Peace Dividend

Dr. Edward Yardeni

On Thursday, March 20, I visited several institutional investors in Boston with Professor R. Glenn Hubbard. Glenn was appointed by President George W. Bush on May 11, 2001, as chairman of the Council of Economic Advisors (CEA).* He resigned on February 28, 2003, and returned to Columbia University. Glenn has been a long-time advocate of eliminating the double taxation of dividends, an idea that President Bush fully endorses. Indeed, the proposal is the major component of the administration’s latest economic stimulus plan. Although I was among the advocates of eliminating the double taxation of dividends last summer, even I am surprised at the President’s strong commitment to doing so.**

Operation Economic Stimulus. Clearly, if all goes well with Mr. Bush’s campaign to liberate Iraq, then he will likely have the political capital to get his way in the capital. In other words, one of the peace dividends may very well be the end of the double taxation of dividends. Another very stimulative dividend is that the temporary cuts in marginal tax rates scheduled for 2006 are likely to be accelerated and made retroactive to January of this year, and made permanent.

This should be quite bullish for the stock market. In my Target Scenario, the S&P 500 and the Dow Jones Industrial Average (DJIA) rise to 1,100 and 10,500, respectively, by the end of the year. I assign a 70% subjective probability to this scenario in which a combination of lower oil prices, ample liquidity, and additional fiscal stimulus boost both economic and earnings growth.

I am now raising my subjective probability for the Better Scenario (DJIA 11,500), to 20% from 10%, and lowering the odds of the Worse Scenario (DJIA 7,000) to 10% from 20%. As a result, the probability-weighted DJIA target at year-end is 10,500, the same as in my Target Scenario (Figure A).

Is it too soon to turn more optimistic? The attack on Iraq has just begun. Too bad Saddam Hussein didn’t take the severance package he was offered. On the other hand, he could be dead and his body doubles might soon surrender. Still, the war isn’t over yet. The outcome may be certain, but wars often have unexpected developments and consequences.

* Dr. Hubbard was on a leave of absence from Columbia University when he served as CEA Chairman. At Columbia, he is the Russell L. Carson Professor of Economics and Finance, Co-Director of the Entrepreneurship Program in the Graduate School of Business, and Professor of Economics in the Faculty of Arts and Sciences. Dr. Hubbard received his Ph.D. in economics from Harvard University in 1983.

Before the war started, market pundits frequently observed that stock prices were falling because “the market hates uncertainty.” I agree. Fear of the unknown—the so-called fear tax—has been a major source of bearishness. However, it was soaring oil prices that were certainly depressing stock investors. Now that the “oil tax” is plunging, the risks of an economic downturn are greatly reduced. The nearby futures contract price of a barrel of crude oil is down from a closing high of $37.78 on March 7 to $26.91 on March 21 (Figure 1). This is the most immediate dividend from resolving the Iraq issue.

Another very positive sign for the economy is the incredible jump in the Mortgage Refinancing Applications Index in recent weeks. It is now 36% above 2002’s October peak. I estimate that during the previous round of refinancing, most applicants had to wait two to three months to

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**Figure A. Ed Yardeni’s Target Scenario (As Of March 20, 2003)**

<table>
<thead>
<tr>
<th>End Of Period</th>
<th>S&amp;P 500 Forward EPS</th>
<th>X</th>
<th>S&amp;P 500 Forward P/E</th>
<th>S&amp;P 500</th>
<th>DJIA</th>
</tr>
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<tr>
<td>March 20, 2003</td>
<td>$55</td>
<td>15X</td>
<td></td>
<td>876</td>
<td>8,287</td>
</tr>
<tr>
<td>December 2003</td>
<td>60</td>
<td>18</td>
<td></td>
<td>1,100</td>
<td>10,500</td>
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</table>

**Scenarios—Subjective Probabilities And Assumptions**

**Target Scenario: DJIA = 10,500 (70% Probability):**

- The economy continues to grow—no Double Dip—with inflation near zero but positive, no widespread deflation. Consumer spending continues to grow as solid productivity gains boost real pay per worker. Retroactive cuts in marginal income tax rates are also very stimulative. The housing industry remains strong. Home prices continue to rise, providing a positive wealth effect on consumer spending. Interest rates remain near current levels.

- Earnings recover as profit margins rebound. Trend growth in earnings remains around 7%, although it could be closer to 5%.

