FISHER WEALTH MANAGEMENT

Markets Commentary
Autumn 2008

Executive Summary

Recent market action wiped out what had been a great start to the second quarter. We think a major recovery lies ahead and any additional downside should be limited in magnitude and relatively brief.

In our view, sentiment tied to the world economy is as detached from tangible reality today as we can recall. "Grow-cession" might best describe today. The economy is growing, yet people's moods are recessionary. When investors realise economic Armageddon isn't upon us, equities should respond dramatically.

There are actually many positives in today's seemingly ominous world. US personal income, consumer spending, exports and corporate earnings (ex-Financials) are all tracking well ahead of gloomy expectations. In fact, the whole US economy grew by an annualised 1% in the first quarter[1]. Preliminary results show the UK economy expanded at 1.6% from a year earlier in the second quarter. Not stellar, but not recession. Better yet, the other 70% of the world's economy grew between 3% and 4%[2].

Unlike the January and March lows, June lacked novel negative stories. Instead, the same fears have been rehashed: housing, credit, Iran, inflation, oil. Other than some further credit market weakening, these topics have evolved very little in the last four months. Some are even mischaracterised. For example, the rampant inflation many fear is highly illusory. Yes, energy and food prices have skyrocketed, but these make up less than a quarter of consumer spending. Housing, autos, clothing and leisure services make up more than double that[3]. As we all know, prices of many homes as well as cars, electronics and clothing have been falling helping offset rising prices elsewhere.

Many investors remember what was coined as the Goldilocks economy during the 1990s – ideally balanced growth and inflation. Today is viewed as "anti-Goldilocks." 1970s-style stagflation fears abound. But unlike then, when oil prices soared due to supply shocks, today's oil prices are driven primarily by strong demand. In our opinion, this is evidence the global economy is growing.

Some fear global central banks have limited room to prevent a severe credit crunch; they argue stimulatory policy measures will stoke inflation. But central banks have demonstrated a wide array of innovative tools, beyond interest rate shifts, that directly reduce systemic risk.

Uncertainty and fear tied to the upcoming US presidential election is also overwrought. No matter the victor, neither Senators Obama nor McCain will have a super-majority in Congress, making the possibility of overreaching legislation unlikely.

The world is not without risks: protectionist interests could impede global trade, politicians could overhaul financial industry regulations, central banks could overshoot in either direction with monetary policy, war could break out across the Middle East. But right now these appear remote possibilities, not likely probabilities.

As the next three months progress, we expect attention will turn away from the financial sector and toward politics. US Presidential election years tend to be back-end loaded and positive for equities. We believe this year will be no different.

This year's extreme volatility has undoubtedly caused discomfort, but we strongly believe the second half will be far better for equities. A time when the world is fearful is a time to buy.

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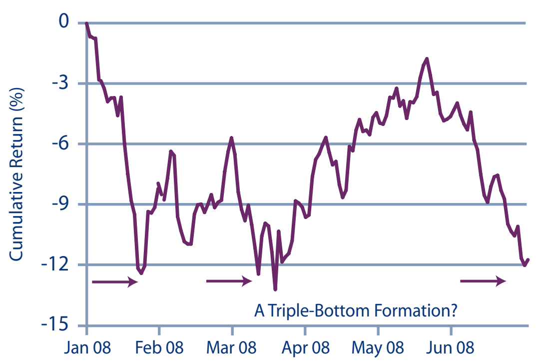
Continued Volatility

Equity market volatility thundered again in the second quarter as negative sentiment stifled a strong mid-quarter rally, sending equities to new year-to-date lows by mid-July. The MSCI World Index returned -1.8% for the quarter and -10.5% for the first half of 2008[4].

Table 1 shows the latest pullback resulted in a third test of recent lows, forming what might be the last leg down in a triple-bottom pattern. As we've discussed in past commentaries, we see the market environment very similar to what we observed in the 1997-98 period, when worries tied to the Asian banking "contagion," the Russian Ruble crisis, and the failure of hedge fund Long Term Capital Management created a similar market pattern, only to see equities touch new highs by the end of 1998. Likewise, the 2007-08 period has seen the credit crisis, concerns of systemic failure upon the near failure of Bear Stearns, and fears of a US government bailout of Freddie Mac and Fannie Mae. Then, like today, many predicted the end of capital markets as we knew them. But overly dour sentiment passed then, as we expect will happen again soon and equities should similarly respond positively.

