



Weekly Market Commentary



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Attention on the Deficit Disorder

Jeffrey Kleintop, CFA

Chief Market Strategist
LPL Financial

Highlights

The federal budget deficit is the top issue with voters, after the economy.

The stability in government bond yields and the extended stock market rally may be because market participants view the current surge in government borrowing as temporary and not part of a sustained trend.

Whether the markets are right or not will depend on a potential second stimulus package, the pace of healing in the economy, the cost of the health care bill, changes to tax rates, and the cap-and-trade climate change legislation.

A surprise to the assumptions investors have priced into the markets leading to higher deficits could cap the rally that has lifted stocks to the highs of the year and result in a sell-off in the government bonds.

The success of this week's record Treasury issuance, measured by the movement in Treasury yields, may be a key driver of market performance for this week and the months to come. If rates rise significantly, concerns over the ability to finance the mounting deficit will rise and may put downward pressure on the markets.

According to recent polling data, the federal budget deficit is the top issue with voters, after the economy. The percentage of respondents voicing concern over the size of the deficit has doubled over the past three months as concerns over the economy have faded. The deficit ranks ahead of other issues such as health care, national security, and other considerations.

"Let me list some issues that have been proposed for the federal government to address. Please tell me which one of these items you think should be the top priority for the federal government. [See below.]" If more than one: "Well, if you had to choose just one, which do you think should be the top priority?"

NBC NEWS/WALL STREET JOURNAL POLL

Conducted by the polling organizations of Peter Hart (D) and Bill McInturff (R). June 12-15, 2009.

Job creation and economic growth	31
The deficit and government spending	19
Health care	16
National security and terrorism	14
The wars in Iraq and Afghanistan	9
Energy and the cost of gas	5
Social issues such as abortion and same-sex marriage	2
All equally	3
Unsure	1

One year ago, the forecast for the deficit for 2010 was 37% of GDP, now it is expected to be 60%. This week, the government will issue a record amount of Treasury debt. So far this year, the supply of Treasury debt, excluding bills, was \$1.15 trillion, up sharply from the \$434 billion issued last year by this point and \$350 billion in 2007.

Even though the deficit may appear to be soaring out of control, interest rates have remained at historically low levels and stocks are at their highs for the year. Foreigners have demonstrated a continued willingness to buy our debt. The stability in government bond yields and the extended stock market rally may be because market participants view the current surge in borrowing as a temporary boost to the economy and not part of a sustained trend. Whether market participants are right or not will depend on a potential second stimulus package, the cost of the health care bill, changes to tax



rates, the tax increases associated with climate change, and the healing in the economy. A surprise to the assumptions investors have priced into the markets leading to even higher deficits could cap the rally that has lifted stocks to the highs of the year and result in a sell-off in the government bonds.

American Recovery and Reinvestment Act II?

While some advisors to the administration have voiced support for a second round of stimulus and the administration has said it has not ruled it out, another round of spending to boost the economy is highly unlikely for two reasons. First, less than 10% of the \$787 billion stimulus package, the American Recovery and Reinvestment Act passed in February, has been spent so far, leaving plenty of fuel still in the pipeline. Second, the economy has been showing signs of recovery for months, and voters' concerns over the economy and job losses have started to fade. Market participants are not pricing in a second stimulus package; however, if conditions take a turn for the worse, stimulus could be back on the table.

Health Care

The most noise coming out of Washington last week was focused on health care. Last week, the Congressional Budget Office (CBO) estimated the total cost of the health care bill being worked on in the House to be \$1.04 trillion. This total would be partially offset by tax increases that would raise \$583 billion and would lower Medicare and Medicaid by \$219 billion. The net addition to the federal budget deficit of \$239 billion makes it hard for fiscal moderates to support the bill heading into a mid-term election year.

The Managed Care industry, the most sensitive to legislation, helped the health care sector to outpace the overall market last week as it became clear a bill would not pass the Senate by the August recess. The market appears to be pricing in health care legislation that either does not pass the Senate or does not include a subsidized public plan that would compete with the options offered by managed care companies. A more likely outcome for action on health care is an expansion of Medicaid that would target the uninsured. This option would have a lower price tag, possibly making it deficit neutral (after offsetting tax increases), since it would only be covering the currently uninsured and not also providing a taxpayer subsidized option for people that already have health insurance. However, there is a chance that debate could shift over the summer recess, and the legislation could end up with enough support to pass close to the current form and result in an expansion of the deficit.

Taxes

Whatever the form of the final health care changes, one outcome of any legislation is likely to be a tax hike for top wage earners. In fact, taxes will be headed higher even in the absence of legislation, since the tax cuts of 2001 and 2003 will expire if not extended by Congress. The administration wants to keep some of the tax cuts and eliminate others, which could end up impacting the deficit. However, it is hard to separate the impact of tax code changes from the economic backdrop for both the stock and bond market to determine what market participants are expecting. Historically, changes



in 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 has also been the case for stocks we can look at earnings and valuation.

Earnings

Generally, higher taxes mean less of an incentive for individuals to work, invest, take risks to create value and become entrepreneurs. They 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 pattern 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%. Investors appear to be pricing in the Wall Street analyst consensus for a typical cyclical recovery in earnings growth in 2010 of about 20-25% and a longer term growth rate of about 7%, without any direct impact from the likely tax code changes.

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) in %
Sep-59	3.43		
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

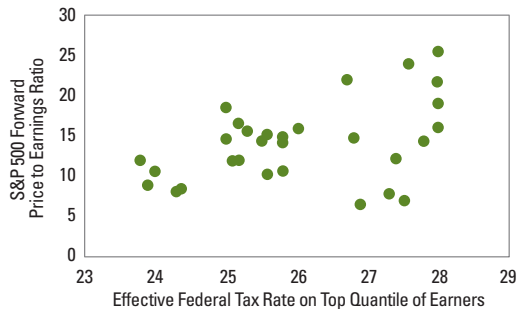
Source: LPL Financial, Thomson Financial, Center for Tax Policy

Valuation

Over the past 30 years, higher effective federal 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 twelve 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 market history 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. With the forward P/E for the S&P 500 near the long-term



1 Valuation and Taxes
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

average, market participants do not appear to be factoring in any impact on valuation from potential tax changes. [Chart 1]

Cap and Trade

The cap and trade bill, the American Clean Energy and Security Act of 2009, passed by the House at the end of June includes regulation of derivatives, banning naked credit default swaps, and requiring collateral for over-the-counter contracts, among other regulatory reform measures. It also represents a major tax increase on energy that could have the impact of reducing the deficit. The CBO estimates that in total, the changes in the bill would reduce the federal budget deficit by about \$24 billion over the 2010-2019 period. However, the magnitude of the deficit reduction is relatively small, and there is skepticism that the Senate will pass the bill, especially considering there are 12 senators from coal-rich Appalachian states that would be negatively impacted by the bill. Should changes be made to make the bill more palatable to moderate senators, it could end up adding to the deficit rather than reducing it.

The success of this week's record Treasury issuance, measured by the movement in Treasury yields, may be a key driver of market performance for this week and the months to come. If rates rise significantly, concerns over the ability to finance the mounting deficit will rise and may put downward pressure on the markets. A rise in rates may also shape the political process by reducing the likelihood of deficit expanding legislation.

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