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**Strategas Research Partners, LLC**

Daniel Clifton (202) 290-8262 dclifton@strategasrp.com  
Elizabeth Karasmeighan (202) 223-7645 ekarasmeighan@strategasrp.com

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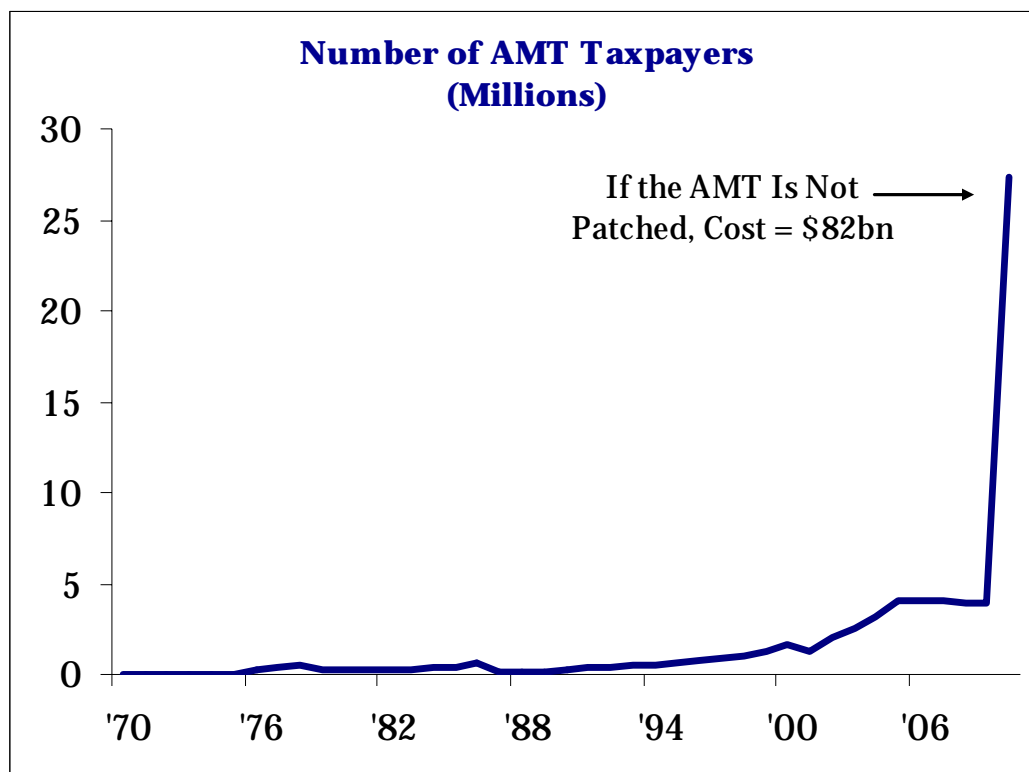
## TAX CUT EXTENSION REMAINS THE BASE CASE, BUT CONGRESSIONAL INACTION COULD WEIGH ON EQUITIES

**Summary:** Despite very noisy headlines, we continue to believe that Congress will enact a temporary extension of all of the expiring tax provisions by the end of the year. Before the extension occurs, however, both the House and Senate will cast symbolic votes on different aspects of the tax cuts, including an extension of just the middle class tax cuts in the House. In the Senate, however, we expect a number of votes, including tax cuts for just those making under \$250k, with a possible \$1 million limit, and a permanent extension of all of the tax cuts. *We don't expect any of the Senate votes to pass but rather to demonstrate the split in the Senate and create the path forward for a temporary extension as the time winds down on the legislative clock.* Yet, there is still a probability that the tax cuts do not pass before December 31<sup>st</sup> and, should this process drag on, we would expect selling pressure in the equity markets to pick up.

- **Pressure Is Beginning To Build For Resolution.** Although we are at the opening round of the negotiations on the tax cuts, catalysts for action are beginning to come in. Extended unemployment benefits eligibility expires today. IRS Commissioner Schulman is warning Congress that without action soon, the entire tax filing season will need to be delayed. Roughly 85 members of the House who will lose their seats next year have to be out of their offices today and will be moved to a cubicle with very little room for staff. The staffs of the leaving members are searching for jobs, and the Holiday Season is quickly approaching. We expect pressure to ratchet up from rank and file members and from the leadership as the year-end deadline approaches.
- **Republicans Have Leverage.** The Senate vote will require 60 votes and the Democrats only have 58 members and the Caucus is split into three factions. Because there is very little agreement among Democrats, a temporary extension will become a much more viable outcome as the clock winds down. House Democrats are vehemently opposed to extending all of the tax cuts, but we believe a majority of House members (Republicans + moderate Democrats) support a clean extension of the tax cuts. Democrats in the House also realize that Republicans will pass their own plan next year if there is no action now, and that this is the last chance for unemployment benefits to be extended.
- **Alternative Minimum Tax Patch Remains The Key Catalyst.** The patch for the Alternative Minimum Tax expired at the end of 2009, which means 27 million Americans are on the hook for the tax for CY '10, and will be forced to pay an additional \$70bn of tax payments in March/April 2011. Unlike the other tax cuts, we don't believe this could be fixed retroactively should the patch not be resolved before the end of the year. Expiration is both a political and economic disaster for the Obama Administration, and we believe this should be the incentive to get the presidential leadership needed to complete the bill before the end of the year.

