

The Week

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Worth noting

- A recent editorial in the Wall Street Journal has many investors worried that the upcoming expiration of the Bush tax cuts will derail the economic recovery. We believe higher taxes next year will restrain economic growth, but not stop it.
- We remain positive, but cautious, on the economy and the stock market, anticipating increased market volatility in the months ahead. As a result, we reduced our year-end target last week, after equities hit our original year-end target in April.
- We also made a tactical tilt to our investment strategy, reducing exposure to developed international equity markets while increasing exposure to emerging market equities and U.S. mid-cap equities. The decline in the euro has reached a point that signals increasing risk to foreign equity markets, especially in Europe.

Higher taxes will dampen growth

The equity markets were stress tested again last week as the nearly two-month old correction continued. Fortunately, the market held at important support levels near the February low. This is a sign that the equity markets are probably oversold in the short run and could begin to recover some of the sharp drop in prices since the market peaked in late April.

A big concern for investors last week was an editorial, suggesting that the U.S. economy will fall back into recession next year when the Bush tax cuts expire. We disagree. The course of the economy is seldom determined by one factor alone. We do believe that higher taxes will dampen economic growth but do not expect another recession, unless something else happens on top of the tax increase.

Our work suggests that it is important to look at what else is happening in the economy when taxes increase. In particular, if corporate profits are rising, as we anticipate next year, then higher taxes may only slow growth, not stop it. If the economy was already weakening and corporate profits were rising, then higher taxes could derail an economic recovery. However, that is unlikely to be the case next year. If companies are making more profit and are hiring more workers, as appears likely, the economy can still expand, even if taxes go up. Of course, the economy would probably expand faster if taxes were not going up.

Moreover, taxes are currently low, and the anticipated increase in taxes would not push the tax burden too high. The latest data show that personal taxes as a percent of personal income are at the lowest percentage since the 1950s. These lower taxes are due to both the Bush tax cuts and the Obama stimulus measures. If the Bush tax cuts and Obama stimulus measures expire as currently scheduled, then personal taxes as a percent of personal income could rise from just under 9% currently to about 11% in 2011 and 12% in 2012. This would put the personal tax burden at about the mid-range for the past several decades.

We do not believe that the increase in taxes from current low levels would derail the economic recovery because corporate profits are still rising. However, we do believe that these higher taxes will reduce consumer purchasing power, keeping economic growth slow next year, rather than robust.

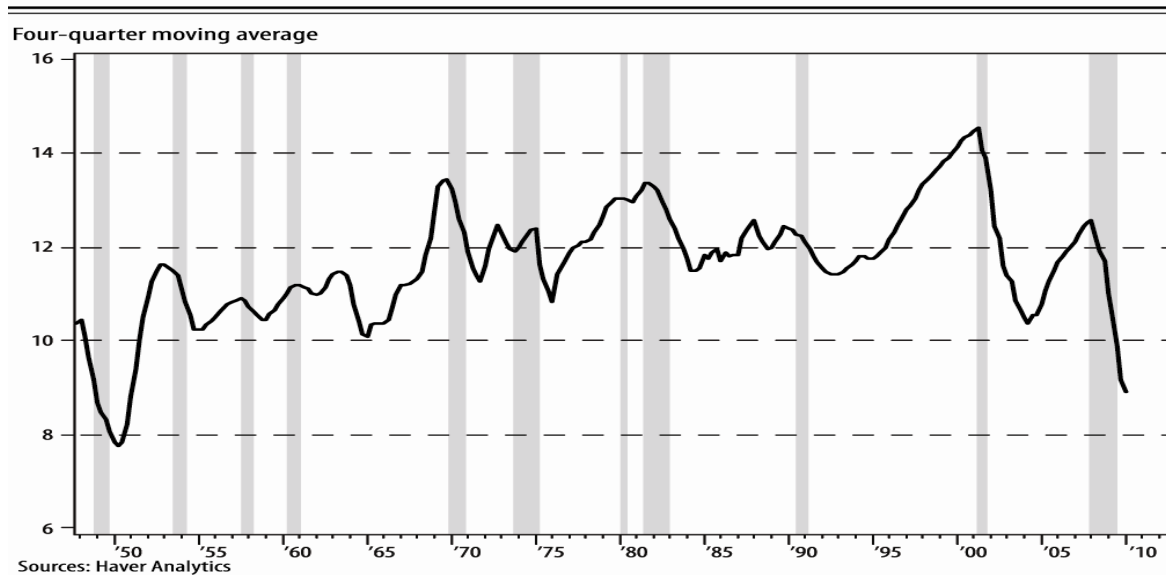
It is also important to remember that President Obama has appointed a National Commission on Fiscal Responsibility and Reform to consider measures to restore fiscal responsibility. This could mean that some of the expiring Bush tax cuts will not take place, especially if the President limits tax increases to families earning more than \$250,000.

Looking ahead, the equity markets are coming off a year of more than 80% gains from the March 2009 low to the April 2010 high. Therefore, markets are likely to be volatile with limited gains the rest of this year, as the market works off its excesses. Consequently, our equity strategy team recently reduced our year-end target for the S&P 500 slightly from 1175-1200 forecasted in our 2010 economic and market outlook to 1100-1140 currently. We continue to expect the market to be higher a year from now, but the market could be very volatile in the months ahead, potentially trading in a range slightly less than 1000 to slightly more than 1200 on the S&P 500.

Finally, we remain concerned about problems in Europe and believe that investors may be better rewarded in other areas. Consequently, we initiated a new tactical tilt, reducing international equity exposure by 200 basis points (two percentage points) while increasing the allocation to emerging markets 100 basis point (one percentage point) and U.S. mid-cap equities 100 basis points (one percentage point).

The U.S. economy faces many challenges in the months ahead. Sovereign debt problems in Europe will probably dampen the European economic recovery, reducing the demand for U.S. exports. In addition, the tax increases that are likely to take place next year could keep investors cautious until there is more evidence that the economy can still grow despite higher taxes. Finally, the upcoming November Congressional elections are likely to be very contentious with a lot of negative political rhetoric, making the economy look bad. Together, these factors, along with already cautious consumer and business spending, could keep the economic recovery slower than normal for this stage of the economic cycle.

Personal taxes as a percent of personal income



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