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Commentary

Market Opinions and Topics of Interest

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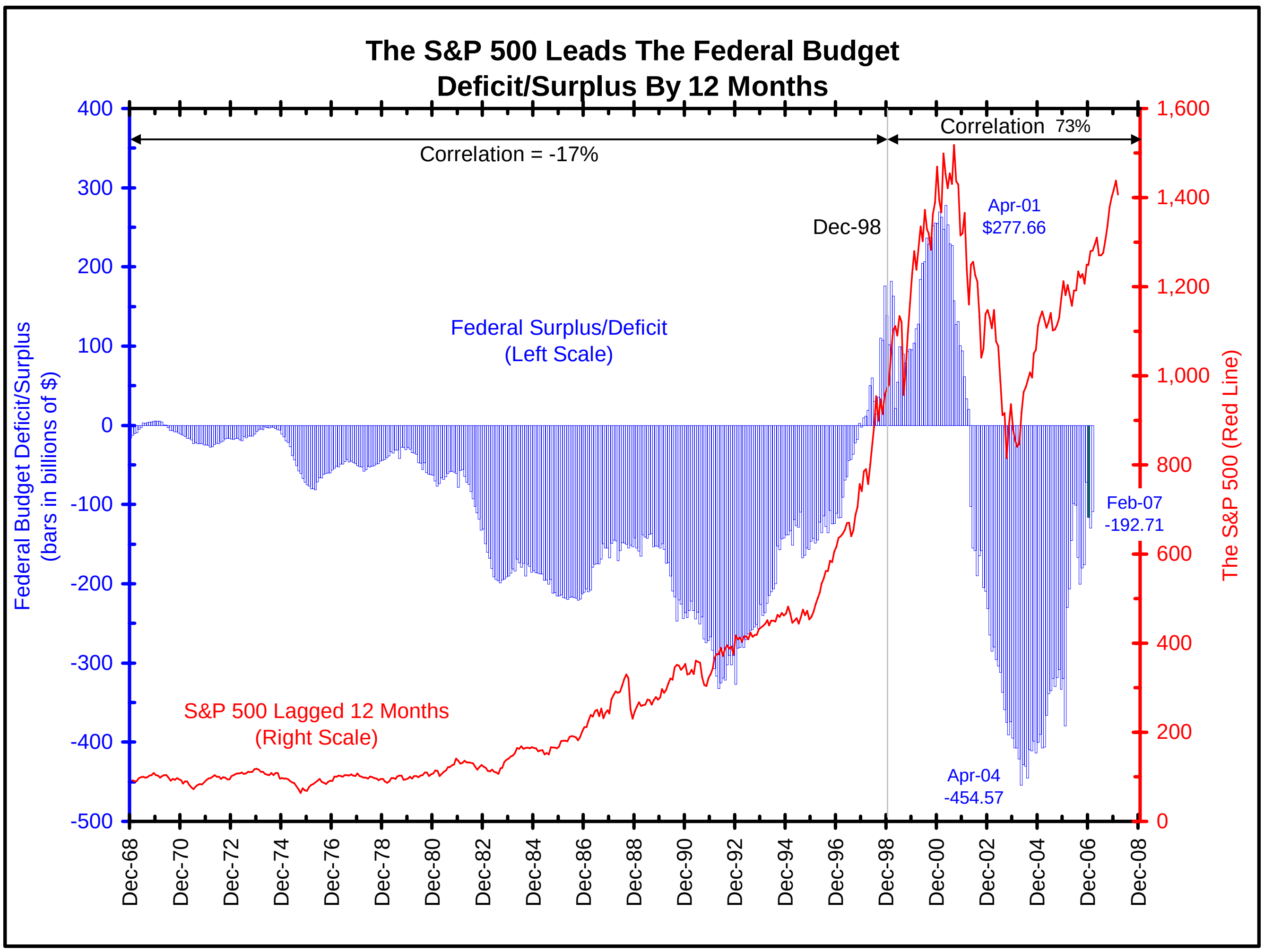
Can The Stock Market Balance The Budget?

