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First Trust

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Monday Morning Outlook

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A Simple Win-Win for Investors and the Government

With each passing month, partisan fighting in Washington gets harsher and harsher. The hostility is in large part due to the debate on health care, which is an issue where the two parties and their supporters have very different visions for the country.

In this atmosphere, we would like to make a simple proposal – having nothing to do with health care – that could temporarily bring the parties together in a way that helps the American people without costing the taxpayer a dime. The idea is to eliminate taxes on all newly-issued inflation-adjusted Treasury securities (TIPS).

Right now, an investor who buys 10-year TIPS can get a guaranteed inflation-adjusted ("real") return of 1.5%. But the return is on a *pre-tax* basis. After taxes, the return could be positive or negative depending on the level of inflation.

For example, if inflation ends up at 5%, the nominal return on TIPS will be 6.5% (the "real" return plus inflation). A taxpayer in the 39.6% tax bracket would pay taxes equaling 2.6%, which is greater than the real return, meaning he loses money on an inflation-adjusted after-tax basis. There is also a problem with investor cash flows. Inflation causes an annual adjustment to the securities' principal amount, but investors have to pay taxes on the increase in principal every year, even though they don't get the principal until the security matures.

As the US population ages, more and more investors have a simple goal: to hit a targeted living standard in retirement with minimal risk. Right now, there is no security anywhere in the world that guarantees an after-tax return, inflation-adjusted, in US dollars. The only entity that can even make that offer is the US government and so far, it's decided not to do it.

Making this change is a win-win for the US government and investors. Although the government would lose some tax revenue, investors should respond by bidding up the prices of the securities, resulting in a corresponding reduction in federal interest outlays, leaving the federal budget roughly unchanged. We say roughly, because there is a good chance the reduction in interest outlays will be greater than the loss in tax revenue, as many investors should be willing to pay a premium for TIPS that give them absolute certainty about their after-tax return.

Meanwhile, economic populists concerned about foreign ownership of the US debt should also like this idea. Right now, foreign central banks are already tax exempt. By leveling the playing field, we could increase the share of the debt owned domestically.

The one key obstacle to this proposal is that state and local issuers of municipal debt, which is already tax free, won't like the competition. But the budget process in Washington only requires simple majorities (not a filibuster-proof 60 Senators) when the plan doesn't increase the deficit. Presidential leadership and a few creative minds in Congress should try to make this happen.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
10-13 / 1:00 pm	Treasury Budget - Sep	-$35.5 Bil	**-$31.0 Bil**		-$111.4 Bil
10-14 / 7:30 am	Retail Sales - Sep	-2.1%	**-2.6%**		+2.7%
7:30 am	Retail Sales Ex-Autos - Sep	+0.2%	**+0.5%**		+1.1%
7:30 am	Import Prices - Sep	+0.2%	**+0.4%**		+2.0%
7:30 am	Export Prices - Sep	+0.1%	**0.0%**		+0.7%
7:30 am	Business Inventories - Aug	-1.0%	**-0.9%**		-1.0%
10-15 / 7:30 am	CPI - Sep	+0.2%	**+0.2%**		+0.4%
7:30 am	"Core" CPI - Sep	+0.1%	**+0.1%**		+0.1%
7:30 am	Empire State Mfg Index - Oct	17.5	**18.9**		18.9
7:30 am	Initial Claims - Oct 10	523K	**523K**		521K
9:00 am	Philly Fed Survey - Oct	12.0	**10.3**		14.1
10-16 / 8:15 am	Industrial Production - Aug	+0.2%	**0.0%**		+0.8%
8:15 am	Capacity Utilization - Aug	69.8%	**69.4%**		69.6%
8:45 am	U. Mich. Consumer Sentiment	73.5	**73.5**		73.5