Table 1: MSCI World 2008 YTD as of 30/6/2008

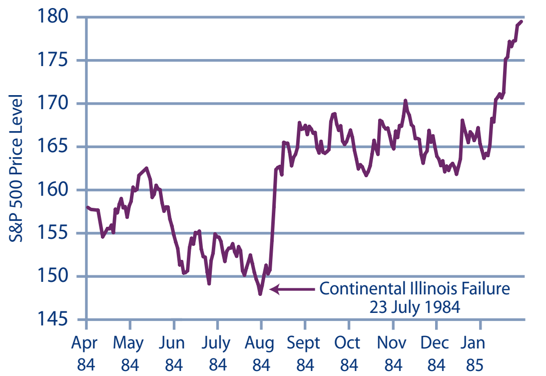


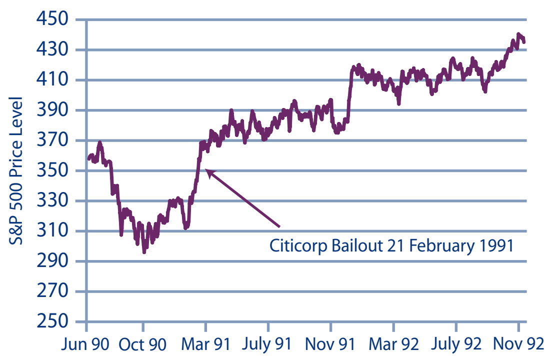
Source: Thomson Financial Datastream

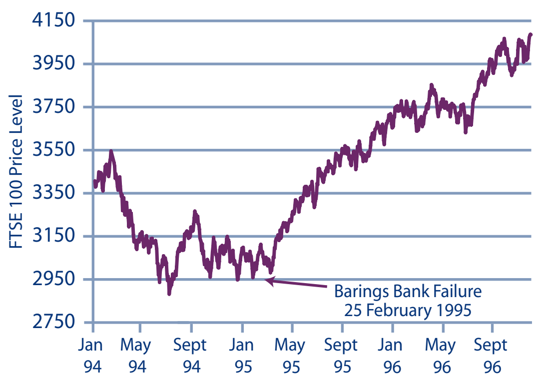
Talk of a bear market and impending recession prevailed throughout the quarter yet no new big negative catalysts emerged. Mostly old worries persisted. Housing, oil prices and inflation among others were again blamed for the malaise. As commented extensively in past commentaries and on MarketMinder.com these concerns are already widely reflected in share prices and should not have meaningful, lasting downward force left in them. Meanwhile, US economic data consistently came in stronger than too-pessimistic expectations.

Financials shares have been the main culprit of this market down leg. Fears of systemic banking failure persisted, particularly concerning the solvency of mortgage giants Fannie Mae and Freddie Mac. However, the US government has made clear it will go to extraordinary measures to prevent major failures from happening. In the meantime, we expect some weaker, less significant financial institutions will fail (such as IndyMac), but the financial system as a whole will strengthen as a result. This process is likely to coincide with a market bottom. As the tables below show, equities have often recovered after high-profile bank failures.

Table 2: Three Major Bank Failures and Subsequent Market Returns







Source: Bloomberg

The Glass Is Half Full – Bullish Facts

Though headlines were persistently dour, US and global economies actually fared decently in the first half of 2008. In our view sentiment is as detached from reality as we've seen in recent years. The fact is, global economic conditions simply aren't as bad as many believe and aren't pointing to a deep recession.

Recession Fears Remain Fears

Despite near ubiquitous expectations for a US recession entering 2008, one has yet to materialise. The generally accepted definition of recession is two consecutive quarters of negative GDP growth. Final US GDP growth (annualised) was 1% for Q1[5]– positive and better than expectations. GDP growth of 1% isn't stellar, but far from calls for a New Depression.

Those claiming the US is in a recession now are generally redefining the term to suit today's gloomy sentiment. Remember, sentiment is not a factor in measuring economic growth. It is true parts of the US economy are weak but headline-grabbing problems in the financial and property sectors, simply do not tell a complete story. Rarely, if ever, do all areas of an economy uniformly grow or recess at the same time. GDP's predominant contributor, personal consumption, continues to grow. Exports are surging, business investment is stable and government spending is advancing. On balance, the positives have outweighed the negatives and the result is continued mild GDP growth.

