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KING

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Mergers and acquisitions are a motor for stocks…. The financial environment is historic for takeovers. Interest rates are low, and companies have reduced debt and built up a lot of cash.

— Christophe Donay, Chief Strategist, Kepler Equities

The equity markets continued to move forward in a steady manner during the first quarter. The Dow Jones Industrial Average rose 4.11%, while smaller-cap securities staged an impressive rally tacking on 8.85%. Commodity prices also continued to rise as oil surpassed $80 per barrel. Investors' appetite for risky assets certainly increased as evidenced by the high yield bond index, which rose an impressive 4.82%

One of the big questions many investors are asking today is, "Can the equity market continue to move forward?" Some of the greatest bull markets have developed as a result of markets that have climbed a wall of worry. There have certainly been many issues causing investors to be nervous over the last several months: a ballooning deficit, potential inflationary pressures, high unemployment, increased government regulation, and rising tax rates. All of these concerns are valid and are significant problems for investors to confront. However, contrary to popular consensus, we think several of these problems may unfold much later than widely anticipated. Further, there are many positive developments, which are being overlooked, that should help produce positive returns for equity investors over the next year or so.

The yield on the 10-year Treasury recently topped 4% for the first time in 18 months, sparking fears of potentially rising rates and building inflationary pressures. We believe the Federal Reserve will not raise rates for quite some time, and while inflation will eventually become an issue, it will not materialize in the near term. A primary reason for this is the existence of massive amounts of excess, worldwide manufacturing capacity. It is difficult for corporations to raise prices on items if more supply is available. Historically, inflationary pressures develop as manufacturing

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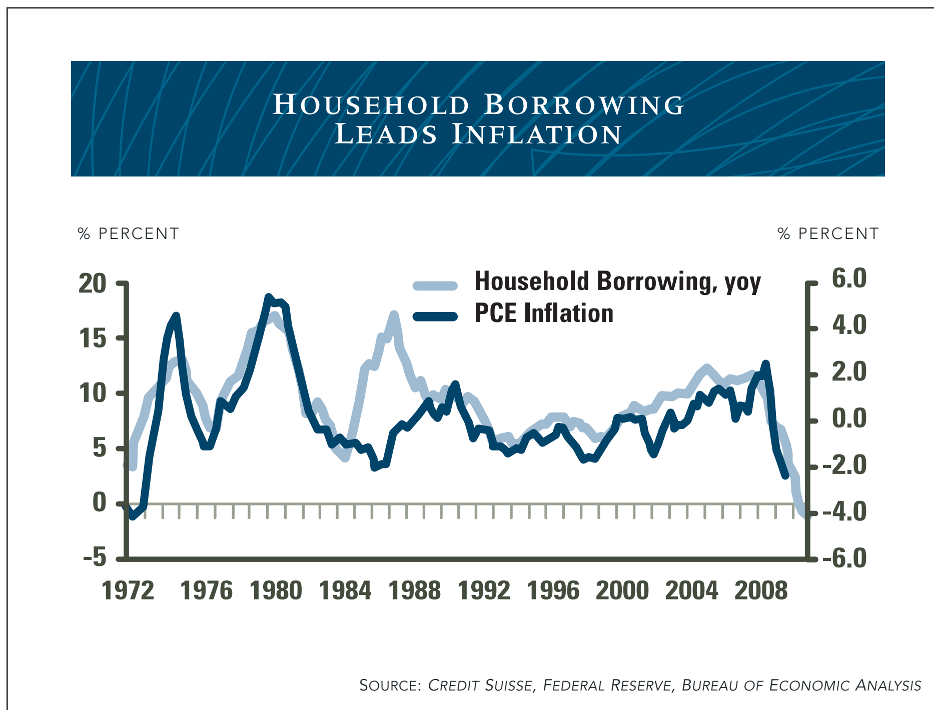
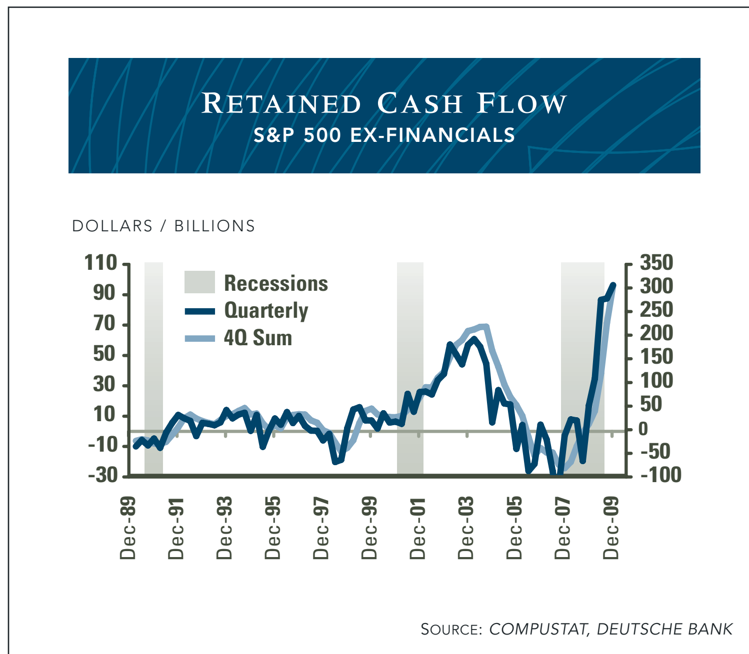