In our February 8 Commentary (Revisiting the Original Conundrum: The Interest Rate-to-Stock Relationship") we said:

> *Now that the stock market heavily influences the economy and the deficit, it also influences interest rates as never before. This results in both interest rates and stock prices moving up and down together, in defiance to what most were taught in business school.*

In the weeks since and to our surprise, the argument greeted with the most skepticism has been that the stock market drives the federal surplus/deficit. We used the chart below which compares the S&P 500 (red line) lagged 12 months to the federal surplus/deficit (blue bars). The correlation shifted from 17% before 1998 to 73% afterwards. The shift in this relationship, we believe, was caused by stock market capitalization exceeded GDP.

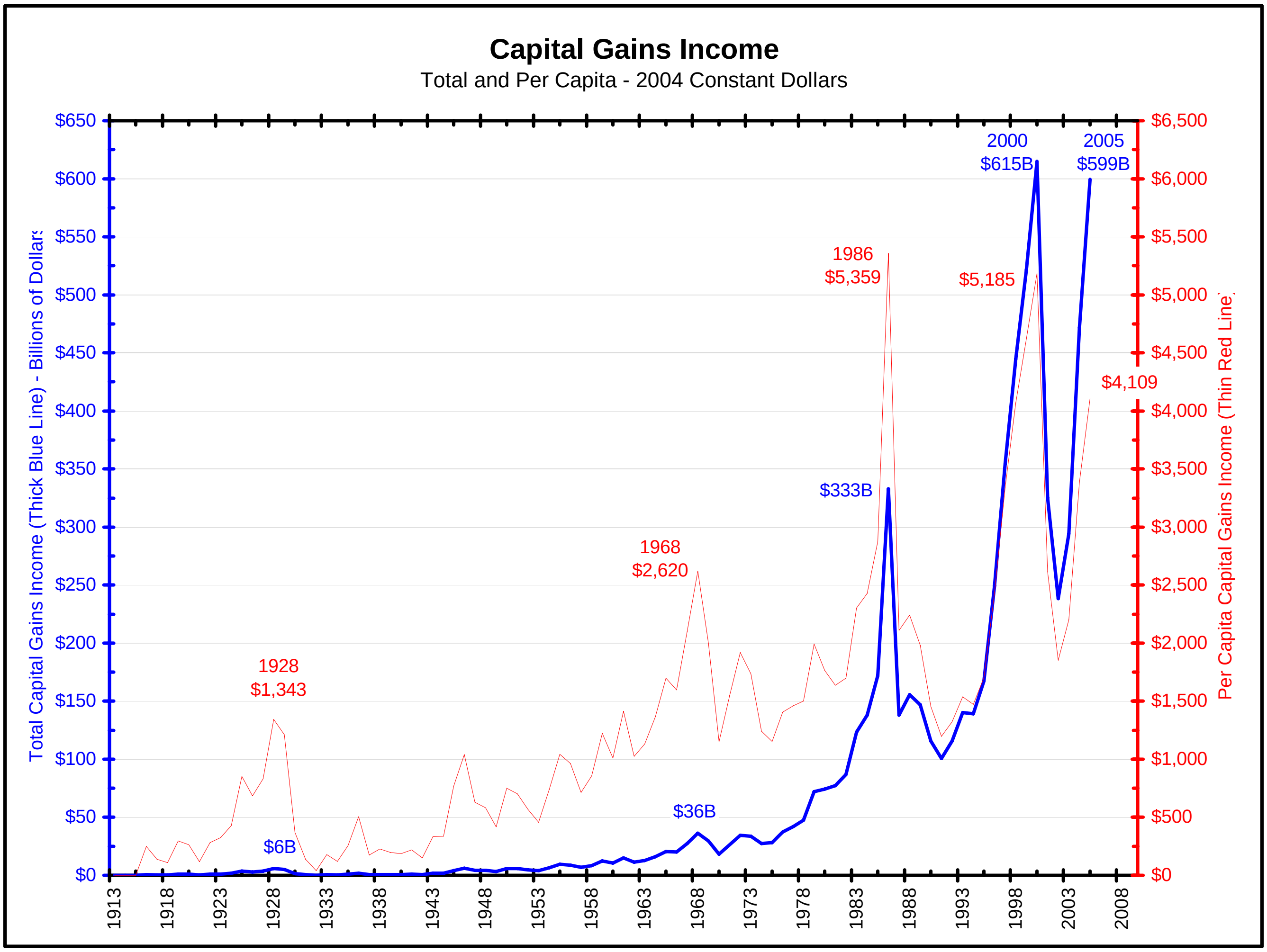


New Data

University of California, Berkeley, Professor EMMANUEL SAEZ released income data from 1913 to 2005 last week from which we constructed the chart below.