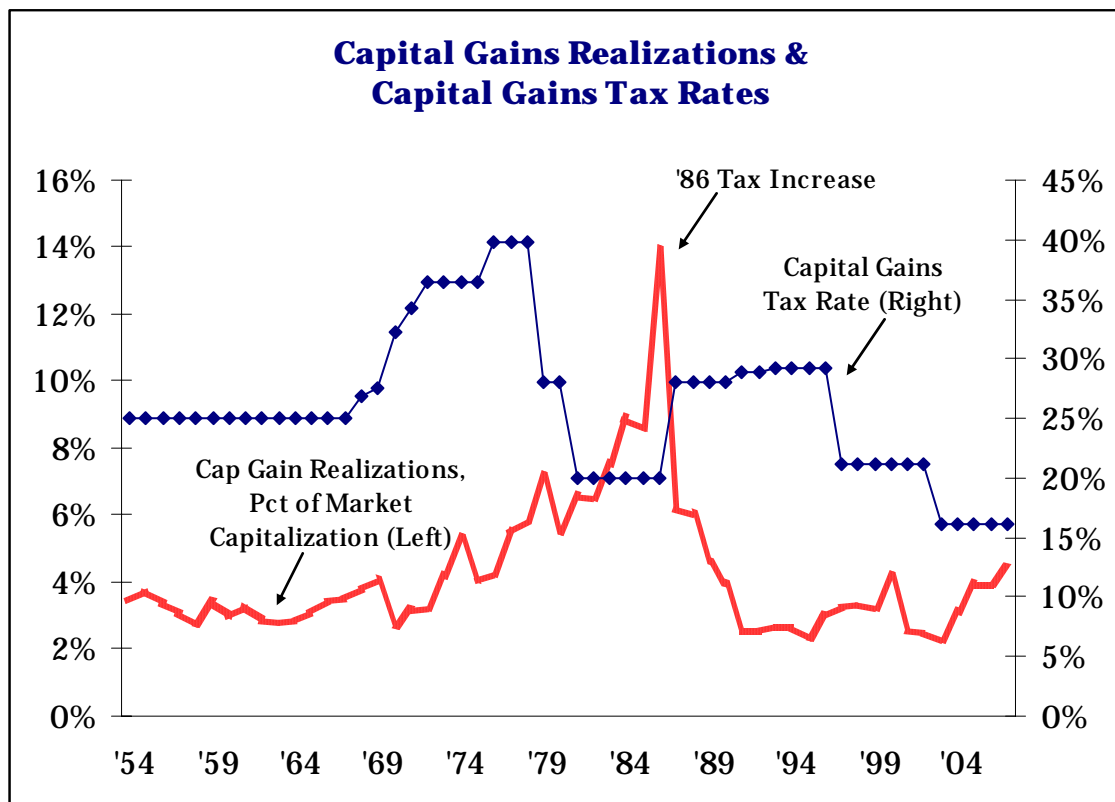
## FISCAL DRAG FROM THE BUSH TAX CUT EXPIRATION ALONE EQUATES TO 2 PCT OF DISPOSABLE INCOME IN 2011, AMT PATCH IS THE LARGEST COMPONENT OF THE DRAG

<b>Effects of Extending Expiring Tax Provisions (\$BN, CBO)</b>						
<b>Tax Provision</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>5 Year</b>
Deduction for Ed. Expenses	-0.7	-0.6	-0.6	-0.6	-0.7	-3.2
Child Credit	-7.1	-35.6	-36.4	-36.9	-37.3	-153.3
EITC	*	-4.4	-4.5	-4.6	-4.6	-18.1
Education Provisions	-0.7	-1.0	-1.1	-1.1	-1.1	-5.0
Estate & Gift Tax	-11.0	-42.0	-49.0	-55.0	-60.8	-217.8
10 Pct. Bracket	-30.7	-44.7	-45.9	-46.8	-47.2	-215.3
Tax Rates of 25, 28, 33, 35 Pct.	-33.9	-50.3	-55.1	-61.0	-65.6	-265.9
Itemized Deduction & Personal Exemption Phaseout	-4.9	-10.6	-12.2	-13.6	-15.0	-56.3
Eliminate Marriage Penalty	-6.0	-8.7	-8.8	-8.8	-8.6	-40.9
Other (Dependent Care, Adoption Credit etc)	-0.1	-1.0	-1.2	-1.3	-1.4	-5.0
Making Work Pay	-28.8	-62.0	-62.5	-61.8	-62.0	-277.1
Cap Gains & Dividends Rate	-14.4	-12.7	-30.4	-29.2	-32.4	-119.1
<b>SUBTOTAL</b>	<b>-138.3</b>	<b>-273.6</b>	<b>-307.7</b>	<b>-320.7</b>	<b>-336.7</b>	<b>-1377.0</b>
AMT (Interactive Effects)	-12.6	-43.4	-48.2	-53.2	-57.9	-215.3
AMT	-71.9	-31.0	-35.0	-38.8	-43.1	-219.8
<b>TOTAL (With AMT &amp; AMT Interactive Effects)</b>	<b>-222.8</b>	<b>-348.0</b>	<b>-390.9</b>	<b>-412.7</b>	<b>-437.7</b>	<b>-1812.1</b>

