

DecisionMaker

Published Quarterly by King Investment Advisors, Inc.

Government's view of the economy could be summed up in a few short phrases: If it moves, tax it. If it keeps moving, regulate it. And if it stops moving, subsidize it.

— RONALD REAGAN

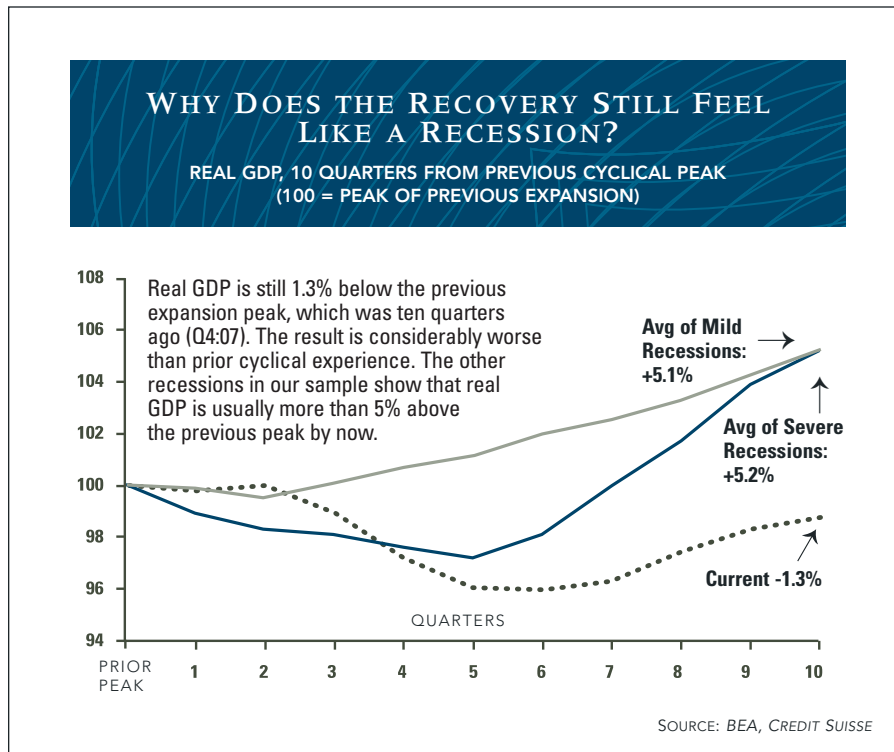
If America's economic landscape seems suddenly alien and hostile to many citizens, there is good reason: they have never seen anything like it. Nothing in memory has prepared consumers for such turbulent, epochal change, the sort of upheaval that happens once in 50 years. That may explain why so many voter polls, taken as the economy shudders towards the November election, reveal such ragged emotional edges, so much fear and misgiving....

The outward sign of the change is an economy that refuses to recover from the... recession. In a normal rebound, Americans would be witnessing a flurry of hiring, new investment and lending, and buoyant growth.... Unemployment is still high; real wages are declining.... The current slump already ranks as the longest period of sustained weakness since the Great Depression.

— TIME

Do these words sound eerily familiar? While they could have easily been taken from a recent news story, they were actually pulled from the archives of a 1992 *Time* magazine article. History tells us that following the release of this pessimistic view of the economic climate, the S&P 500 Index recorded an 18.0% annualized rate of return or 170.5% on a cumulative basis for the period 1992-1997. These days, we are undoubtedly awash in bad news as similarly described by the *Time* magazine writer in 1992. So, what does the future hold for investors given today's tenuous economic state?

The Recession is over, but it doesn't feel like it. According to the National Bureau of Economic Research (NBER), the official end of the Great Recession occurred in June 2009, but the 9.6% unemployed in the U.S. (or 17.1% underemployed—which includes those that just gave up looking for a job) would certainly disagree. Although we are in a recovery, it is a very slow one at best. This recession, which was sparked by a total shock to the financial system, has been very unusual in terms of its severity, its length, and its resistance to federal stimulus. Even though we are recovering, the growth in GDP is still 1.3% below the previous peak 2½ years later versus previous recoveries where GDP was ahead of the previous peak by at least 5%.



cut to move inventory, orders are canceled, and production stops, perpetuating the downward spiral. That was certainly the case with this most recent recession—the worst experienced since the Great Depression.