It shows capital gains income in **2004 constant dollars** on total (blue line) and per capita (red line) bases. What jumps out is how volatile and large capital gains taxes have been in recent years. In 2005, for instance, capital gains accounted for $599 billion of all tax income and accounted for $4,109 of the average taxpayer's income.

Constant-dollar per capita capital gains income is derived by dividing total capital gains income by the total number of taxpayers and then dividing this quotient by the $2004=100% deflator. From 2000 to 2005, the total number of taxpayers and the deflator increased by 15% and 17%, respectively. These adjustments account for the nearly $1,000 drop in constant-dollar capital gains income per capita since 2000.



Capital Gains and the Federal Surplus/Deficit

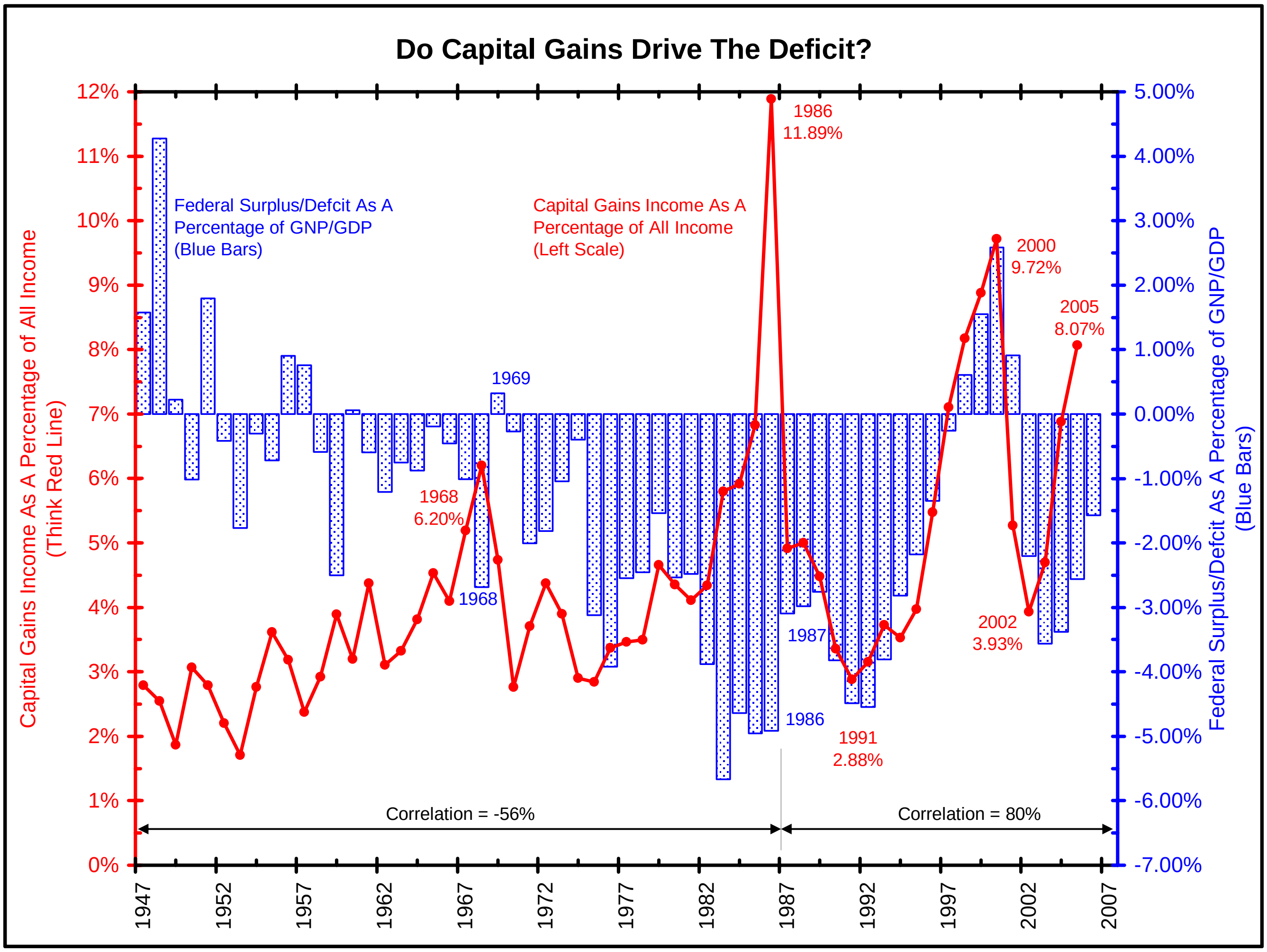
The chart on the next page shows post World War II data for capital gains income as a percentage of all income (red line) and the federal surplus/deficit as a percent of GNP/GDP (blue line). As seen on the bottom of the chart, the correlation of capital gains to the federal surplus/deficit shifted from -55% prior to 1986 to 80% thereafter.