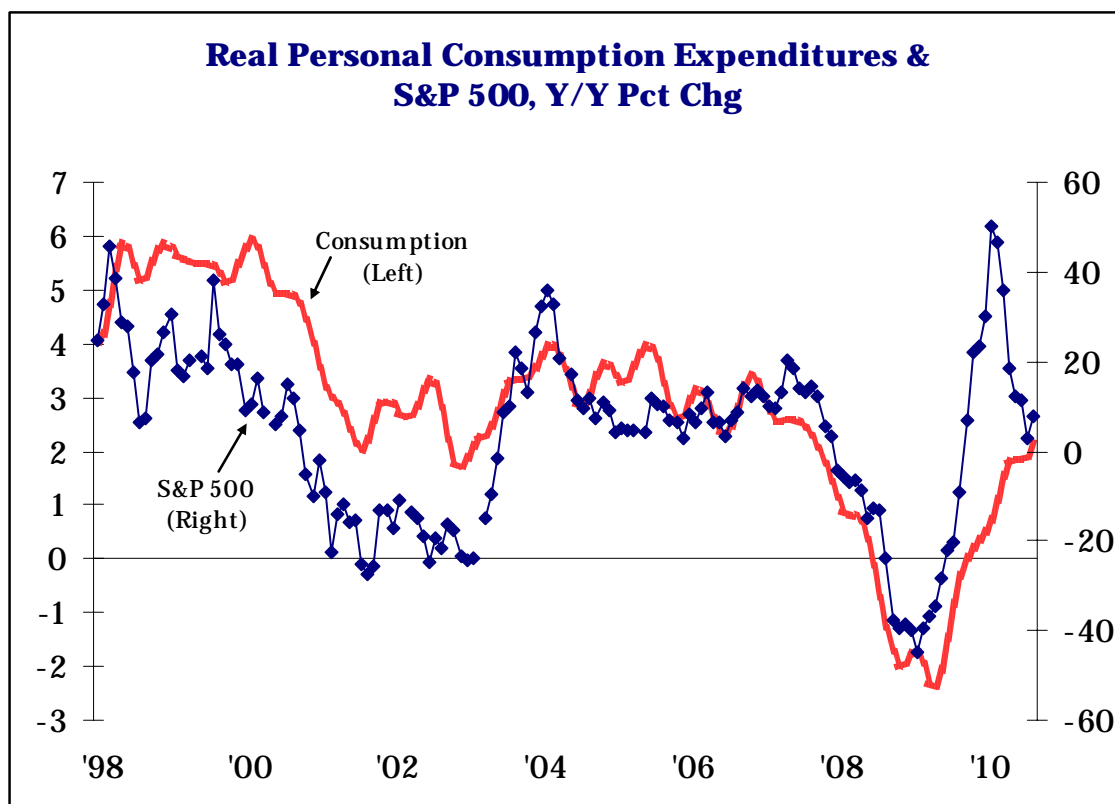


The talk of retroactively fixing the tax cuts ignores the fact that the AMT patch cannot be retroactively fixed and is the largest component of the tax increase. Hence, in March and April, 27 million taxpayers will be facing an additional \$70bn in tax payments. The hit to consumer spending would be significant, particularly since the data are annualized.