Many remain anchored in the past, believing the US economy will drive the world. But today the US accounts for about 25% of the world economy. On balance, the other 75% continues to see healthy economic expansion. As of the most recent estimates, the International Monetary Fund (IMF) predicts annual global GDP growth of 3.7% for 2008. The larger part of the global economy should pull the smaller part along, not the reverse. The US may lead or lag but because the global economy is increasingly integrated, it would be difficult for the US to head in a markedly different direction than the rest of the world.

We can't help but quote Franklin Delano Roosevelt, "The only thing we have to fear is fear itself." Maybe negative thoughts will cause consumers around the world to suddenly curtail spending, but we can't find a precedent to support that theory. Based on our fundamental analysis, the US and global economies should avoid the nastiness so many fear.

Earnings... Stronger Than Advertised

Another little-noticed positive development in the second quarter was corporate earnings. Financials continued to be a weak spot but this is hardly surprising tied to ongoing asset write downs. If the Financials sector were removed from earnings forecasts, the second quarter US earnings growth number would be about 8.3%. Energy and Technology are forecast to have particularly strong quarters, growing at an estimated 28% and 16% respectively. If both Energy and Financials (the respective strongest and weakest sectors this quarter) were removed, the Q2 earnings growth rate is still expected to be 2.9%[6]. A similar story holds true for non-US earnings.

This again highlights that economic sectors rarely move in lockstep. Some areas can experience weakness but that doesn't mean they must drag down the whole of the economy. Likewise, some economic areas can be very strong during recession. For example, during the 2001 US recession and the 2000 to 2002 bear market, one economic bright spot was housing, ironically. One, or even a couple of areas of the economy, do not dictate the whole.

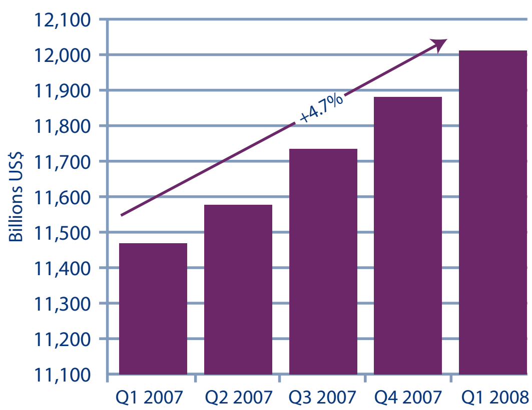
> The fact is, global economic conditions simply aren't as bad as many believe and aren't pointing to a deep recession.

US Consumers Still Afloat

Americans continued spending despite high oil and food prices. As covered in our last commentary, consumer spending is linked most strongly with personal income, not home equity or financial assets.

Consumer spending and incomes were much stronger than forecast in May and have grown in each successive month so far this year. Some of this strength can be attributed to the tax rebate checks many Americans received. Ironically, when politicians debated the stimulus package, many complained it wasn't enough and wouldn't have any material impact. Those same people now believe May's strength was due wholly to the stimulus program and the economy will wilt once the stimulus effect passes. Which is it? As Table 3 shows, even stripping out the tax rebate effect, this doesn't explain spending and income increases that consistently beat expectations in prior months.

Table 3: US Personal Income Growth



Source: BEA, US Personal Income in Billions of Current Dollars (Annual Rate, Quarterly Series).

Today's deals tend to be transacted by larger firms who still have cheap, easy access to capital.

Trains, Planes and Getting Railroaded

Another little-noticed positive is the strength of transportation shares this year. Call it a different kind of "Dow Theory" – the Dow Transports index was up 8.3% year-to-date at the quarter's close. Other US transport indexes were similarly strong – the S&P 500 Railway index was up a big 25.4%. These indexes cover the firms that ship goods via trucks, trains and even air. In fact, we've seen railway bottlenecks and railway capacity utilisation has increased. There simply aren't enough trains to ship America's goods. This isn't activity consistent with a recession. Traditionally, a meaningful drop in transport indexes has coincided with most US recessions as in 2000, 1990 and numerous others [7].

M&A Resurgence and IPO Drought

A reduction of overall share supply is bullish for share prices. Continued acquisition activity and low IPO numbers kept share supply constrained in the second quarter.

The second quarter featured a return to big, headline-grabbing deals like InBev's initial $49 billion bid for Anheuser-Busch, later bid up to $52 billion. Though many decreed the "death" of M&A during Q4 2007, tied to worsening high yield credit markets, year-to-date 2008 is tracking to be another big year for acquisitions.

