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FIRST Trust ADVISORS L.P.

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Monday Morning Outlook

Brian S. Wesbury - Chief Economist
Robert Stein, CFA - Senior Economist

Are the Investment Tax Cuts Going to Expire?

Since 2001 a number of important changes have been made to the US tax system. Marginal tax rates have been cut, with the top rate on regular income reduced to 35%, rather than the 39.6% that prevailed from 1993 to 2000.

In 2003 the top marginal tax rate on qualified dividends and long-term capital gains was reduced to 15%. Previously, dividends were taxed as ordinary income – even though this is a second layer of tax for companies that pay dividends out of their after-tax earnings. Before 2003, capital gains had been taxed at a top rate of 20%, which had been in effect since 1997.

As most investors are already keenly aware, the 15% top rate on qualified dividends and capital gains is not permanent. Without new legislation, on January 1, 2011 these tax rates revert to their previous levels. For dividends that means being treated like ordinary income; for capital gains that means a top rate of 20% (18% for assets held longer than five years).

We think higher tax rates on dividends and capital gains would harm the financial markets and result in slower economic growth. Ideally, dividends paid out of after-tax corporate earnings should not be taxed at all. The same goes for capital gains.

The outcome of this year's presidential election will obviously have a great deal of influence on whether the investment tax cuts continue. These tax cuts are at risk but investors should not assume they are going away.

Senator McCain says he is committed to making all the tax cuts permanent. In the end, a McCain White House and Democrat-controlled Congress would likely compromise, with some tax rates going up and others staying down. Although it is always risky to guess the political landscape a year or two from now, we think McCain's economic advisers would make low tax rates on dividends and capital gains a priority. That said, we would not be surprised to see the top rates on regular income go back up.

Contrary to popular opinion, and their own campaign rhetoric, we do not think a President Obama or President Clinton would mean investment tax cuts are automatically doomed. In 1993, President Clinton's tax hike passed with not one Republican vote in either the House or Senate. As a result, the GOP was able to re-brand itself as the "anti-tax" party, helping it gain majorities in the House and Senate in 1994.

We doubt the next Democratic president will want to make that same political mistake and will therefore put a high premium on getting at least a few Republican votes. If so, the price of making their tax hikes bipartisan may very well be maintaining lower tax rates on dividends and capital gains.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
3-31 / 9:00 am	Chicago PMI - Mar	46.0	**46.7**	48.2	44.5
4-1 / 9:00 am	ISM Index - Mar	47.5	**47.7**		48.3
9:00 am	Construction Spending - Feb	-1.0%	**-0.8%**		-1.7%
sometime	Domestic Auto Sales - Mar	5.0 Mil	**5.3 Mil**		5.0 Mil
during the day	Domestic Truck Sales - Mar	6.5 Mil	**6.7 Mil**		6.6 Mil
4-2 / 9:00 am	Factory Orders - Feb	-0.7%	**-0.9%**		-2.2%
4-3 / 7:30 am	Initial Claims - Mar 29	370K	**360K**		366K
9:00 am	ISM Non-Man. - Mar	48.5	**49.3**		49.3
4-4 / 7:30 am	Non-Farm Payrolls - Mar	-50K	**-30K**		-63K
7:30 am	Unemployment Rate - Mar	5.0%	**4.9%**		4.8%
7:30 am	Average Hourly Earnings	+0.3%	**+0.3%**		+0.3%
7:30 am	Average Weekly Hours - Mar	33.7	**33.7**		33.7
7:30 am	Manufacturing Payrolls - Mar	-35K	**-35K**		-52K

Consensus forecasts come from Bloomberg. This report was prepared by First Trust Advisors L. P., and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.