# THE LONGER CONGRESS WAITS, THE GREATER THE PRESSURE ON EQUITY MARKETS

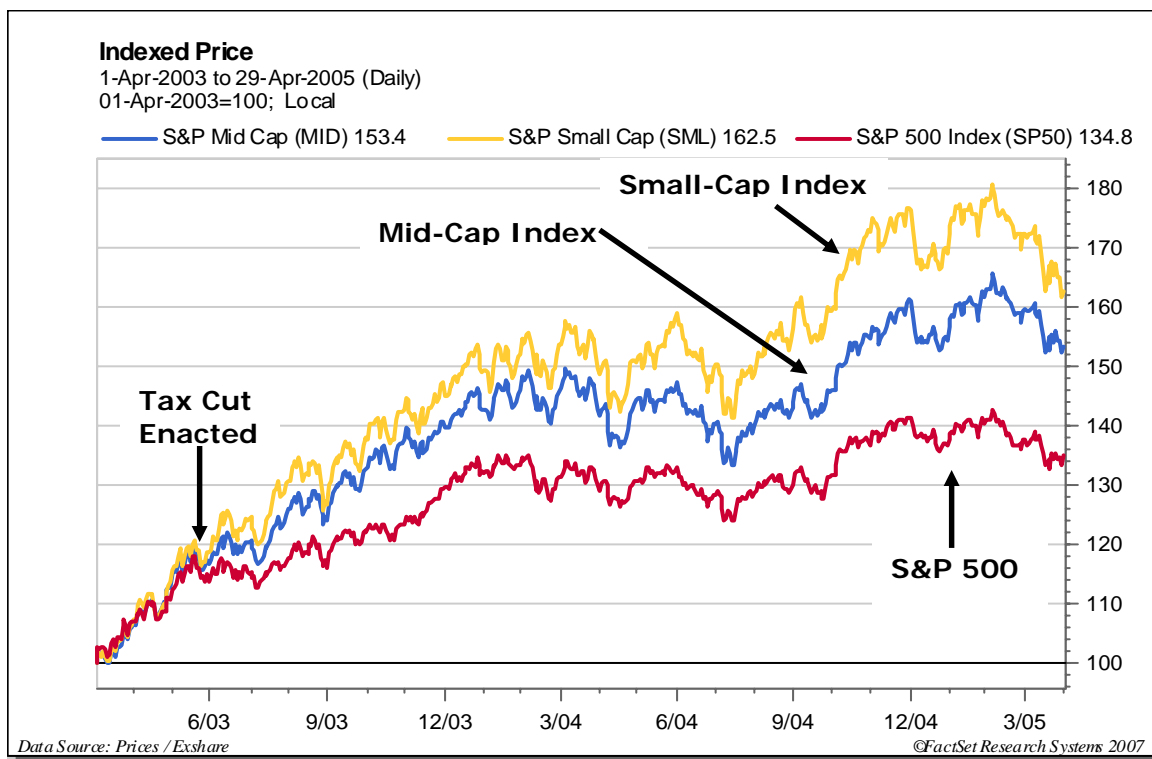


There has only been one other time when the capital gains tax increase was telegraphed in advance, and investors unlocked their gains ahead of the tax increase in 1986. The date we most often hear from clients is December 15<sup>th</sup> for resolution before tax selling intensifies.



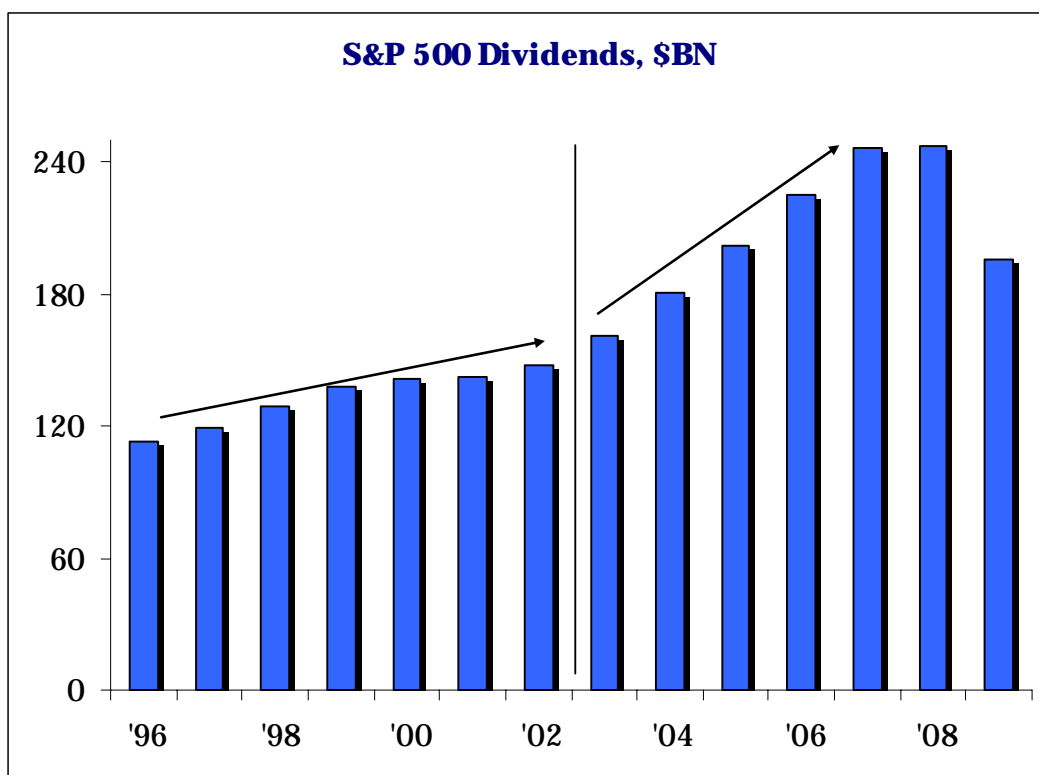
The summer talk of a double dip has abated. But, should the tax cuts not be extended this year, we would expect the double dip talk to reignite. Taxes would go up in workers' paychecks and the spring tax collection season will be a major negative for spending. Note the relationship between spending and equity values.