- The Iraq issue is resolved by spring. The price of oil tumbles, boosting both U.S. and global economic activity.

**Better Scenario: DJIA = 11,500 (20% Probability):**

- Geopolitics: A quick victory in Iraq stabilizes the Middle East; Iranians peacefully force their anti-Western regime out of power. Israelis and Palestinians resume a peace process that is peaceful and lasting. Bullish consequences for the global economy and stock markets are comparable to what happened after the end of the Cold War. In other words, the U.S. won the Cold War and now wins the “Clash of Civilizations.”

- Liquidity pours out of savings deposits into the economy and stock market as consumer confidence rebounds.

- The earnings rebound is stronger than expected as pricing improves on a cyclical basis. The elimination of the double taxation of dividends is also very bullish.

**Worse Scenario: DJIA = 7,000 (10% Probability):**

- Iraq is defeated after a very messy war. The U.S. wins, but the Middle East becomes even more unstable. Oil prices remain over $30 per barrel.

- Deflation becomes a big problem for profits as consumers reduce spending and home sales fall. Consumer and business credit problems mount.

- Earnings are flat or down in 2003, and growth now trends around 3%, or less than half the trend since 1960.

**Probability-Weighted: DJIA = 10,500**

Source: Prudential Securities.
get their new loans processed and approved. Many used the opportunity to borrow more money, i.e., to cash out some of the equity in their homes. Fannie Mae estimates that cash-outs totaled over $100 billion both in 2001 and 2002. I believe that most of these funds have been parked in very liquid savings deposits, which rose $439 billion and $446 billion in 2001 and 2002, respectively (Figure 1). Another wave of refinancing and cash-outs suggests that there is more than enough liquidity to stimulate better-than-expected economic growth and higher-than-expected corporate earnings.

The jump in the ten-year bond yield from a recent low of 3.59% on March 10 to 4.10% on March 21 is likely another important sign that the outlook for the economy is improving now that the fear and oil taxes are falling. I’ve previously argued that the stock market’s P/E ratio would rise only if the bond yield moved back up over 4%. This seems to be happening now (Figure 1). The P/E, based on 12-month forward earnings, which was 14.6 just before the Gulf War II rally started, is 15.8 now. I am still forecasting that the bond yield could rise to 5% and that the P/E should rise to 18 by the end of this year. If consensus S&P 500 12-month forward earnings rise to $60 per share by the end of the year from $55 per share currently, as I expect, then the S&P 500 could be at 1,100 by the end of this year (Figure A and Figure 2).

I am not worried that higher interest rates will burst the housing bubble. First, I don’t believe that there is a housing bubble currently. Furthermore, rising interest rates imply that would-be homebuyers would be more optimistic about the outlook for the economy, employment, and their financial prospects. Many might rush to buy a house before mortgage rates move still higher. In this scenario, home prices might rise at a faster rate. This could trigger a speculative bubble, which would be great for housing activity, at least until the bubble bursts.

The Persistent Dr. Hubbard. I enjoyed spending the day in Boston with Glenn. I learned from him that his brother plays the keyboard in Sawyer Brown, a successful country music group whose songs tend to be upbeat. I was surprised that Glenn didn’t know that when you play most country songs backwards, you get your job back, your house back, and your wife back. Nevertheless, Glenn is clearly a very knowledgeable economist and a leading expert on tax policies.

He certainly deserves most of the credit for the plan to eliminate the double taxation of dividends. Indeed, he first devised the plan when he was deputy assistant of the U.S. Treasury Department in the first Bush administration during the early 1990s.* He is persistent. Glenn believes that good policy ideas can take a long time to promote, but that they can eventually prevail. He told me that his latest research efforts are on policies to reform the health care system, which he believes poses the greatest challenge to the government’s financial health.

Glenn is not concerned about the deficit-widening impact of the President’s latest economic plan. Excluding dividends from the personal income tax is the centerpiece of the President’s plan, which is expected to cost the Treasury Department $670 billion over the next ten years, with $364 billion attributable to tax-free dividends.

Glenn observes that the deficit projections are based on “static” rather than “dynamic” scoring. He believes that some of the proposals, especially eliminating the double taxation of dividends, will partly pay for themselves by stimulating faster economic growth and generating more tax revenues.** According to Glenn, “Those static cost numbers are substantially overstated. That is, maybe 60% of them are actual cost to the Treasury. And of course the revenue cost is still in an economy that would have higher GDP and higher wages as a result.”


