TABELL'S MARKET LETTER

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August 22, 1986

Just about the entire media industry has spent the last week or so bombarding its readership with analysis and commentary on the tax reform bill. We are, nonetheless, in our modest-circulation sheet, not embarrassed to throw in our own two cents worth, especially since tax policy and financial markets are not unrelated. Herewith, then, a few comments.

It will, first of all, not surprise our readers to know that we agree with the multitudes of our peers who assess the bill as one of the most important and far-reaching pieces of legislation to come along in years. One reason, and one reason only, is necessary to compel us to that assessment---lower marginal tax rates---the magic 28%. The purists who carp about the effect, equality or logic of this or that feature totally fail, it seems to us, to appreciate the importance of the single essential one. Having been life-long commentators on markets, we perforce admire them and cannot help but applaud legislation which, by allowing each and every American citizen his own control over the deployment of at least 72 cents of each dollar he earns, returns a huge dose of major economic decision-making to the market place.

The retreat from the use of the tax code for economic and social engineering, is, in our view, to be applauded, the major recent results of such attempts having been, as far as we can see, capped oil wells, vacant office buildings, and bankrupt farmers. Even the most apparently successful of these tax-manipulation attempts, the 40-year effort to encourage owner-occupied, single-family housing, so politically sacrosanct that it had to be left in the new tax code, is beginning to show a few warts, it having come to the attention of numerous observers that a new generation finds itself unable to afford housing equal to that obtainable by their parents at the same age. Nonetheless, the new bill takes a long step in returning taxation to what should properly be its single function--revenue raising.

Having gotten the above off our chest, we can now return to the specific area we are supposed to know something about and look at those provisions of the new code which specifically affect the stock market. The first and most obvious of these is capital gains, and the purists referred to above are, of course, bemoaning the rise in the rate from 20% to 28%. A simple-minded comment on this is that, in our 32 years in the business, we have been subject during most of them to a capital gains rate in the general area of 28% and occasionally higher. We seem to remember, during those years, some pretty good stock markets. It is suggested in various quarters that venture capital will immediately disappear and entrepreneurship cease to exist. Being personally acquainted with a few venture capitalists, we are skeptical of this arguement. Not surprisingly, these gentlemen would prefer to see their profits taxed at 20% (they would prefer 0% even more), but they are, by and large, simply attuned to assuming unusual risk in order to obtain unusual reward. We doubt that they intend immediately to transmogrify themselves into investors in government bonds.

Our own purist's view is, of course, that capital gains should not be taxed at all, but the problem with tax law has always been in defining precisely what constitutes capital gain. It has never been enough to say simply that it is the profit arising from the purchase of an asset at one price and its sale at another price. Such a transaction involving a can of soup by the A & P has never been regarded as anything but income. On the other hand, retention of a financial asset for a protracted period of time has always been thought to be a different breed of cat, for reasons that can be discussed at length.

American law has always emphasized a compromise, the length of time held, as the criterion for differentiating between capital gains and income, that length most often having been six months, although we recently underwent a short experiment with one year. It is one of those principals that has lasted a long time because it has, more or less, worked, but we would be reluctant to try to contruct a philosophical arguement for it.

In any case, one of the most significant features of the new law is that the time test is going away. Capital gains are synonomous with income for holding periods ranging from 30 seconds to infinity. This will, we think, have some interesting effects, one of which will be more active trading starting in 1988, an increase which will, however, be mitigated by the large entent to which current stock holdings (i.e. pension fund positions) are not taxable in the first place. Short-term, as many analysts have pointed-out, we should see a pressure to take profits before the end of 1986.

The other major aspect affecting the stock market, of course, is the corporate tax which, overall, will be increased to pay for the cuts that the majority of voters will be receiving. We cannot, however, view this with alarm. The corporate tax had, in recent years, become an incredible melange, largely due to additional social engineering attempts based on the thought that the useful life of an asset could be legislated. The result was a huge list of major companies paying little or no tax at all made this obvious. On the other hand, a uniformly-applied 34% tax may make economic sense. The conventional wisdom has long bemoaned the low rate of U.S. savings. Many studies have suggested that the corporate tax eventually becomes, in large part, a pass-through and, thus, a consumption tax. It could, therefore, provide a savings stimulus more effective than the ones which notably have failed to date.

In a political environment, the new law was obviously forced to make trade-offs for the ultimate goal of lower marginal rates. In our view these trade-offs were eminently worth the result.

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Dow Jones Industrials	1880.76
S & P 500	250.40
Cumulative Index (August 21, 1986)	3135.62