SOURCE: *CREDIT SUISSE, FEDERAL RESERVE, BUREAU OF ECONOMIC ANALYSIS*

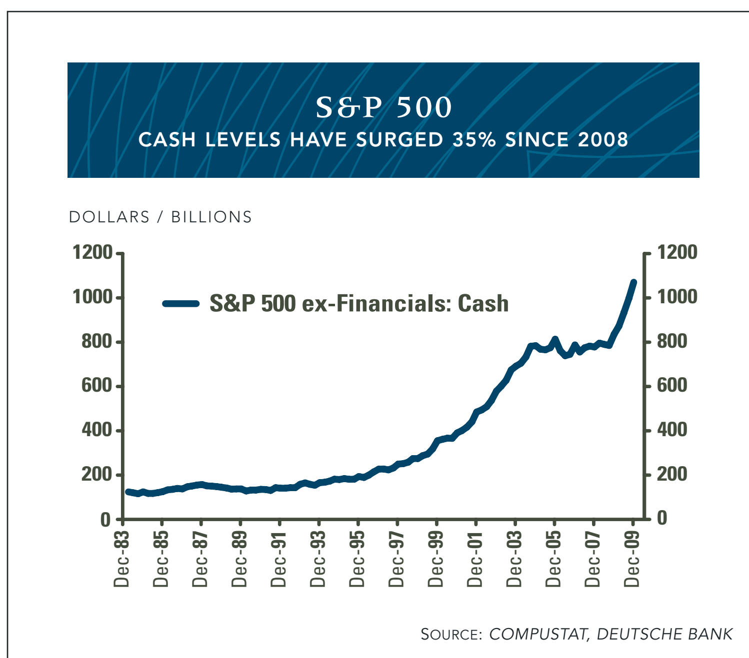
capacity becomes limited; when less supply is available, prices begin to rise. In the '70s and the early '80s, inflationary pressures were able to build much more rapidly in the U.S. because the world was not as interconnected as it is today. In today's world, manufacturing plants are located around the globe, and the easy credit environment of the late 1990s and early 2000 decade has produced a boom in infrastructure build-out, especially outside of the U.S., creating a very large output gap and a reduction of inflationary pressures. The size of the current output gap should help keep inflation at bay for quite a while. To put things in perspective, the output gap created in 2002 allowed five years of non-inflationary growth. Today's output gap is three times larger than in 2002. The recession felt around the world has left a legacy of spare capacity, which will take many years of above-trend growth to eliminate. Another inflationary factor in the past has been excessive lending by the banks (i.e., too many dollars chasing a limited quantity of goods). A great example was in 2006 and 2007 when inflationary pressures started to build, especially in housing prices, as loose credit conditions led to excessive household borrowing. While banks have raised a significant amount of capital and have shored up their balance sheets considerably, lending has not resumed to the levels seen just a few years ago. A newfound focus on fiscal discipline has resulted in a tightening of credit at the banks. As seen in the chart, bank lending is down substantially, as is household borrowing. These conditions are not consistent with inflation.

