What Effect Will Changes in Tax Rates Have on Stock Prices?

Now that the elections are behind us, the political focus has shifted to avoiding the fiscal cliff and resolving the large gap between federal government spending and revenues. If Congress fails to act, the Bush tax cuts will sunset at the end of this year. This will result in a change to federal income tax brackets and increased tax rates for capital gains and dividends.

This week’s edition of Election Perspectives looks at the potential impacts of these tax increases to stock returns in the near and long term.

### 2013 Fiscal Cliff

<table>
<thead>
<tr>
<th>Income —</th>
<th>Dividend Rate</th>
<th>Long-term Capital Gains Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Joint Filers</td>
<td>2012</td>
<td>2013</td>
</tr>
<tr>
<td>$17,400-70,700</td>
<td>15%</td>
<td>15%</td>
</tr>
<tr>
<td>$70,700-142,700</td>
<td>15%</td>
<td>28%</td>
</tr>
<tr>
<td>$142,700-217,450</td>
<td>15%</td>
<td>31%</td>
</tr>
<tr>
<td>$217,450-388,350</td>
<td>15%</td>
<td>36%</td>
</tr>
<tr>
<td>$388,350+</td>
<td>15%</td>
<td>39.6%</td>
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Top rate 15% 43.4%* 15% 23.8%*

*Includes 3.8% Investment Tax Under Affordable Care Act for those whose income comes primarily from investments. Tax is levied on the lesser of the net investment income or the amount Modified Adjusted Gross Income exceeds $250,000.

**Capital Gains**

If we look at the changes to capital gains rates since 1955, there have been four decreases and three increases. In years with large rate decreases, large- and small-cap stocks have performed much better than years with rate increases. Small-cap stocks are nearly twice as sensitive to changes as large-cap stocks.
Moreover, investors have tended to harvest capital gains ahead of a tax increase. In 1986, before rates increased from 20% to 28%, realized gains as a percent of gross domestic product (GDP) went from 4% to 7%. This likely contributed to the 2.8% drop in large cap and 2.4% drop small cap returns in December, 1986. In fact, the market dropped every December before the tax increases. Large caps dropped 1.2% to 4.2% and small caps dropped 1.1% to 2.4%. These losses contrast with the median return in December of 1.4% for large caps and 1.7% for small caps. We could see similar harvesting in the weeks ahead if there is no resolution out of Congress during the lame duck session.

While there is an impact to stock returns in years when gains rates change, over the long run tax rates do not appear to have a significant impact on returns. For example, after rates rose in 1987, the stock market enjoyed one of its longest bull markets. Instead earnings growth and valuations are the key driver of returns. This has been consistent regardless of prevailing tax rates.

Dividend Tax Rates
Another investor concern is how a rise in dividend tax rates could impact returns of dividend-paying stocks. While tax rates on qualified dividends are set to increase relative to capital gains, we should not take this increase as a given. There are many proposals for resolving the fiscal cliff that involve keeping the rates equal to each other, or with a small increase. If that happens, any impact to dividend-paying stocks could be muted.

Historical tax increases are hard to compare to the current situation. In 1993 when top dividend rates rose relative to capital gains, the S&P 500 Dividend Aristocrats underperformed the S&P 500 by 6%. However, at that time investors had more options for yield — the Barclays U.S. Treasury Index yield was almost twice the yield of the S&P 500 Index. In today’s world of low-interest rates, the situation is reversed — the S&P 500 is yielding more than 2.5 times the U.S. Treasury Index. Therefore, dividends will likely remain an important yield source.

Furthermore, an increase in dividend tax rates relative to capital gains rates could halt or partially reverse the increase we’ve seen in a number of companies paying dividends. This could drive demand for a smaller number of dividend stocks — leading to price appreciation for the remaining dividend payers rather than underperformance. We continue to believe that we are still in a very attractive period for dividend-paying equities.

Finally, the process to resolve the fiscal cliff will also be important for investors. In the coming weeks stock markets will likely see increased volatility as negotiations over the fiscal cliff unfold. Many are optimistic that a resolution will be reached in the lame duck session. Others see last year’s handling of the debt ceiling as proof that compromise will be elusive. Acrimony and inaction would be a negative for stocks while a resolution that mitigates or defers impacts would be positive particularly if it is coupled with a framework for long-term tax reform.

So in the near term, we may in for a bumpy ride for large-cap stocks, small-cap stocks and high dividend payers. In the longer term, the impacts will be mitigated by earnings growth, valuations and the income opportunity that dividends provide.
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It is not possible to invest directly in an index.

The Standard & Poor's (S&P) 500 Index tracks the performance of 500 widely held, large-capitalization U.S. stocks.

The S&P 500® Dividend Aristocrats index measures the performance of large cap, blue chip companies within the S&P 500 that have followed a policy of increasing dividends every year for at least 25 consecutive years.

The Barclays U.S. Treasury Index is an unmanaged index of public obligations of the U.S. Treasury with a remaining maturity of one year or more.

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