## CAPITAL GAINS TAX INCREASE WILL LIKELY HURT SMALLER COMPANIES RELATIVE TO LARGER COMPANIES



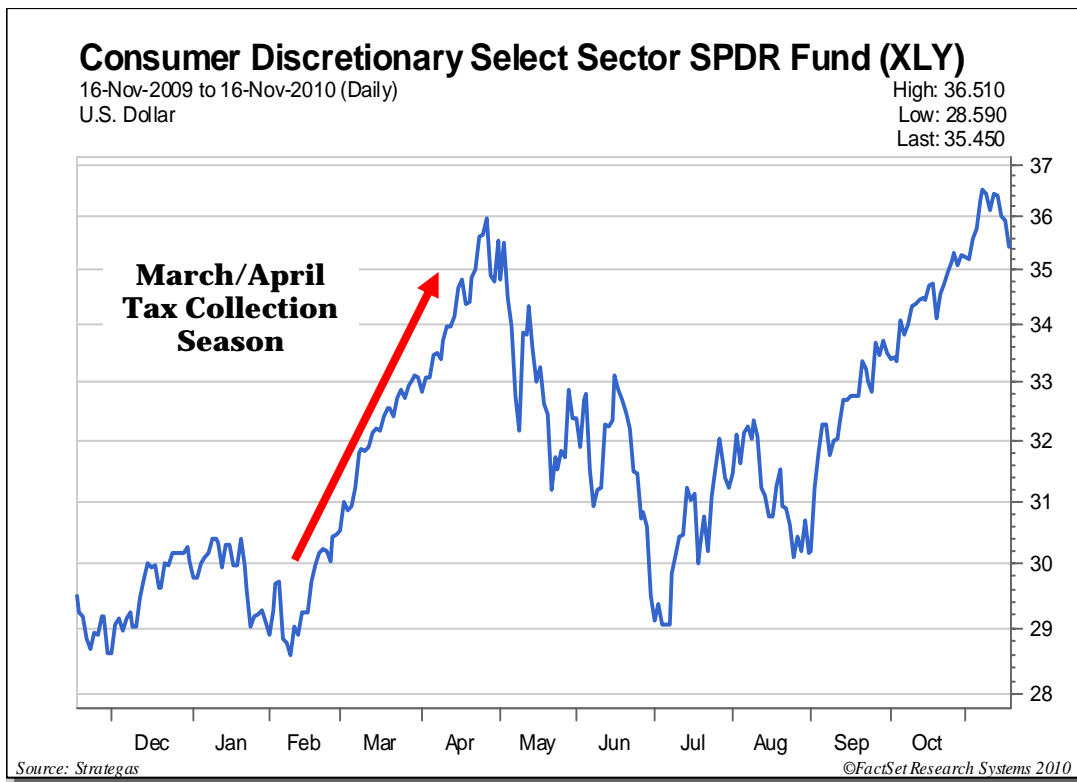
The capital gains tax cut was not introduced until right before the tax cut was enacted. Stocks priced in these together but once the capital gains tax cut went through, small and mid caps outperformed the broader index. We could expect the reverse this time.