We've said in previous commentaries the so-called credit crunch is actually a credit reallocation benefiting larger, better-rated firms. Today's deals tend to be transacted by larger firms who still have cheap, easy access to capital. So far for the year there has been $849 billion in total global M&A, of which $332 billion is cash-based[8]. Credit is no doubt tighter for poorly-rated, usually smaller companies and private equity firms. In past years, private equity firms acted as competition to other public firms who wanted to make acquisitions. Private equity's current absence has allowed strategic buyers to step into the void left by the financial buyers.

It's also important to note IPO activity is the slowest in years. Low IPO activity indicates constrained equity supply growth and is bullish for share prices. According to IPOHome.com, total IPOs in the first half of 2008 were 36, the weakest since 2003. By contrast, the first half of 2007 saw 133 global IPOs. Also, the second quarter saw zero US venture-backed IPOs. Many see this as a negative development, but in our opinion it is in fact very bullish.

One source of new share supply has been Financials where recently a flurry of firms issued shares to obtain desperately-needed capital infusions. This effect has been limited to the Financials sector and the resulting share dilution will weaken earnings-per-share measures, looking ahead. This is a compelling reason why Financials will likely continue underperforming the broad market.

Valuation Update

Global equities remain at or near historically cheap levels relative to fixed interest. This ongoing situation provides ample incentive for firms to continue acquiring smaller peers cheaply and buying back their own shares – both positives for share prices. Table 4 shows the earnings yield-bond yield gap is wider now than the beginning of the year.

Table 4: MSCI World EY/BY Spread

	World Earnings Yield – Bond Yield Spread	
	as of 31/12/2007	as of 30/06/2008
MSCI World Earnings Yield	7.4%	8.0%
GDP Weighted Bond Yield (World)	4.0%	4.1%
Spread	**3.4%**	**3.9%**

Source: Thomson One Analytics, Bloomberg, IMF; as of 31/12/2007. MSCI World 10-year bond yield calculated using the GDP-weighted average of each constituent country's gov't 10-year yield.

The Glass Is Half Empty – What the Bears Fret

Though US economic data results are consistently proving stronger than expected, prevailing sentiment has remained stubbornly "glass half empty."

Many investors remember what was coined as the Goldilocks economy during the 1990s – ideally balanced growth and inflation that was "just right." Today is viewed as anti-Goldilocks. 1970s-style stagflation fears abound. Inflation is "too hot" and growth is "too cold," they say. People hate the status quo while simultaneously fearing that stimulatory policy changes would stoke inflation and restrictive ones would crush any hope of growth – no way out. Such an overly pessimistic view is irrational and ultimately bullish for equities.

Sentiment indicators and informal polls consistently show most people believe the world is far worse off now than a decade ago. Today may not be ideal but it's vital to keep perspective. Taking a step back from the immediacy of today's breathless headlines, a much different picture emerges, as shown in Table 5.

Table 5: It's Not So Bad...

US Economic Indicators	Cumulative Growth (Q1 1998-Q1 2008)
Non-Farm Employment	10.5%
Real Average Hourly Earnings	5.7%
Real Personal Income	32.1%
Real Consumption Expenditures	39.6%
Real GDP	31.0%
Household Net Worth (nominal)	56.0%
Productivity (output per hour)	30.3%
Real Disposable Income	33.6%
Industrial Production	19.0%
Exports (nominal)	92.7%

Source: Thomson Financial Datastream.

Certainly this isn't to say all things are perfect or that nothing can deteriorate in the future. But hopefully it offers useful context for interpreting today's world.

High Demand Equals High Oil Prices

High oil prices particularly troubled investors in the second quarter and speculators have become popular scapegoats for higher energy prices. In fact, some US politicians have put forth proposals aimed at curbing speculation in oil futures. We believe such fears are inane.

Like all goods and services, oil prices are driven by supply and demand. Speculators trading futures contracts don't consume commodities. Because virtually none take physical delivery of the commodities in which they invest, speculators don't contribute to actual demand. Speculators don't organise to move prices – even in today's oil futures markets, many speculators are betting oil will fall. US Energy Secretary, Samuel Bodman, sums up our belief on what is really driving prices: "Market fundamentals show us production has not kept pace with growing demand for oil, resulting in increasing prices and increasingly volatile prices . . . There is no evidence we can find that speculators are driving futures prices for oil". Well said.