Although the economic decline started in the financial markets in early 2007 with the collapse of the subprime residential mortgages and the subsequent spread to Wall Street during the summer with the demise of the Bear Stearns hedge funds, the official recession did not begin until December 2007 when production, employment, and spending turned negative. However, buyers did not really

The typical post-World War II recovery has been fueled by an ending of inventory liquidation, employment gains, consumer spending growth, and a resurgence in residential construction. Only one of these four, the ending of inventory liquidation, has shown significant signs of strength. The employment picture is bleak and will remain so for some time as it is always a lagging indicator. The U.S. consumer, who is clearly depressed, is more focused on deleveraging and saving than spending, and the housing market remains in a slump in many areas of the country.

Historically, the liquidation of excess inventories has accounted for the majority of the decline in economic activity associated with recessions. When the business cycle peaks, sales at the manufacturing, wholesale, and retail level begin to slow down, but a slight downturn may not necessarily be a trend. Managers wait until the slowdown becomes a confirmed trend before cutting production, thus leading to a build-up in inventories. Depending on how long it takes to recognize meaningful weakness, inventories may be only slightly inflated or could become excessive. At some point, prices are

go on strike until the latter part of 2008. As home equity dried up due to plunging home values, pink slips surfaced as companies laid off employees, and banks stopped lending to all but those who did not need the money, the consumer went into hiding. Inventories soared, and everyone was forced to cut backlogs at all costs, leading to the largest inventory liquidation in post-World War II history. Starting in the second half of 2009, the tide began to turn, and the reduction in inventory liquidation began to fuel the economic recovery. During the third quarter of 2009, this reduction accounted for 66% of the 1.6% annual rate of real GDP growth and 58% of the fourth quarter's 5.0% gain. This year, inventory building has been responsible for 67% of the 3.7% annual rate rise in real GDP during the first quarter and 36% of the 1.6% increase in the second quarter. Combined over these four quarters, the positive swing in inventory has generated 58% of the 3% annual growth in real GDP. Whether or not this is sustainable is the big question. For manufacturers, wholesalers, and retailers to be willing to significantly rebuild inventories, the consumer needs to be willing to buy, and for that

to occur, the rest of the economy needs to show signs of sustained strength, which is not yet happening.

With nearly 10% unemployment in the U.S., the consumer is still frightened—and rightly so—because many of these jobs may not come back for a while. Of the 7.7 million net nonfarm jobs eliminated between December 2007 and July 2010, 86% were in construction, manufacturing, wholesale and retail trade, finance, and leisure and hospitality. To make matters worse, job losses in these areas have spawned job losses in

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service areas and other sectors that depend on them. For example, home building drives employment in production of appliances, furniture, and home furnishings, and home insurance that in turn generates revenues that support state and local employment. Given the massive excess housing inventories in certain areas of the country, residential construction will not show a significant rebound for quite some time, leaving construction workers and many others idle for the near future. Also, as globalization has taken hold, U.S. businesses have been forced to cut costs drastically in an effort to become more competitive. They have increased their efficiencies through labor cost reductions by moving jobs overseas, outsourcing to domestic and foreign suppliers, promoting productivity, and curtailing hiring. Many of those who have been fortunate enough to keep their jobs have had their benefits cut or reduced and have been doing the work of former employees as companies delayed hiring new personnel. Many of the newly hired have been forced to take lower salaries than they earned at their previous

jobs. This is beginning to improve in the private sector as jobs are being created, but the public sector—state and local governments—is continuing with layoffs as budgets come under pressure from lower property tax revenues.

All of the layoffs, involuntary furloughs, as well as benefit and wage reductions have been devastating to employee compensation and thus consumer spending. In fact, without government intervention via the various fiscal stimuli, the consumer would be virtually nonexistent. The consumer has been supported by massive government stimuli in the form of transfer payments and tax cuts. Overall, Disposable Personal Income (DPI) was enhanced by \$532 billion from an increase in government transfers (e.g., pension benefits, Social Security, Medicare and Medicaid payments, and unemployment insurance) and by \$382 billion from lower taxes. Without this massive influx from the government, the DPI would have dropped \$247 billion instead of rising \$667 billion. There has been more governmental support during this downturn than in any previous post-World War II recession. These figures do not even include wages from jobs created by federal spending on infrastructure or jobs saved by federal transfers to state and local governments to reduce teacher and other employee layoffs.