## IF THE DIVIDEND TAX RATE IS GOING HIGHER, ARISTOCRATS WILL LIKELY CONTINUE DIVIDEND INCREASES

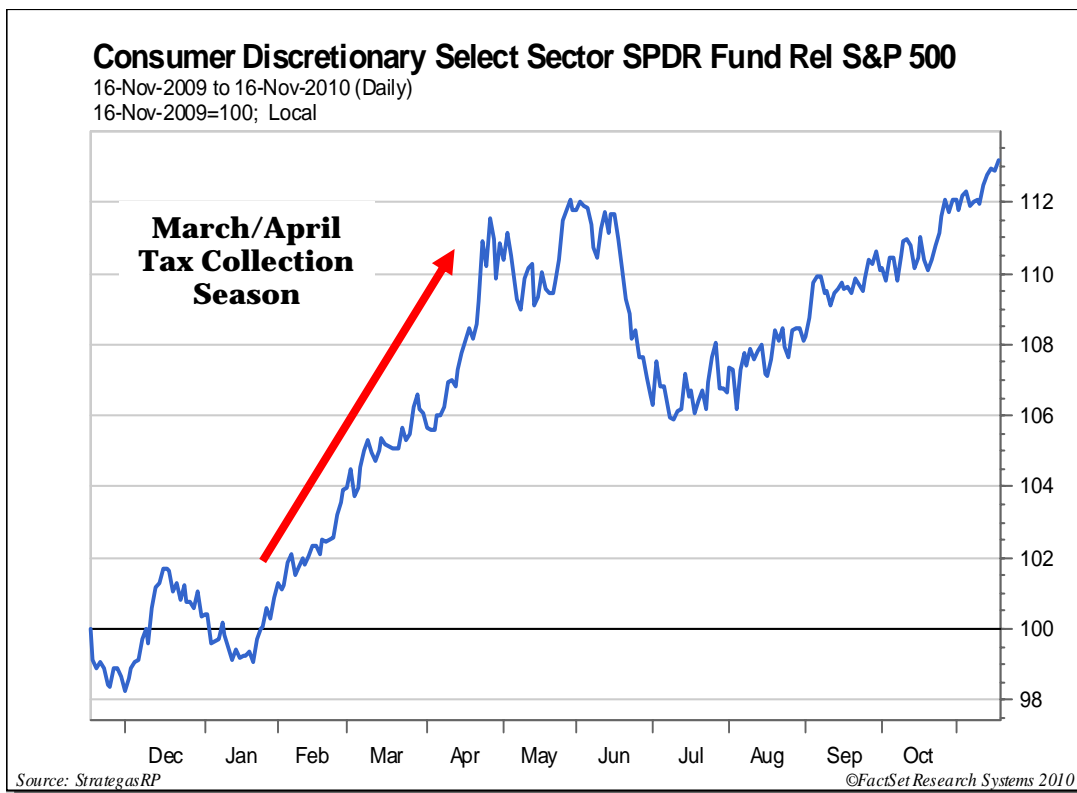


The dividend tax cut helped companies on the margin to pay or increase their dividend which powered dividend income growth. But the *Dividend Aristocrats* have increased their dividend for the past 25 years, regardless of the tax rate. We would expect them to continue even if the dividend tax rate goes to 39.6 pct.

# BUSH TAX CUT EXTENSION & TAX EXTENDERS MATTER FOR SPRINGTIME CONSUMER DISCRETIONARY PERFORMANCE



The 2009 stimulus provided an additional \$32bn of tax cuts that were paid out in the March/April tax collection season. On a q/q annualized basis, the refunds powered the consumer discretionary space. We are expecting a similar effect this year under our base case that the tax cuts get extended before the end of the year. Should the AMT extension not get done this year, the \$30bn benefit will turn into a \$50bn liability for taxpayers and will likely weigh on the consumer discretionary space.