By contrast, emerging countries do actually consume commodities including tens of millions of barrels of oil per day. World oil demand is expected to advance over the next two years due to strong growth in emerging markets. Supply on the other hand is constrained. These conditions mean even small percentage increases in demand can yield huge percentage increases in price. It is not a linear relationship. In our view, this is not cause for worry. History shows oil prices don't correlate meaningfully with share prices.

Today's oil prices (and rising commodity prices in general) strongly evidence a growing global economy. It's worth noting that from a global view, huge wealth is being created by today's commodity boom. Resource-rich developing nations like Brazil and Russia are seeing huge increases in wealth as the world buys its products.

In our view, increases in demand, not supply shocks, are driving today's higher prices. Oil prices dropping precipitously would require not just a slowdown in global growth, but a fairly severe global recession – which no one wants. Our advice is to be patient. In the absence of a big supply disruption, high energy prices should indicate forward economic growth in the years ahead. Aside from a demand-crunching world recession, the paths to considerably lower oil prices will be major new discoveries, conservation, and substitute technologies – all of which will take many years to have material impact.

Inflation Fears Persist

Low interest rates coupled with rising commodity prices have stoked inflation fears. However, inflation isn't about certain prices rising; it's a measure of aggregate prices. Inflation is a monetary phenomenon – excess money supply unabsorbed by real economic activity causing *aggregate prices* to rise. While rising oil and food prices garner major attention, we tend to forget other prices – homes, cars, electronics and clothing are dropping.

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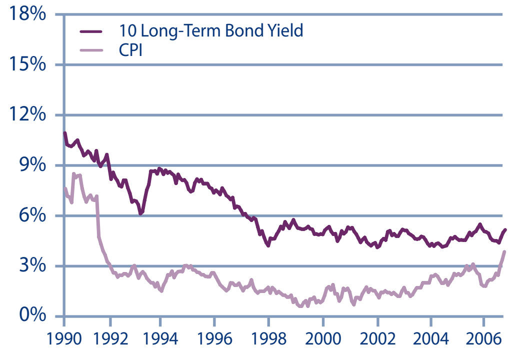
Table 6: Major Components of US CPI

Component	May 2008 CPI Weight in CPI*	1–Year Change
Goods (ex. food and energy)	21.6%	0.1%
Services (ex. energy services)	54.9%	3.2%
Food	13.8%	5.1%
Energy	9.7%	17.4%
CPI	100%	4.2%
Core CPI (ex. food and energy)	76.5%	2.3%

*Weights as of December 2007 (most recent available). Data reflects Consumer Price Index for All Urban Consumers (CPI-U)
Source: US Bureau of Labor Statistics

As we've covered in past commentaries, global long-term interest rates are a better gauge for the market's expectations for inflation. Rates ticked up slightly from extremely low levels in the last weeks of the quarter, but remain historically benign, as shown in Table 7. The UK 10-year Gilt rate stands at 5.05%, as of July 21st[9]. To us, this indicates the market doesn't view inflation as a major concern looking forward. Additionally, US Treasury Inflation Protected Securities (TIPS) similarly indicate modest inflation expectations at a current spread of 2.43%.

Table 7: Benign Interest Rates Persist



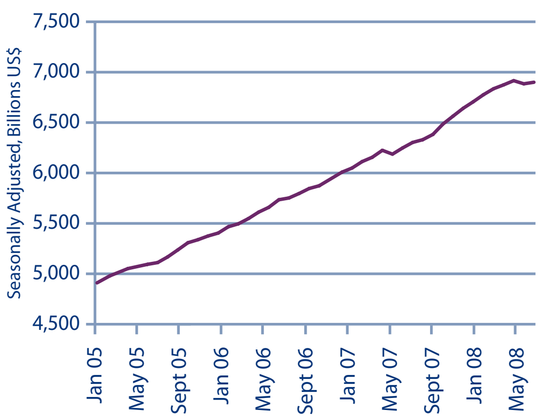
Source: Thomson Financial Datastream; as of 31/05/2008

Financial Markets Stabilising

In our view, the economy has largely moved past credit problems that dominated first quarter worries, but the spectre of Financials' woes continues to breed fear. These fears have lingered for over a year now and in our view, their power to move markets much, going forward, is largely spent.