Unemployment is a major concern of most Americans. While lingering high unemployment will serve as a drag on the housing industry and on state and federal budgets, the U.S. economy has orchestrated successful jobless recoveries in the past. Prior to the last two cyclical downturns, the unemployment rate tended to peak at the end of recessions. However, at the beginning of the 1990s and early 2000s, the timing was different. The economy troughed in March 1991, but the unemployment rate did not peak until 15 months later, and payroll employment did not show consistent gains until 12 months later. The jobless rate peaked 19 months after the recession ended in November 2001, and employment did not rise until 22 months later. The most recent recession may have ended June 2009, and the unemployment rate most likely peaked during October.

Payroll employment fell as recently as February 2010. In March, however, a solid gain was produced—nine months after the end of the recession. It is possible that this recovery will not be as "jobless" as the previous two. While the Federal Reserve will inevitably raise interest rates, Mr. Bernanke will probably hold off until he sees several more months of consistently increasing employment. Of course, rising employment produces all sorts of positive results: (1) it provides a sustainable economic recovery by stimulating consumer spending, which leads to more jobs; (2) it creates a positive climate for banks; as the unemployment rate drops, delinquencies, nonperforming loans, and provisions for bad loans decline; (3) it generates more taxpayers, which alleviates the fiscal crisis of state and local governments and narrows the federal deficit.



SOURCE: *COMPUSTAT, DEUTSCHE BANK*



SOURCE: *COMPUSTAT, DEUTSCHE BANK*

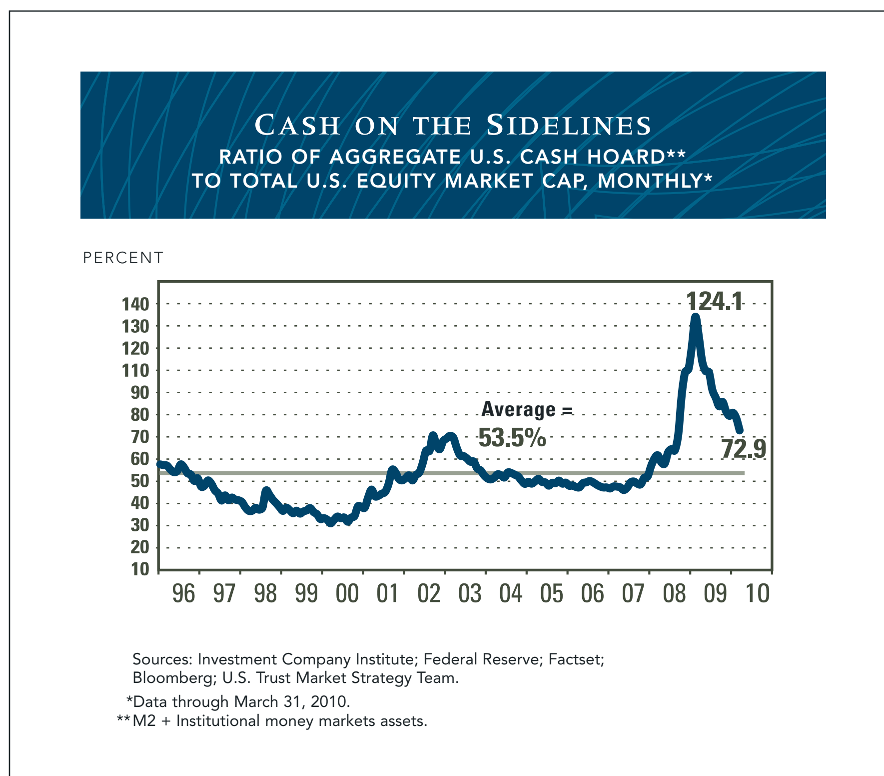
Despite the lackluster economy, corporate cash flow is soaring. According to the National Income and Product Accounts (NIPA), cash flow from corporations rose $1.52 trillion during the fourth quarter of 2009, matching the previous record high during the third quarter of 2008. Corporate cash flows are expected to continue to hit record highs as the year progresses. Excess cash rarely burns a hole in corporate pockets for long. In fact, recently the most aggressive buyers of equities have been companies buying each other for cash. We expect this merger and acquisition trend to continue, and our focus on buying stocks trading at a discount to their private-market values should be nicely rewarded. We recently had the opportunity to speak with Gary Posternack, Head of M&A, Americas, for Barclays Capital. He said merger activity began picking up in the fourth quarter of 2009, led by large companies making primarily cash offers for strategic acquisitions.