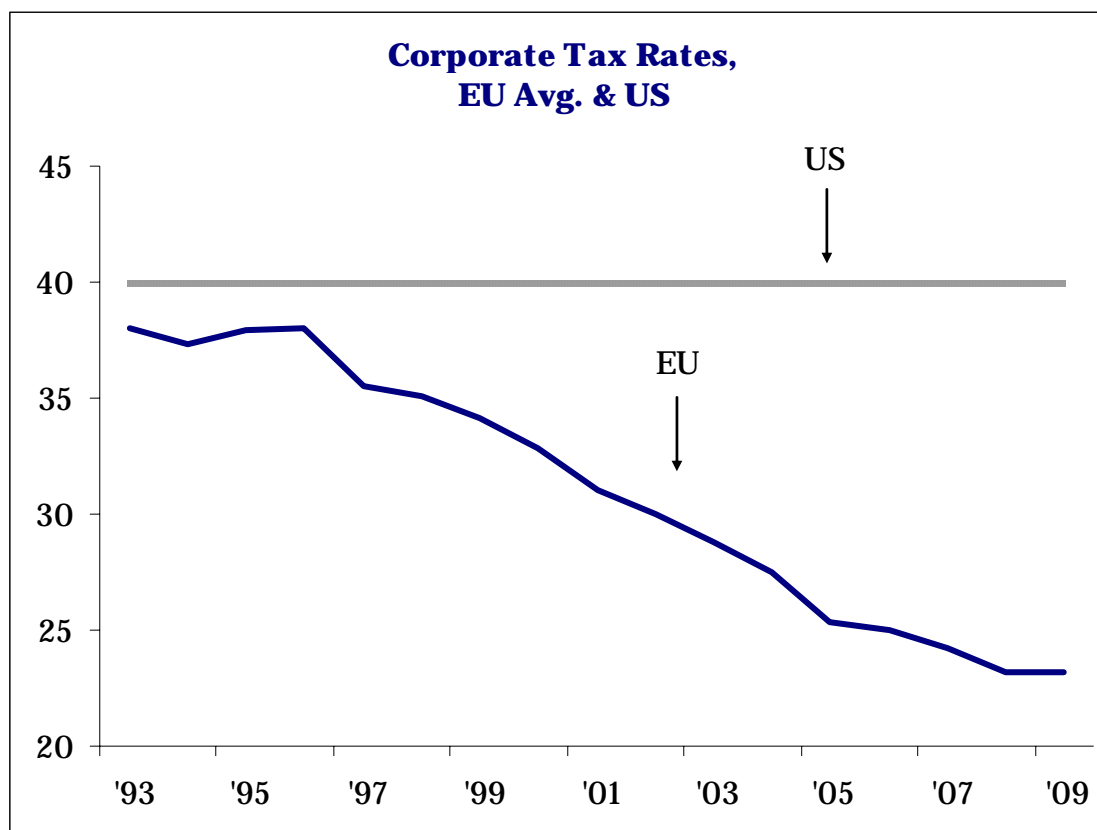
## LENGTH OF TAX EXTENSION COULD DETERMINE THE TIMING OF CORPORATE TAX REFORM

### Think Tanks Seek US Corporate Overhaul

In a report obtained by the Financial Times that could catalyse the debate over corporate tax reform, the Hamilton Project and Center for American Progress (Cap) will argue US companies should no longer be taxed on foreign earnings. At the same time, however, they would no longer be able to take tax deductions on the costs of doing business overseas and interest payments on money borrowed from banks located outside the US. Capital investments in the US could be immediately written off for tax purposes instead of being subject to long depreciation schedules. The proposal, which is being examined by White House officials, seeks to marry two seemingly conflicting aims of corporate tax reform: to encourage investment in the US and discourage “offshoring”, while bolstering the competitiveness of US companies with large international operations

*FT, 11/30/10*

If the Bush tax cuts are extended for one year, we would accelerate our timetable for potential tax reform. Treasury Secretary Geithner has been pushing for corporate tax reform. Should cap gains and dividend tax rates expire on 12/31/11, Republicans would be forced to the table for some type of tax reform. Interestingly, two think tanks aligned heavily with the Obama Administration will put forward new recommendations on corporate tax reform, which would eliminate the double taxation of foreign source earnings and provide for expensing, and it would be paid for with ending corporate deductibility of interest payments.



## STATE FISCAL SITUATION CONTINUES TO IMPROVE, WATCHING FOR POTENTIAL LEGISLATION ALLOWING STATES TO ENTER CHAPTER 9 BANKRUPTCIES

### States Lift Spending After A Spell Of Cuts

State government spending is growing again amid higher taxes and a slowly improving economy, although budgets continue to face severe pressure. **The total spending of all state budgets for fiscal 2011, which for most states began July 1, rose 5.3% to \$645.1 billion from the year before**, according to a report from the National Governors Association and the National Association of State Budget Officers to be released Wednesday. This follows two years of lower spending amid a grueling recession.

*WSJ, 12/01/10*

### US State Tax Receipts Rose Third Straight Quarter

State tax revenue rose 3.9 percent in the third quarter from a year earlier, the third consecutive gain, as a recovering economy boosted receipts from sales and personal-income levies, a study of 48 states shows. Increases occurred in 42 states, according to data compiled by the Nelson A. Rockefeller Institute of Government in Albany, New York. The gain was mainly driven by higher personal-income tax collections and growth in payments of levies on retail sales, the group said.

*Bloomberg, 11/30/10*

### Let the States Go Bankrupt

University of Pennsylvania law professor David Skeel, writing in *The Weekly Standard*, suggests that Congress pass a law allowing states to go bankrupt. Skeel, a bankruptcy expert, notes that a Depression-era statute allows local governments to go into bankruptcy. A state-bankruptcy law would not let creditors thrust a state into bankruptcy — that would violate state sovereignty. But it would allow a state government going into bankruptcy to force a “cram down,” imposing a haircut on bondholders, and to rewrite its union contracts. **The threat of bankruptcy would put a powerful weapon in the hands of governors and legislatures: They can tell their unions that they have to accept cuts now or face a much more dire fate in bankruptcy court.**