There is no doubt the Financials sector continues to have problems. But so far, the effects have not bled widely into the broader economy as many anticipated. Excluding big credit-related write-offs, most financial firms remain profitable and core operating revenue continues to be sound. As shown in Table 8, aggregate lending continues to grow.

Table 8: Aggregate Bank Lending Activity

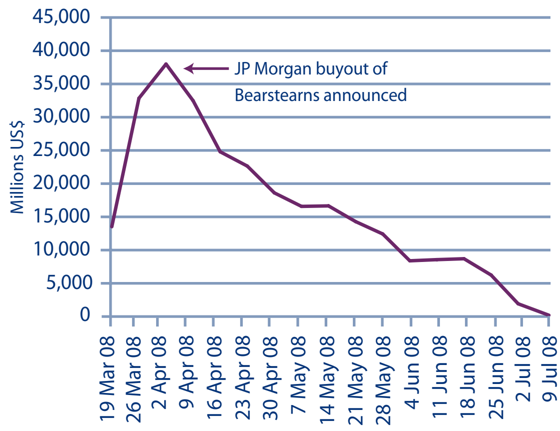


Source: Federal Reserve

After the unexpected announcement of JP Morgan's planned buyout of Bear Stearns last March, many were convinced systemic failure would follow, anticipating a "domino-effect" from further bank failures. But months have passed, the JP Morgan-Bear Stearns merger was completed in an orderly fashion, and clients and vendors remained whole. Only shareholders were left holding the bag. We expect some weaker, much smaller and less significant financial institutions will fail (like IndyMac); maybe a lot in fact. In our view, this period isn't likely to be as extreme as the 800-plus bank failures during the Savings and Loan crisis of the early 1990s. But even then systemic failure didn't result. Instead, a wave of consolidation resulted that strengthened the industry for the next decade. The government has made it abundantly clear it will not allow systemic failure, particularly for the largest and most important entities such as Fannie Mae and Freddie Mac.

The Federal Reserve's initiative to provide greater liquidity and stability to securities firms through the Term Securities Lending Facility (TSLF) has proved highly effective. Some hackles have been raised about the Fed's plan to continue TSLF through 2009. But we note securities firms' usage of TSLF is consistently dwindling – a signal of improving stability, as seen in Table 9. We continue to view TSLF and similar Fed measures as innovative and useful tools for the industry in distressed periods.

Table 9: Primary Dealer Credit Facility



Source: Federal Reserve

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Geopolitics: Never a Dull Moment

Renewed concerns of war between Iran and Israel have triggered a bevy of fears, including geopolitical instability and an even sharper increase in oil prices. An unexpected exogenous event could always occur but history shows world conflicts, even major ones, do not have a track record of derailing equity markets for long. So far, 2008 has been relatively quiet on the geopolitical front. No major upheavals or regime changes have occurred and no major policy changes have disrupted global commerce.

However, many are concerned that Israel might soon strike Iran's nuclear facilities. We aren't predicting it will happen but an Israeli strike is of course possible and could further unsettle markets. But in our view the effect would likely be limited. Israel's military might is superior to Iran's. There is a history of Israel bombing weapons facilities without war breaking out (Syria 2007 and Iraq 1981, for example). Iran's military position is likely much weaker than many fear. Iran's limited air force wouldn't stand much of a chance against Israel's and probably couldn't project power on the ground through Iraq or Saudi Arabia, as the US would undoubtedly intervene. Iran's naval power is virtually nil. It could potentially fire ballistic missiles at Israel which may or may not be able to reach their targets. But even that is not an attractive option for Iranian leaders because retaliation from Israel would most assuredly lead to a rapid end to the Iranian regime. If Iran instead decided to disrupt commerce in the Persian Gulf, which in effect would be an attack on Western and Arab interests, oil prices would almost certainly spike, but the US would see to "regime change" even faster. None seem attractive options for Iran. A more likely scenario, in our view, would be no immediate direct military reaction on Iran's part.

No major upheavals or regime changes have occurred, and no major policy changes have disrupted global commerce.

As humans we tend to forget the intensity of past fears. But by doing a quick scan of historic world events and subsequent market returns, we can see there's never a dull moment in history. While the threat of a conflict in the Middle East might seem dire, we've been through periods just as frightening, if not more so. Rare is the period in history without geopolitical strife. Yet, over time, markets rise. Page 298 of Ken Fisher's 2006 book *The Only Three Questions That Count* contains a list of historic events and subsequent annual market returns. You may be surprised at how indifferent markets were to seemingly terrifying world events.