Now these large strategic buyers, as well as medium-sized companies, are searching for smaller, bolt-on transactions for their enterprises. The financial buyers, private equity funds, are also eager to bid for assets after being sidelined for the past two years due to a lack of debt funding. Now that the public credit markets are open again, these funds will have cash burning a hole in their pockets as they search for new investment opportunities.

✶ This combination of receptive sellers and well-funded buyers should be a powerful and positive force in the market for the coming year. ✶

Sellers are now more open to merger discussions with the recent rise in the stock market. During the recent market downturn, stock prices were so depressed that even a premium offer of 50% would not achieve a 52-week high for a stock, a minimum goal of most selling management teams. Now that the stock market has rebounded, a more standard offer of a 30%-40% premium places the acquisition target's stock price at a new 52-week or all-time high, making the selling company's management team and directors look like heroes. This combination of receptive sellers and well-funded buyers should be a powerful and positive force in the market for the coming year.

Productivity is growing rapidly and making new highs, suggesting that real pay per worker will continue to do the same. There is a very strong correlation between nonfarm productivity and inflation-adjusted wages, salaries, and benefits per payroll employee. The former rose 5.8% year-over-year during the fourth quarter of 2009 to a record high, while the latter has flattened out in recent months, also at a record high. Real pay per worker is likely to resume, climbing along with productivity as the economy improves. This should lift consumer confidence and spending, especially since considerable pent-up demand may exist.

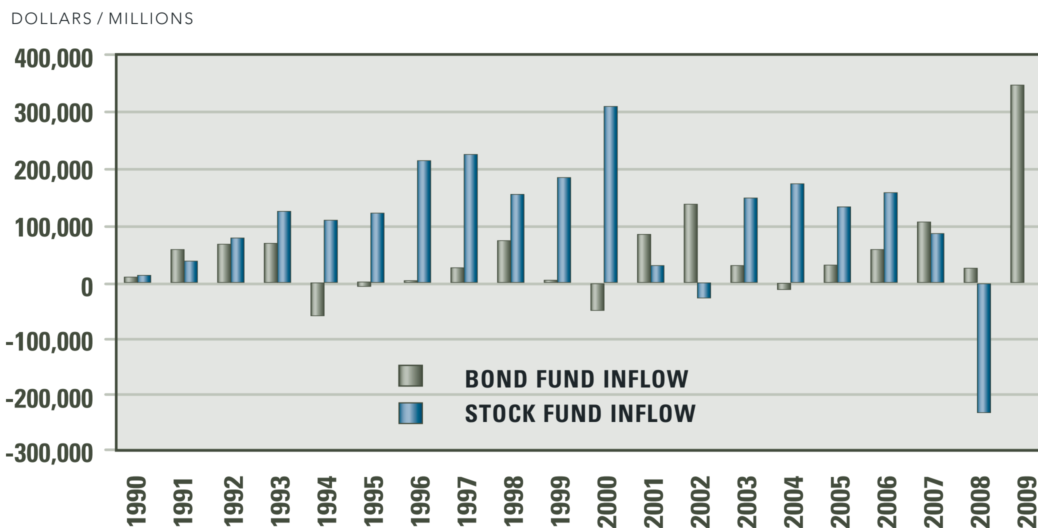


Sources: Investment Company Institute; Federal Reserve; Factset; Bloomberg; U.S. Trust Market Strategy Team.

