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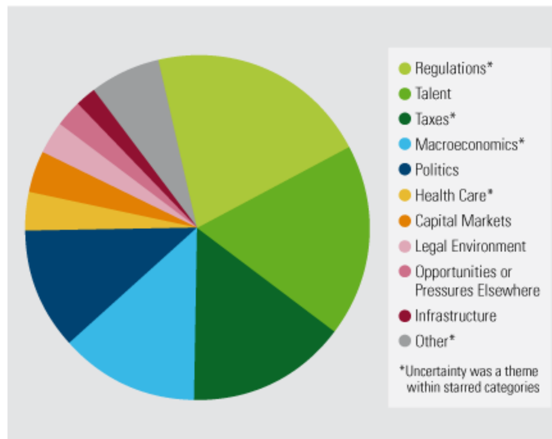
The Tax Code and U.S. Competitiveness

While investors prepare for tax hikes in 2013, it isn't surprising to learn that taxes have become increasingly important when it comes to the economy and U.S. competitiveness. The Harvard Business School recently published results of a survey on U.S competitiveness, which aims to lay out facts and realities of international competition and implications for the U.S. In October 2011, about 10,000 alumni completed an in-depth survey on U.S. competitiveness. According to the survey, the greatest current or emerging weaknesses are perceived to be America's tax code, political system, K-12 education system, macroeconomic policies, legal framework, regulations, infrastructure, and workforce skills. Respondents were deterred from investing in the United States not only by a high statutory corporate tax rate, but also by the sheer complexity and uncertain future of the tax code.

Most Commonly Mentioned Impediments to Investing and Creating Jobs in the U.S.



Source: "Prosperity at Risk: Findings of Harvard Business School's Survey on U.S. Competitiveness" by Michael E. Porter and Jan W. Rivkin (January 2012).

Advisor Corner

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The Fiscal Cliff

By Louis E. Conrad II, CFA

- Without action from Congress, income, capital gains, dividends, and estate and gift taxes are slated to soar as of January 1, 2013.
- Combined with federal spending cuts that are scheduled to begin in 2013, this "fiscal cliff" will have a serious negative impact on economic growth without congressional intervention.

Economic headlines have wreaked havoc with the stock market recently. Whether it has been the ongoing European debt crisis, a deceleration of growth in China, or our own tepid economic and employment growth, these types of headlines led to a decline in the U.S. stock market during the months of April and May. As if this wasn't enough to shake investors' confidence, at the beginning of 2013 we face what has become known as a "fiscal cliff," or a combination of reduced federal spending and increased federal taxes, which are expected to be a meaningful drag on economic activity next year if nothing is done to alleviate their effects.

Federal Tax Rates to Rise

Under the Tax Relief Acts of 2001 and 2003 and subsequent extensions, the lower rates that we have enjoyed over the past decade sunset at the end of this year and revert back to the rates in effect previously. Consequently, only those in the current 15% federal income tax bracket will not experience a rise in income tax rates. Those in the 10% federal income tax bracket will see an increase to 15%, 25% will go to 28%, 28% will go to 31%, 33% will go to 36%, and 35% will rise to 39.6%.

Long-term capital gains tax rates will rise for everyone. For those in the new 15% income tax bracket, the capital gains tax rate will increase from 0% to 10%. For those in higher income tax brackets, the capital gains tax rate will increase from 15% to 20%. With assets held for at least 5 years, the capital gains tax rate will be 8% (instead of 10%) and 18% (instead of 20%), respectively.

Interest income will continue to be taxed at ordinary income tax rates, though at the new higher rates as outlined above. However, tax rates on qualified dividend income will experience a notable increase from 15% for most taxpayers to their new ordinary income tax rate.

Two other tax changes for 2013 involve payroll taxes and taxes related to health care reform. The employee -paid component of Social Security payroll taxes, which had been reduced to 4.2% from 6.2% for 2011 and 2012, will revert back to 6.2% in 2013. In addition, higher earners (those with incomes above $200,000 for individuals and $250,000 for couples filing jointly) will be subject to a new health care reform tax of 3.8% on taxable investment income, such as interest, dividends, capital gains, rents, and royalties; however, retirement plan distributions and municipal bond interest will be excluded. This tax would be eliminated if the U.S. Supreme Court declares the health care reform law unconstitutional in its entirety.

Other noteworthy tax changes will also begin in 2013, including a reduction in the child tax credit, a reduction in the estate and gift tax exemptions, and an increase in estate and gift tax rates. A more extensive discussion of these and other tax changes slated for 2013 are beyond the scope of this article.

Deficit/Economic Impact

In addition to the tax increases scheduled to take effect in 2013, discretionary federal spending is slated to be reduced by $2.1 trillion over the next ten years based on the congressional compromise reached last August, with many of these cuts set to begin in 2013. Based on Congressional Budget Office (CBO) estimates, if the tax increases and spending cuts occur as scheduled, the federal budget deficit will be reduced by several hundred billion dollars or 5.1% of GDP during 2013. However, this will also drive the U.S. into a recession during the first half of 2013, according to projections by the CBO.

Given the draconian economic impact these scheduled tax rate increases and spending cuts would have, Congress is expected to reevaluate them during the post-election lame-duck session this fall or in early 2013.