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Two Elections?

Turmoil in the Labour Party

Much has been made of the Labour Party's unpopularity since last October. However, there has been little division within the Labour Party until now. After a shocking by-election defeat in Glasgow East in late July and an opinion piece in *The Guardian* only days later, Foreign Secretary David Miliband sparked a leadership debate as he called for Labour to offer "real change". A challenge to Brown's leadership would be a significant political development, but markets historically have had little negative reaction to a change in leadership. Since the end of WWII, six Prime Ministers have resigned for various reasons. On average, markets have performed moderately well over the following one, three and six month periods.

Table 10: Turmoil in the Labour Party

Prime Minister (Party)	Resignation	1 month	3 months	6 months
Winston Churchill (Con)	07/04/1955	2.8%	14.8%	7.6%
Anthony Eden (Con)	10/01/1957	7.3%	9.7%	20.1%
Harold Macmillan (Con)	17/10/1963	1.9%	5.3%	3.5%
Harold Wilson (Lab)	05/04/1976	4.2%	-2.0%	-16.2%
Margaret Thatcher (Con)	28/11/1990	0.9%	12.7%	18.9%
Tony Blair (Lab)	27/06/2007	-4.5%	-0.3%	-0.5%
	Median	2.3%	7.5%	5.6%
	Average	2.3%	6.7%	5.6%

Source: Global Financial Data.

If Brown were to step down, and we have no way of knowing whether he will, the new Labour leader would be expected to call a general election immediately. A portion of the public had wanted Brown himself to call an election to validate his leadership last June. A second Labour leader without a general election mandate would be very unlikely in our view. An election today would favour the Conservatives so it seems surprising to us that Miliband would push for the top spot right away. At his young age, he will surely be in a position for the leadership position down the road. We're not sure he would want his first showing as leader of the party to be one of defeat.

However, another scenario could be that he pushes for Brown to step down and for another person to step in and lead the party in a general election. That would allow Miliband to prepare for a future leadership bid, while not having to shoulder the burden of an electoral defeat.

As we said in our previous commentary, the British political landscape has been overshadowed by the US Presidential election but a leadership battle and a subsequent general election would give it a run for its money this autumn.

A challenge to Brown's leadership would be a significant political development, but markets historically have had little negative reaction to a change in leadership.

US Presidential Election Set

This quarter provided closure to at least one uncertainty in the 2008 presidential race: We now have two major party nominees, Senators Barack Obama and John McCain. Political outcomes matter for equity markets. The results of political initiatives involve the distribution of resources, which have a direct impact on the economy and capital markets. Politics can also meaningfully play a role in investor sentiment. It is therefore important to impartially predict elections and their expected impact and continually monitor politics around the globe.

We remind you Fisher Investments is politically agnostic, preferring neither party because we believe both parties' political rhetoric doesn't accurately portray American political reality.

As covered in our last commentary, this election remains very unusual in that it features two senators, both of whom struggled to get the nomination. Running two relatively weak candidates against each other makes predicting the outcome difficult this far in advance. That said, it seems Obama is doing what he must to win by establishing as large an early lead as possible. He'll need to maintain or add to his lead this summer though if he hopes to win, because Republicans historically gain ground starting in September and do better on Election Day than final polls indicate.

Though Obama has the early advantage there are no sure bets and he could easily lose his current lead as fast as he established it. According to Gallup, of the nine most recent competitive presidential races, only three candidates with a July lead wound up the victor. For example, John Kerry had a 7% July lead on George W. Bush in '04, George H. W. Bush led Bill Clinton by 7% in '92, and Michael Dukakis led George Herbert Bush by 6% in July '88. Yet by November, they were all defeated.

Democrats typically nominate candidates whose identity is relatively un-established with the broader public and therefore have more easily movable poll numbers. As the country learns more about Obama, his numbers could fluctuate considerably in either direction.

Political Uncertainty Can Provide a Pop

The fourth year in the presidential election cycle is traditionally good for markets because little material legislation is passed. Instead both sides are busy campaigning and pandering to the middle to gain votes. True to form, this year has featured increased political rhetoric, but little action.

Positive equity market returns in presidential fourth years tend to come in the back half of the year, or are "back-end loaded," as shown in Table 11.