Despite these massive fiscal stimuli, the consumer has not gone on a major spending spree. Of the tax rebates issued in 2008, 80% were held back for savings for a rainy day as were 100% of the 2009 tax cuts and special payments to Social Security beneficiaries. This is particularly unusual, as low-to-middle income households tend to spend their windfalls rather than save them. In fact, approximately 64% of the \$667 billion increase in DPI flowed into savings, which was a dramatic shift in consumer behavior. The consumer continues to be in retrenchment mode, focusing on paying down debt as well as rebuilding 401(k) plans and the like. Consumer sentiment remains in the doldrums as evidenced by the recent drop in the Consumer Sentiment Index (CSI) to 66.6 in mid-September, the lowest reading since last August. Interestingly, higher-income families were less

confident as sentiment fell to a 13-month low, but lower-income families became more confident as sentiment increased the second consecutive month. Perhaps they have determined that the Bush tax cuts will expire for the wealthy and continue for the low and middle classes. We should know after the elections.

On the housing front, the forecast remains stormy. Housing starts surged 10.5% in August; the increase was driven largely by apartment construction, a volatile segment of the market. New construction on single-family homes, which accounts for 75% of the housing industry, grew a paltry 4.3%. Although this was the first increase in four months, it was down 9.1% year-over-year. Permits for new construction grew 1.8% in August and followed a similar pattern with 9.8% growth in the condominium and apartment sector, but single-family permits actually fell 1.2%. House prices are likely to fall further in hard-hit areas of the country where there continues to be a glut of inventory, and commercial real estate does not look much healthier as high vacancies and financial woes weigh heavily on this sector. Given all of this evidence, the residential housing and commercial real estate industries will not be leading us into a robust recovery any time soon.

WHERE IS THE RECOVERY?

With all this gloom and doom, where is the recovery or is there a recovery at all? The market seems to think there is, as evidenced by its recent strength—and as a leading indicator, the market tends to reveal the story. The recovery has started in the U.S., albeit slowly, but the real growth has been abroad, particularly in the emerging market economies. Whereas global growth momentum is expected to slow in the near term, it remains healthy. The important point is that slower growth is still growth. The prospects for emerging markets generally remain strong even with the headwinds of slow growth in the developed economies. Domestic and intra-regional demand are fueling the fire rather than the traditional economic ties to the developed world. In fact, the BRIC (Brazil, Russia, India, and China) economies, as a whole, are now