The year 1986 was critical for two reasons. First, the markets were up strong in 1986. Thirty-year bonds were up 26% (fixed-income mutual funds were larger than equity mutual funds in 1986) and the S&P 500 was up 14%. Housing also experienced a good year as the OFHEO Index was up 8.27%. Rising markets create capital gains.

Second, the Tax Reform Act of 1986 was one of the most sweeping tax changes ever. The short-term capital gains rate was made equivalent to ordinary the income tax rate. This induced many to realize gains in 1986. As the spike in 1986 in the chart below (and above) shows, such a favorable treatment of capital gains is powerful incentive to realize profits.

There are two issues with capital gains that make them nearly impossible to forecast. First, one has to accurately forecast the asset markets to see if capital gains will be created. Then one has to forecast the timing of capital gains. For instance, owning open-ended mutual funds means your capital gains are taxed every year as the fund's gains are passed-through every year. Owning an ETF or equity means the gains are not realized until they are sold. Sales could also be influenced by changing the capital gains rate, as was the case in 1986.

As the chart below shows, the combination of the 1986 tax act with booming financial markets linked the federal surplus/deficit to capital gains as never before.



Conclusion

During the recent period of increased market volatility, we have been arguing the U.S. equity market is the center of the financial universe. Its movements drive other markets.

With this new income data, we can vividly see that the fortunes of the stock market drive the federal surplus/deficit as well. In this vein, the center of Washington is now on the corner of Broad and Wall. See the chart on the first page again.

In fact, it is possible, all things held equal, that with another 20% to 30% stock market gain before December 31, 2008, President Bush could leave office as he entered, with a budget surplus. Of course, a bear market could do the opposite.

The endless debate in Washington is what to do about the federal deficit. Economists fret about its effect on both the dollar and interest rates. They are in fact arguing over the effect of the stock market on other financial markets.

This is a simple concept many are still having a hard time accepting.

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