MID CONTINENT CAPITAL

CONSILIUM*

Volume 10 ~ April 2012

*advice; judgment; resolution; wisdom

Fear Gives Way to Optimism, For Now

On the very first trading day of the New Year, the equity markets said their goodbyes to the drama and volatility of 2011 and have not looked back. The S&P 500 Index delivered a 12.6% total return so far this year, its best start to a calendar year since 1998, and with reinvested dividends has reached an all-time high. The gains have been persistent, with the equity market rising every week but two in 2012. Signs of a renewed investor appetite for risk abound:

- Treasury bond prices have tumbled almost 10%.
- The CBOE "VIX" index, a measure of stock price volatility, has slumped 35% to the lowest level since before the 2008 financial crisis.
- Technology stocks have soared over 20%, a phenomenon that extends well beyond just Apple Inc.
- Even more tellingly, financial stocks -- the bane of investors for more than two years -- have risen over 20%.[1]

What's behind the market's renewed vigor, and can it last?

Root causes are not in evidence, unfortunately. It would be fair to say that the environment for equity investors is much the same today as it was three months ago, featuring very low interest rates, very modest economic growth in the U.S. (and recessionary conditions emerging in Europe), high levels of corporate profitability and attractive valuations. With background factors unchanged, then, we are chalking up this year's gains as a reminder that shifts in sentiment are far more important than fundamentals in determining short term stock market returns. Markets are enthusiastically embracing that which they shunned last fall. Things are rarely as bad as they seem to be when things are going badly - and vice versa.

So does the equity market's carefree abandon actually suggest a need for caution? We believe the answer is a qualified "yes". While one can always find reasons to be nervous or skeptical, we would like to highlight one unique -- perhaps even unprecedented -- challenge facing the U.S. economy and investors later this year. This matter is receiving scant attention at present, but we believe it will be uppermost in investors' minds within six months.

We refer, of course, to the largest tax increase in U.S. history, set to commence on January 1, 2013.

By way of background, the reductions in tax rates on dividends, capital gains, and ordinary income that took effect in 2003 were only temporary and are set to expire at this year's end unless there is a legislative action which will be understandably difficult in an election year.

Please turn to next page

If no action is taken the following will occur:[2]

- Tax brackets at every level of income will return to the levels that were in place prior to 2003, with the highest marginal rate rising to 39.6% from 35%.
- The top tax rate on capital gains will return to 20% from 15%, and to 39.6% from 15% on qualified dividends.
- The "marriage penalty", whereby married couples' standard deduction is below that of single filers', will be reinstated.
- Itemized deductions and personal exemptions will once again be phased out as income rises.
- The Alternative Minimum Tax will be greatly expanded, affecting 26 million (mostly) middle-income filers who were shielded previously.
- Payroll tax rates will rise from 4.2% to 6.2%.

In addition, various taxes included in health care reform will commence, including a new levy on investment income of 3.8%. Thus, higher-income taxpayers will be paying a total federal tax rate of 43.4% on dividends and 23.8% on capital gains. Combined, investors could see their after-tax rates of return reduced by well over 100 basis points per annum.

The non-partisan Congressional Budget Office estimates that the combined effect of these changes will be a tax increase of $512 billion in the first year, equivalent to 2.9% of GDP, and 3.9% of personal income - roughly a year's worth of growth.

Adding to this headwind is an array of planned spending reductions, mostly the result of the failed "supercommittee" budget negotiations last fall. At $194 billion, this represents another 1.1% reduction in GDP. All told, the CBO and virtually every private economic forecast estimates that the fall from the looming "fiscal cliff" (as described by Princeton's Alan Blinder) will be enough to push unemployment back over 9%, and the economy back into recession.

The equity market's lack of concern about this issue seems based on an unstated conviction that "something, surely, will be done". And indeed, a furious negotiation will likely begin – *after* the elections.

This is a matter of great significance to the U.S. economy and great uncertainty for investors, and its resolution will have an important impact on investors' portfolios. As we discussed in *Consilium* last fall, high stock prices depend on high levels of conviction; but there is no basis for any strong conviction about how the fiscal cliff will be navigated. At present, these events seem distant enough for most investors to ignore. But will they matter by next month? Or by this summer? Will consumers and businesses begin to anticipate and adjust to these changes, thereby affecting the pace of business activity and corporate earnings? Will taxable investors decide to lock in gains at this year's lower capital gains rates?

The moment when this matter becomes an immediate cause for concern to investors will grow closer with each passing week. We will continue to monitor all tax developments and take investment actions, if appropriate, once there is more clarity.

(1) Source: Baseline

(2) Source: Congressional Budget Office; *The Wall Street Journal*

150 S. Wacker Drive, Suite 400 ◆ Chicago, IL 60606-4101 ◆ Tel: 312.551.8200 ◆ Fax: 312.551.8781 ◆ Web: www.mcllc.com