*Data through March 31, 2010.

**M2 + Institutional money markets assets.

CAN YOU SPOT THE BUBBLE?
INVESTORS HAVE BEEN POURING MONEY INTO BOND FUNDS



SOURCE: *INVESTMENT COMPANY INSTITUTE*

Corporate profits continue to recover at a very healthy rate. Domestic profits of financial corporations increased $65.0 billion in the fourth quarter compared with an increase of $82.8 billion in the third quarter. Domestic profits of nonfinancial corporations increased $59.8 billion or nearly 40% versus the third quarter. In the fourth quarter, real gross value added of nonfinancial corporations increased, and profits per unit of real product increased. For 2010, industry analysts are projecting that profits for companies in the S&P 500 should rise by more than 20%, and operating earnings are projected to grow by 37%. This would be the fastest rate in at least two decades. Are they too optimistic? Historically, during previous cyclical upturns in profits Wall Street analysts were too pessimistic and had to raise earnings estimates.

Finally, leading economic indicators are very bullish. In the U.S., the Index of Leading Economic Indicators (LEI) rose again in February, which was the eleventh consecutive increase, up almost 10% over this period. The average increase over the same time frame during the previous six recoveries was 7.6%, ranging from 4.4% to 13.8%. This suggests the economy may be experiencing a relatively normal recovery rather than the "new normal" subpar recovery with stubbornly high unemployment that many suggest.

Cash on the sidelines is still extremely high. It reached a high of $10.9 trillion in May 2009 and has receded somewhat since that point but still remains well above historical norms. Cash in the bank and in money markets as a percentage of the entire stock market capitalization is currently

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73%—20 percentage points above the historical norm. It is no surprise that investors rushed to park their cash in money market funds as the credit bubble burst and riskier assets were shunned. During 2008, a whopping $637 billion moved into cash, but that trend reversed last year as $539 billion exited money market funds. It is intriguing that in 2009 bond funds saw an influx of $375 billion while their stock counterparts witnessed outflows of $8.8 billion. This occurred in spite of the fact the S&P 500 Index's total return last year was 26.5% compared with a paltry 4.8% for the Merrill Lynch U.S. Corporate and Government Master Bond Index. The healthy pace of inflows has continued through the first quarter. Bond funds have seen cumulative inflows of $429 billion since March 2009 compared with a meager $33 billion into equity funds. With the lion's share of the cash inflows still firmly in bond territory and earning miniscule yields, there is a high probability that U.S. stocks could further add to their gains by year end.

The question for today is, "Are investors migrating into longer-dated bonds at exactly the wrong time?" We discussed this issue at length in the Winter 2010 *DecisionMaker*, but to reiterate the message, we are concerned that investors are jumping from one fire into another. Nearly a year ago, Warren Buffett compared the U.S. Treasury market to the earlier housing and Internet stock bubbles. In December 2009, Citigroup's chief equity strategist, Tobias Levkovich, called investors' stampede into fixed income "quite worrisome," with cash levels in bond funds nearing "three standard deviations above average," a level of risk so far from normal that you might expect to see it just one percent of the time. As rates do eventually begin to rise, bond prices will head south. This turn has already begun for long-term bonds, providing a preview of what the future might hold for bond investors. The yield on 20-year Treasury bonds, for instance, has risen approximately 1.5 percentage points in just over a year, causing the Barclays long-term Treasury bond index to fall by approximately 13%. In our bond portfolios, we continue to buy shorter maturity bonds, which offer lower yields but do not present as much risk to declining prices. As rates rise and eventually stabilize, we will be able to extend maturities and garner higher yields.