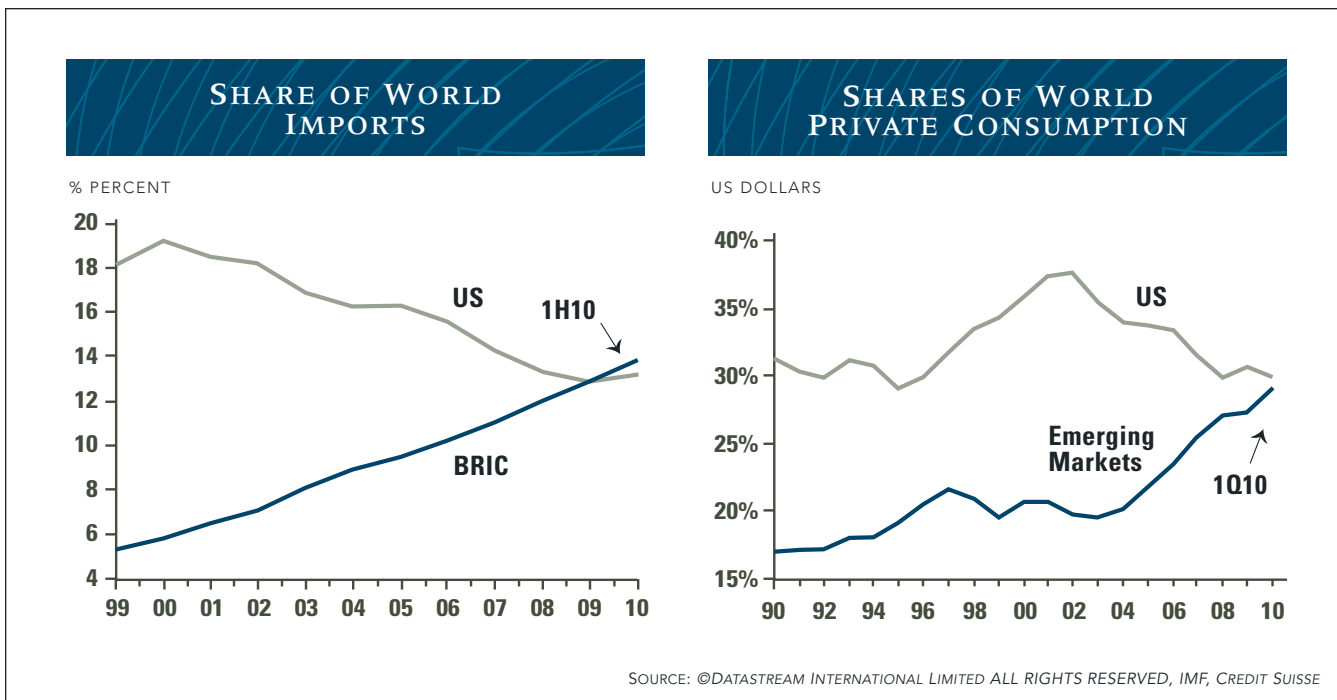
outpacing the U.S. as an importer, and the emerging market consumer is approaching the size of the mighty U.S. consumer. This fast-growing emerging market consumer is earning a decent living, has a healthy balance sheet, and, in some countries, is receiving support from the government to encourage spending. Given this backdrop, the emerging market consumer should continue to support the recovery domestically as well as globally.

Despite the Chinese government engineering a slowdown in its economy and Japan experiencing a dramatic, unintended slowdown, the rest of Asia is chugging right along. Taiwan, Thailand, and Singapore are showing stronger-than-expected GDP growth. Latin America is telling a similar story, demonstrating sustainable growth momentum in Brazil, Mexico, Argentina, Columbia, and Peru. For the most part, inflation pressures remain subdued so a more accommodative monetary policy abroad is likely, whether it comes in the form of outright easing or simply less restrictive policy.

HOW DOES THIS GLOBAL OPTIMISM HELP THE U.S.?

The global recovery is fueling an extraordinary rebound in U.S. exports and business capital expenditures (capex), even more so than previous recoveries from severe recessions. Following a significant round of belt-tightening in corporate America, productivity has improved, and corporate profits have exploded. With cash flows at record highs and extraordinarily liquid balance sheets, U.S. corporations are beginning to replenish aging capital stocks. Growth in equipment and software business investment was at quarter-century highs for the first six months of this year, with much more pent-up demand in store, given the devastation of capex during the recession. The corporations that are in the best shape are the ones with a global footprint, as they are able to take advantage of the growth abroad—particularly in the emerging markets.

In an effort to capture some of the benefits of this global growth phenomenon, we at KING have strategically



positioned our client portfolios to have more of an international bias. Not only does it make sense in the near term given the continued weakness in the U.S. and the strength in other areas of the world, but it also makes sense from a diversification standpoint over the long term to have exposure to revenues outside our own borders. In the past, investors could only gain international exposure by investing in direct international investments or by investing in large, multi-national companies. As globalization has evolved, international exposure is no longer limited to the large-cap sector. Mid-cap and small-cap companies have expanded internationally as well, giving investors more opportunities to invest abroad. Of the top 15 holdings in KING's client portfolios, international revenues account for 32% on average of total revenues, with a few of our holdings deriving 100% of their revenues from international sources. Through this avenue, we are gaining exposure to that fast-growing emerging markets consumer while we wait for a more significant rebound in our own economy.