** The actual costs for tax bills are calculated by the Joint Committee on Taxation in Congress and by the Treasury Department. The Office of Management and Budget conservatively used static scoring in the President’s budget, assuming no growth effects but describing what growth effects are likely to be.
In effect, the President’s plan would eliminate the double taxation of all corporate income, not just dividends. The plan also shelters after-tax retained earnings from the personal income tax: Investors would be allowed to deduct one dollar from their taxable capital gains for every dollar of accumulated retained earnings when they sold their shares. It would reduce the effective capital gains tax by taxing only the gains attributable to a rise in a stock’s price caused by the increase in its valuation multiple, i.e., the P/E. For many investors, the after-tax return from stocks would increase. In other words, earnings after corporate taxes would be worth more to individual investors who would no longer have to pay the personal income tax rate on dividends or the capital gains tax rate on “deferred earnings.” Therefore, the P/E should rise, and so should the stock market.

In a recent interview, when asked about the goal of his proposal, the former CEA chairman said:

> It does two really big things for economic growth. One is to reduce capital taxes and the cost of capital for investment. The second is that it now makes neutral the corporate finance decision. So whether I decide to pay out a dollar or retain it, whether I choose debt or equity, is driven by my judgment as a business person and not by the tax code.*

**The Complexity Issue.** During our day in Boston, I was surprised how often Glenn was asked about the complexity of the proposal to eliminate the double taxation of corporate income. For example, investors would be required to keep track of the percentage of taxes paid on earnings by each of the corporations in which they are shareholders. Here is Glenn’s response:

> This is actually one of the most baffling questions I get repeatedly when talking about the plan, and I must say I don’t quite understand it. The first question we have to ask ourselves is: Complex relative to what? Current law, because of the tax bias against equity financing and the tax bias against dividends, creates a number of highly complicated financial engineering transactions that companies and investors go through, legitimate transactions, to minimize taxes. So we’ve created an incredibly complex system already with what we’ve done. Under what the President has proposed, it is true that not all dividends are literally passed through. There’s something called an “excludable dividend account,” so you have to have paid tax at the corporate level. But our best tax lawyers in the administration claim that if they were in private practice only a few billable hours might be eeked out helping a major company get this set up. This is not a big deal.

And what about individual investors? As an investor, when I get my 1099, the piece of tax information [indicating] my dividends, it will tell me, “Dear Glenn, you got this many dividends that you don’t have to pay tax on and this many that you do.” It doesn’t strike me as that complicated. And in terms of keeping track of the basis adjustment on retained earnings, for most small investors that’s done through financial services companies and mutual funds, [which] have told us that they believe it to be quite easy to do. Indeed, Fidelity, one of the very large mutual fund complexes, has wholeheartedly endorsed the President’s plan.**

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Consumer Stimulus

* Nearby contract, closing price.
Source: Standard & Poor’s Comstock, Mortgage Bankers Association, and Board of Governors of the Federal Reserve System.
Figure 2.

S&P 500 CONSENSUS OPERATING EARNINGS PER SHARE
(Analysts’ average forecasts)

For 2001
For 2002
For 2003
For 2004

Forward Earnings*

S&P 500 Earnings

S&P 400 MID-CAP

For 2001
For 2002
For 2003

Forward Earnings*

S&P 600 SMALL-CAP

For 2001
For 2002
For 2003

Forward Earnings*

* 52-week forward consensus expected S&P 500 operating earnings per share. Time-weighted average of current-year and next-year consensus forecasts.
Source: Thomson Financial.
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When we assign a Buy rating, we mean that the price of the security under consideration is undervalued relative to our fair value estimate. When we assign a Hold rating, we mean that the price of the security under consideration is fairly valued at anticipated returns. When we assign a Sell rating, we mean that the price of the security under consideration may be overvalued. The potential for a price decline of 10% or more is sufficient to warrant a Sell rating. When we reiterate a Sell rating, we are stating our belief that our price target is achievable over the next 12 to 18 months.

A Hold rating signifies our belief that a stock does not present sufficient upside or downside potential to warrant a Buy or Sell rating, either because we view the stock as fairly valued or because we believe that there is too much uncertainty with regard to key variables for us to rate the stock a Buy or Sell.

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Excludes Closed End Funds.

Rating distribution
03/31/03

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Rating distribution
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