With the risks analyzed, our client portfolios are very well positioned to benefit from solid results in 2010 and beyond. Our investment process identifies companies with strong cash flow and sound balance sheets. Such companies should perform well as we enter into the next phase of the bull market. Historically, market uptrends following a severe bear market are characterized by two stages. Typically, the best performance in the first phase is experienced by lower quality stocks (negative earnings/higher financial risk), while higher quality stocks with lower betas usually drive the second phase. Importantly, this second phase advance includes stocks that sport

stronger balance sheets and have desirable financial characteristics, regardless of their market cap. Market historian, James O'Shaughnessy, recently discussed this cycle: "In the first year following severe bear markets, low quality stocks crush high quality stocks—just as we've seen in the junk rally that started last March. Bull markets' second years tend to demonstrate characteristics more consistent with long-term stock movements." This is more consistent with stocks that are characterized by higher return-on-equity ratios, strong cash flow generation, and lower balance sheet leverage. We believe we are entering into this phase of the market recovery, which should prove profitable for our client portfolios.

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We also expect the rebound in growth across the globe to favor our portfolios. While we do own U.S. dollar denominated securities, this does not indicate that we are focused on opportunities in the U.S. alone. The global economy is rebounding, led by the U.S. and Japan among the majors, and by China in the developing world. World GDP is on course to rise by 4% this year, falling just shy of the average of nearly 5% in the four years between 2004 and 2007. With the weakness in the U.K., Greece, and other countries, how is this possible? The above average growth in the BRIC (Brazil, Russia, India, and China) countries helps offset much of the weakness in the developed world. For example, while growth in China has slowed, it may generate GDP growth of 10% in 2010. In terms of investing, one cannot analyze securities in isolation; international opportunities must be taken into account. In addition to gaining direct international exposure via investments in ADRs, many of the U.S.-based companies that our client portfolios own generate a significant portion of their revenues from outside the U.S. In fact, some of these U.S. companies derive 100% of their revenues from outside the United States; such global companies operate in the areas of international telecommunications, generic drugs, consumer goods, agriculture, pharmaceuticals, medical devices, and financials. As a reference, the current top five holdings of the firm derive on average 41% of their revenues from outside the U.S.

Despite the significant move in equity prices overall, we remain diligent in our investment approach and continue to uncover attractive values in many areas. In our judgment, stocks will continue to appreciate, albeit not at the same rate as they have in the recent past. To date, the equity markets have moved upward in a very steady advance, although as the year unfolds more choppiness may take hold. A healthy, near-term pullback could certainly occur and would be a supportive sign for a more sustainable bull market. Today's environment is very attractive for stock pickers like us, and we expect that our client portfolios should benefit as catalysts of the portfolio holdings begin to unfold. In addition, the acceleration of merger and acquisition activity could certainly enhance our returns in 2010 and 2011 as well.

Leah R. Bennett, CFA
Managing Director

The year 2010 marks KING's Thirtieth Anniversary. Our professional staff includes investment managers, security analysts, and other specialists qualified to meet the needs of our individual and institutional clients. We are committed to creating wealth for our clients in the long term.

Over the past thirty years, we have successfully navigated through both good and challenging markets by adhering to a discipline of value investing geared to evaluating ever-changing data and markets.

Our philosophy focuses on the valuation of businesses and their economic worth as measured through cash flow and not accounting artifice. Our work in equity and balanced accounts, which includes fixed income instruments, helps each type of account. Many excellent fixed income opportunities develop as a result of our research in equities, and vice versa.

We eschew "market timing" as theoretical nonsense divorced from the real world of investment decision-making and investing. Cash will accumulate in client portfolios when we do not find stocks that meet our selective criteria.

We are confident that the knowledge, experience, and dedication of our investment team, and the application of a disciplined process which has worked successfully over long periods of time, will continue to reward our clients in the years to come.

OTHER CONTRIBUTORS

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SOURCES FOR THIS ISSUE

Capital Economics; *CBS MoneyWatch.com*; Credit Suisse; Deutsche Bank; Hays Advisory, LLC; U.S. Trust, Bank of America Private Wealth Management; Yardeni Research, Inc.

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