Equities tend to get a big boost toward the second half of the year in an election year. During election years, markets traditionally adopt a "wait and see" attitude until the election outcome becomes clearer, and that uncertainty tends to delay the positive returns. As the market begins to price in the winner, stronger returns are likely in the back half. In particularly tight races, uncertainty can last until the fall and sometimes until Election Day.

As we move closer to Election Day, we anticipate 2008 will be similarly back-end loaded.

Table 11: Election Years Are Back-End Loaded For Equities

S&P 500 Returns in GBP				
Year	January to May Return	June to December Return	Full Year Return	
1928	13.2%	22.5%	38.7%	
1932	-49.6%	70.7%	-13.9%	← Great Depression
1936	5.8%	21.4%	28.4%	
1940	-7.8%	-10.1%	-17.0%	← Early Stages of WWII
1944	5.8%	7.5%	13.8%	
1948	9.1%	-8.9%	-0.6%	
1952	0.2%	10.5%	10.7%	
1956	-0.6%	3.9%	3.3%	
1960	-6.9%	4.0%	-3.1%	
1964	7.1%	5.8%	13.2%	
1968	3.2%	5.3%	8.7%	
1972	4.9%	19.8%	25.7%	
1976	27.5%	11.1%	41.7%	
1980	-3.1%	20.0%	16.3%	
1984	-4.4%	32.9%	27.1%	
1988	9.1%	7.4%	17.2%	
1992	1.6%	27.0%	29.0%	
1996	8.6%	0.3%	8.9%	
2000	4.2%	-6.7%	-2.8%	← Note there was no clear winner until December 2000. Lots of uncertainty broke the pattern
2004	-1.8%	3.3%	1.4%	
Simple Average	1.3%	12.4%	12.3%	

Source: Global Financial Data

US Capital Gains Fear

In recent commentaries, we have discussed the changes in the UK capital gains rate that took effect in April. There might be changes on the horizon in the US as well. US tax cuts put in place in 2003 are set to expire December 31, 2010, in the absence of future legislation. Among other things, the capital gains rate would revert back to 20% from the current 15%. To make matters worse, Senator Obama has said he would consider raising the rate to 25%, or even 28%, if he becomes president. This must be bad for equities, right? Maybe, maybe not.

Since 1981, there have been four major changes to the capital gains rate in America. The results contradict the notion that higher rates immediately lead to bad returns and lower rates lead to better returns.

- In 1981, the rate was cut from 28% to 20%. The S&P 500 declined by -22% over the next 12 months.
- In 1987, the rate was hiked from 20% back to 28%. The S&P 500 rose by 39% over the next eight months.
- In 1997, the rate was cut from 28% back to 20%. The S&P 500 continued its bull market ascent well into 1998.
- In 2003, the rate was cut from 20% to 15%. The S&P 500 began a five-year bull market run.

The first two instances might seem counterintuitive, but think about what a capital gains tax is – a tax on selling. When the tax on something goes up, we get less of it; when the tax goes down, we get more of it. So when capital gains rates rise, people on the margin become less inclined to sell. Less selling yields higher prices. The reverse is true when capital gains rates fall.

In 1981 this prompted a wave of pent-up selling. The opposite was true in 1987 when the increase caused some people to refrain from selling under the higher tax rate. (The October 1987 crash occurred 10 months later for unrelated reasons. The driving forces propelling the bull market of the late 1990s seemingly overwhelmed the fiscal policy change in 1997, as investors didn't want to sell regardless of tax rate.

Lastly, the tax cut of 2003 occurred after two and a half years of a bear market. There were no gains to realise. People had already done their selling. The tax rate change didn't affect selling behaviour. (In the long run, lower rates are arguably stimulatory since they increase the after-tax present value of investments. This can encourage marginal buyers to take action and may partially explain the beginning of the bull market.)

The bottom line is, beyond continued vigilance, there is not much to be done about future-changing tax rates today.

End Notes

1 Bureau of Economic Analysis

2 International Monetary Fund

3 Bureau of Labor Statistics

4 Thomson Financial Datastream

5 Bureau of Economic Analysis

6 Estimates from July 11, 2008 edition of Thomson Reuters “Market Week” commentary

7 Bloomberg

8 Thomson SDC Platinum; 1/1/2008 – 7/10/2008

9 Bloomberg

10 Bloomberg

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