*National Review, 11/29/10*

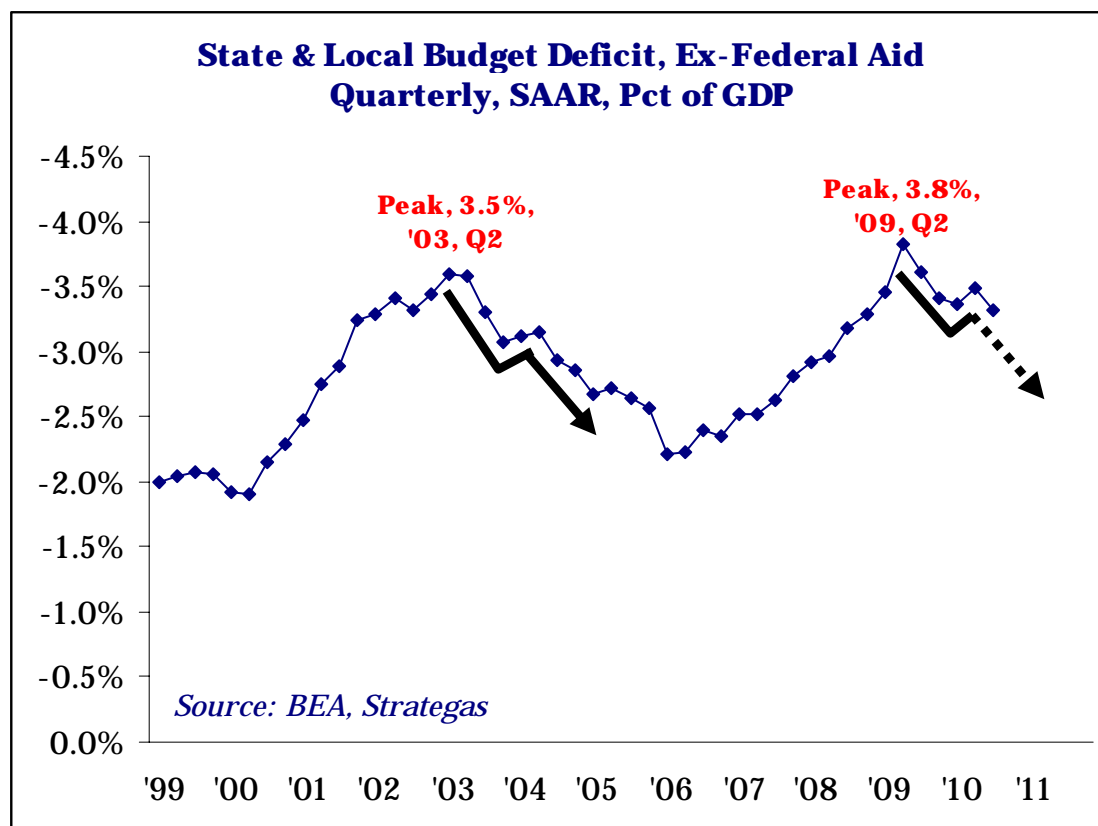
Central to our economic call that state and local governments will not be a large drag for GDP, and that job losses will be less than expected, is that states are set to increase spending in FY '11. We estimated a 4.2 pct increase — a report released today shows the increase will be 5.3 pct.

Tax revenue growth is slowly gaining steam and should pick up with jobs and spending gaining steam (another reason extension of the tax cuts is needed now).

We would not be surprised if federal legislation is introduced that allows states to enter Chapter 9 bankruptcy. This would obviously have a major impact on the muni market and we don't believe the intention is to hurt the muni market. Rather the purpose would be for states to better deal with their unfunded liabilities since states cannot cut pensions for current employees and unions have no reason to take a haircut. But if states can restructure their debts, thus sparking a threat of workers losing their pensions entirely, unions will have an incentive to negotiate. We don't expect this to pass into law.

## IMPACT OF LOST FEDERAL AID FOR STATE & LOCAL GOVERNMENTS APPEARS TO BE OVERSTATED

Last week we showed the state and local budget situation has improved significantly in 2010 with state and local governments holding an aggregate \$50bn *surplus* in their operating budgets (3Q, SAAR). The most common kickback we get from clients is that once the federal aid fades in 2011, the situation will deteriorate again. Some clients have gone one step further and suggested the forward looking CDS market sees this aid loss as a major impediment and is pricing in trouble (even before the unfunded liabilities problems hit). But the facts don't bear this out. We are often told that state and local governments will lose \$135bn of aid starting in 2011. This explains the confusion – \$135bn was allocated for more than two years of aid but has been running at a \$60bn annualized rate (\$40bn at the state level, \$20bn at the local level). But even this is overstated as new aid was extended through the first half of 2011. In sum, states will lose \$20bn in the second half of CY 2011 (i.e. one year from now). **After cutting spending by \$75bn over the past two years, and with tax revenues now growing, states are earning their way through the loss of federal aid.** For frame of reference, the federal government provided state governments \$30bn of discretionary aid in 2003 and there was no indication that the loss of federal aid hurt the states. A growing economy helped states earn through the loss of aid, just as is the case now.



We removed all federal aid from state and local budgets to test their stand alone fiscal situation. Interestingly, states are in no worse condition today than they were in the last recession, despite more severe economic conditions. In fact, state and local budget deficits excluding federal aid have steadily declined since '09 Q2.