We have spoken before of how the recovery from this recession would be a profit-led recovery and not a

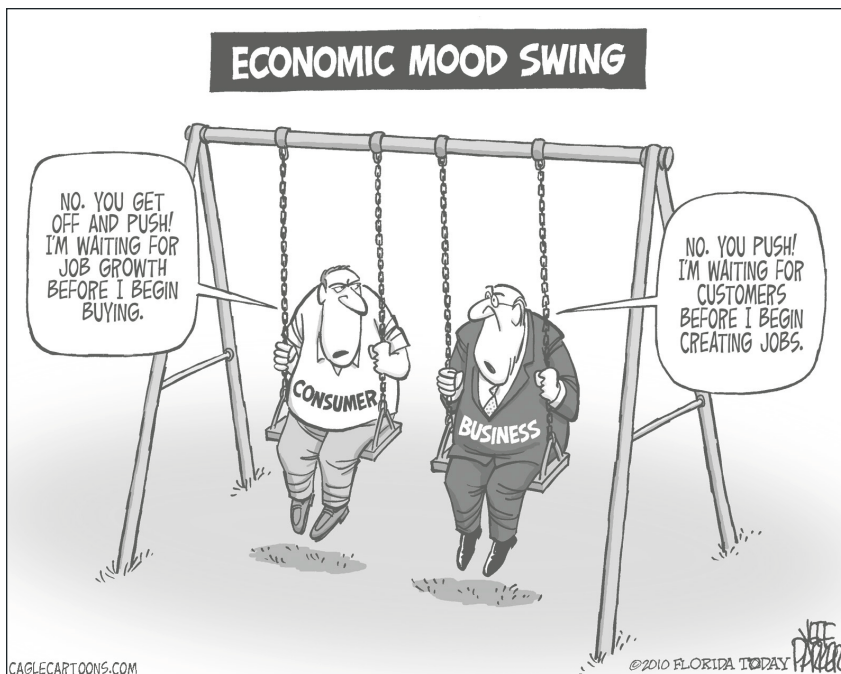
U.S. consumer-led one, and we continue to adhere to this thesis. Profits are the key driver because profitable companies create the jobs and expand capacity, not governments through fiscal stimulus. The most profitable companies offer their customers the best products or services at the most reasonable prices and help improve the standard of living of its customers and employees. These companies are the most competitive when they are allowed to operate in a free market system, unencumbered by government intervention. As U.S. corporations continue to improve their financial position, they will be more likely to post the "help wanted" sign and begin hiring again, reducing our unemployment rolls. When the workforce expands, the U.S. consumer who feels more secure in his financial well-being will begin to venture out with his wallet and stop hoarding cash. Financial conditions by some measures have already shown improvement as evidenced by the surge in corporate issuance and mortgage refinancing activity as well as the lower level of business inventories relative to sales. Corporations with excess cash are beginning to look for bargains in their own backyard as they repurchase shares and expand for the future through strategic acquisitions.

While corporations are investing in their businesses here and abroad, U.S. investors are in proverbial shock with the nightmarish memories of the 2008 meltdown of their nest eggs fresh on their minds. Cash continues to be king in the eyes of the typical U.S. investor even with miniscule rates of return being offered. The Federal Reserve is attempting to allay investors' fears and meet this demand for "safety" through its potential next round of quantitative easing (QE2). In addition, the Fed has stated that as long as inflation remains subdued and capacity is not constrained (high unemployment), it will maintain this accommodative stance for the foreseeable future both in terms of keeping interest rates low as well as its willingness to expand its balance sheet. The Fed is basically absorbing the deleveraging of the U.S. consumer by leveraging up its own balance sheet. This accommodative stance will continue to put downward pressure on the U.S. dollar, upward pressure on commodities, and force the hands of other governments to follow a more accommodative approach as well.

