and Taxes: Individual Tax Rates and Earnings Cycles for S&P 500 Companies

Earnings Cycle Peak	Trailing 4 Quarter Earnings Cycle Peak in \$	Annualized Earnings Growth from Prior Cycle Peak in %	Top Marginal Income Tax Rate (Cycle Average)
Sep-69	5.89	5.4	80
Sep-74	9.11	9.1	70
Dec-81	15.36	7.5	70
Jun-89	26.18	7.4	48
Sep-00	57.33	7.2	36
Jun-07	91.76	7.2	36

Source: LPL Financial, Thomson Financial, Center for Tax Policy



2 S&P 500 Forward Price-to-Earnings Ratio and Effective Federal Tax Rate on Top Quintile From 1979 to 2009



Source: LPL Financial, Thomson Financial, Congressional Budget Office 7/23/10

Impact of Income Tax Rates on Stock Market Valuation

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 the forward price-to-earnings ratio (the current price divided by the next 12 months expected earnings) for the S&P 500 index. Counter-intuitively, periods of higher valuations were during periods of higher effective tax rates and lower valuations when tax rates were lower. However, 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.

Time is Short

On July 30, the House departs for the August recess and the Senate departs on August 8. They return in mid-September and only have a few weeks until early October before they adjourn to campaign for the November 2 mid-term elections. It is highly unlikely that a fractured majority party that is lagging in the polls and an opposing minority party can come together on such a controversial issue ahead of an election in three weeks this fall. The state of the soft spot in the economy may be a motivating factor pushing for an extension of the Bush tax cuts for a year.

Our base case is for a tax bill to be passed in November after the election that raises the top income tax rates to 39.6% and 36%, caps dividend and capital gains rates at about 25%, and the estate tax gets an exemption of \$3.5 million and a 45% tax rate above that. However, last week's news suggests the outcome may be for lower rates than we are forecasting and the market is discounting.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

This information is not intended to be a substitute for specific individualized tax, legal or investment planning advice. We suggest that you discuss your specific tax issues with a qualified tax advisor.

The P/E ratio (price-to-earnings ratio) of a stock is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher P/E ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower P/E ratio.

This research material has been prepared by LPL Financial.

The LPL Financial family of affiliated companies includes LPL Financial and UVEST Financial Services Group, Inc., each of which is a member of FINRA/SIPC.

To the extent you are receiving investment advice from a separately registered independent investment advisor, please note that LPL Financial is not an affiliate of and makes no representation with respect to such entity.

Not FDIC or NCUA/NCUSIF Insured | No Bank or Credit Union Guarantee | May Lose Value | Not Guaranteed by any Government Agency | Not a Bank/Credit Union Deposit