Monthly Market Commentary

Fear grew in May as bad news out of Europe and China continued to dominate the markets. Greece remained the epicenter of European problems as Greek election results have made it difficult to form a new government. Bank runs in Greece and rumors of an exit from the eurozone have plastered headlines as people speculate the possibility and implications of such an event. On a lighter note, investors breathed a slight sigh of relief for the eurozone, which managed to eke out a very slight GDP growth in the first quarter of 2012 after contracting in the fourth quarter of 2011, avoiding the technical indication of a recession (back-to-back quarters of negative GDP growth).

As China's growth rate continued to soften because of manufacturing and export demand weakness in tandem with Europe's slowdown, China cut interest rates for the first time since 2008 with the hopes of spurring more growth. Barring a complete financial collapse, there should be minimal impact on the U.S. economy because the U.S. exports next to nothing to Europe (and even less to China), while Chinese exports to Europe represent a significant portion of China's GDP.

Employment: Markets tanked as a result of a disappointing employment report, with only a meager 69,000 jobs added in May. Worse, the previous two months of unemployment data were revised downward by a total of 49,000 jobs. Despite these setbacks, Morningstar economists still expect monthly employment growth to average about 195,000 jobs per month, with better housing employment and continued 2% or so GDP growth to drive that employment. The unemployment rate rose slightly to 8.2%.

Manufacturing: Despite a tepid manufacturing sector outside of the U.S., domestic manufacturing data mostly came in above expectations in April. Almost every category showed strength, led by utilities, which rebounded nicely as weather returned to more normal-conditions. While autos have been a huge help in the past couple of months, April showed a broadening of the improvement in manufacturing across all categories. Investors should be aware that while the month-to-month numbers looked positive, the year-over-year growth rate remained flat, indicating just steady, forward progress as opposed to a boom-or-bust scenario.

Housing: Seasonally adjusted home prices increased 1.1% from the fourth quarter 2011 to the first quarter 2012, the largest increase since the third quarter 2009. Year-over-year, prices fell by 1.9%, which was much better than the 4.6% year-over-year decline in the first quarter of 2011. As home prices stabilize, this will likely help the difficult appraisal process that had prevented thousands of homes from closing. April's pending home sales fell from March but was still up 14.4% year-over year, marking the 12th straight month of positive growth. Morningstar economists believe that the U.S. housing market has far more room for upside than downside at this point in the business cycle.

Consumers: Consumer spending continued to increase on both a month-to-month and year-over-year basis despite the apparent volatility in the employment market. Some of the reasons include greater availability of credit, falling gasoline prices, and a substantially lower inflation rate. However, in the face of weakening employment as businesses hit the pause button on hiring, there is little chance that consumption growth will accelerate.

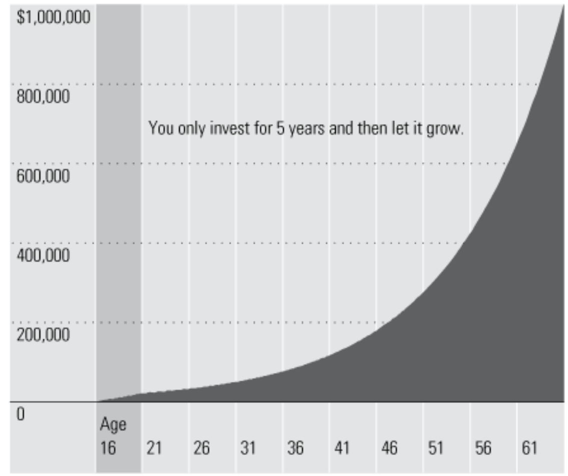
Market: The U.S. stock market suffered its worst day of the year on June 1, 2012; the Standard & Poor's index fell by 2.5% after the release of a surprisingly weak employment report. Fears of the impact on the U.S. because of the slowing global economy saw a flight to safety away from stocks and into Treasury bonds.

Retirement: The Next Generation

- This article points to the power of compounding and having time work for you.
- The importance of staying invested through the vagaries of the market is required for such a result.

If you had a dollar for every time you heard the phrase “Start investing early,” you could retire with a million. If you actually acted on that phrase, you are probably retiring with more. Now is the time to encourage your children and grandchildren to start saving as soon as they get their first job. Let’s assume that your teenage child or grandchild is employed for five years from age 16 to age 21. During this time, he or she saves $276 per month ($3,315 per year) and invests the money in a Roth IRA (paying taxes, of course, but at a low tax bracket). This may be a serious sacrifice for a teenager, so any contribution from you would be of great help. Assuming the money returns the historical equivalent of a diversified 60% stock/40% bond portfolio, your child can retire at 65 with $1 million tax-free, without having to invest another dollar after age 21.

Retiring With $1 Million



Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. Government bonds are guaranteed by the full faith and credit of the United States government as to the timely payment of principal and interest, while stocks are not guaranteed and have been more volatile than bonds.

Source: Stocks in this example are represented by the Standard & Poor’s 500®, which is an unmanaged group of securities and considered to be representative of the stock market in general. Bonds are represented by the 20-year U.S. government bond. An investment cannot be made directly in an index. The data assumes reinvestment of all income and does not account for taxes or transaction costs. The diversified portfolio was rebalanced every 12 months. The return used for calculations was the average of 50-year rolling returns for 1926–2010.

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