The U.S. consumer/investor is no longer significantly overleveraged; the focus on deleveraging and saving has taken care of that. The biggest problem now

is excessive caution. This extreme pessimism and resulting caution is creating extraordinary values in the marketplace. With yields on 3-month U.S. Treasury Bills at 0.13%, 5-year U.S. Treasuries at 1.12%, and 10-year U.S. Treasuries at 2.50%, U.S. equity yields far exceed government bonds. Looking at it in terms of total returns, U.S. equities are trading at 3½ standard deviations cheaper versus bonds, the extreme opposite of March 2000 when equities were 2½ standard deviations expensive versus bonds. Although we do not recommend purchasing equities without reservation, we do believe there are opportunities in equity investments. Valuations are extremely low for many stocks, and as we have stated, pessimism is running rampant. Historically, a high level of pessimism has been a positive contrarian indicator for the stock market. In August of this year, the yield on the Dow Jones Industrial Average exceeded that of bonds, a phenomenon which has not occurred since 1962. The risk premium for bonds as measured by the difference between the earnings yield of the S&P 500 Index and the 10-year U.S. Treasury Note is at the highest level since the start of the modern era's bull market that began in 1982. Nearly 80% of the companies making up the S&P 500 Index possess earnings yields that are greater than bond yields. In addition, most have dividend yields equivalent to their own bond yields, and they are increasing their dividends. The performance gap between bonds and stocks over the past 10 years is wider than it has been in any decade in history. Whenever stocks have had a negative 10-year disparity in performance relative to fixed income, the average yearly return for stocks in the following decade has been approximately 13%.

Why won't investors take advantage of these equity opportunities? We believe it is because of fear of the unknown. We have a pivotal election coming up in November, when the



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American people will undoubtedly register a call for a shift in fiscal policy. On September 29, Congress decided by a one-vote margin to adjourn until after the election without passing a federal budget or extending even a portion of the Bush tax cuts. Thirty-nine Democrats in the House and two in the Senate joined Republicans in opposing motions to adjourn, citing the need to renew the tax cuts to assure business and the public that they will not incur big tax increases next year while the economy remains so fragile. Undoubtedly, there are strong opinions on both sides of the argument regarding the pending expiration of the Bush tax cuts but the bottom line is: if they are allowed to expire on the upper income earners, an estimated 0.3%-0.4% will be shaved off nominal GDP. Regardless of the outcome of the Bush tax cuts, greater fiscal drags will continue from the state and local government fiscal crisis (about 0.8%) and the sequential decline in the "recovery act" stimulus (about 1.0%). Future tax hikes are also in the offing as we pay for our new healthcare reform bill. Many historians compare the current fiscal policies to those of the New Deal era characterized by bigger government, higher taxes, and protectionism. History proved that these policies did not work to bolster growth in the economy, so it will be interesting to see if the American people recognize these similarities and are willing to pay for the "change" that so many voters desperately wanted in 2008. With the groundswell of the conservative Tea Party movement, there is definitely an element of dissatisfaction in the ranks. Individuals who believe the government is doing a bad job (41%) are more than double those who believe the government is doing a good job (16%).

Today's environment is one of low interest rates, low inflation, and low valuations. Given the widespread pessimistic outlook, many cyclical stocks are priced for a double-dip recession scenario. As we have stated, we believe we are in the midst of a slow recovery, and if our thesis plays out, many stocks could rally 30% to 50% over the next year. Many large-cap stocks are starting to engage in shareholder enhancing behavior, such as instituting large share repurchases and/or increasing their dividends. We have also witnessed a significant pick-up in M&A activity, which has already benefited client portfolios. With a catalyst-rich portfolio, this could continue to enhance performance over the next several years.

Down the road we will be dealing with higher interest rates and, most likely, higher inflation. Historically, in periods of low GDP growth coupled with higher inflation and higher interest rates, the gap between winners and losers in the stock market grows dramatically, providing significant opportunities for gifted stock pickers. Small-cap stocks and commodities tend to perform well during periods of inflation. We currently have exposure to both and plan to be well positioned as we approach this period. Companies, whose assets are not easily replicated, whether they possess a unique technology or even have a successful global brand, are likely to be winners. Cost pressures may further an increase in M&A activity. All of these factors suggest there will be positive days ahead for KING's client portfolios.

Dana B. Croswhite, CFA
Senior Vice President

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.

SOURCES FOR THIS ISSUE

Bloomberg L.P.; Credit Suisse; Don Hayes, *Hayes Advisory*; John Mauldin, *Outside the Box*; Gary Shilling; *The Wall Street Journal*; *Time*; Ed Yardeni, *Yardeni Research*



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