



RUMINATIONS AND OBSERVATIONS

An Inflection Point—If Not Now, *Soon?*

October 2010

We are often asked, “What do you think the market is going to do?” While we can offer an educated guess, the question is best responded to with another inquiry. Exactly which market are we discussing, and what is the time frame in which to couch an answer? More often than not, most inquiries directed to us refer to the U.S. stock market, as evidenced by the Dow Jones Industrial Average (institutional investors usually refer to the S&P 500 or Russell 3000 as an equity barometer for the U.S.). There also seems to be a general expectation that a prediction should be viewed as having a life expectancy of at least a few months.

Actually, there are many publicly traded markets available to investors. Some of the most publicized are the equity markets, bond markets, commodity markets, futures markets, and currency markets. These arenas are available for investment and speculation in hundreds of countries around the world on an almost 24-hour basis. While U.S. investors most often think of stocks, especially domestic companies, as being the venue in which most market activity takes place, equities around the globe are actually dwarfed by the value of securities issued and traded in the bond markets. Today, it is essential that one’s investment outlook be framed within the context of a global economy. While opportunities for investment abound around the globe, the U.S. is the world’s largest economy and offers the largest and most liquid financial markets. The *DecisionMaker* discusses our outward look in terms of capitalizing on growth overseas as well as in the United States, but there presently exists an investment dynamic that has significant importance for investors both at home and abroad.

The investment world is certainly one filled with the potential for great reward and great risk. It is also one that requires investors to make choices among a wide array of complex alternatives. Nearly all investments present varying degrees of certainty as to their anticipated return of principal as well as a return of dividends and interest on that principal. Yet, there are also times when broad strategic themes become particularly compelling and do not necessitate an esoteric analysis or “on the other hand” opinions. We believe such is the case today with regard to the relative attractiveness of equity securities versus fixed income. Although there are trends afloat that may spell attractive rewards for investors in commodities, there are avenues to exploit higher commodity prices in the equity market other than through direct participation in commodity markets.

Essentially, we believe the reward versus risk for equities, domestically and internationally, is far superior to that of fixed income investments. Owning bonds

today presents a greater risk over the long term than owning stocks. In fact, equities may be the most attractive on a relative valuation basis vis-à-vis bonds than at any time in the past fifty years. The U.S. investment stage is a reasonably appropriate proxy to illustrate why this is so. It is no secret that interest rates are very low. Currently, the yields on U.S. Treasury issues are: 90 day bills—0.15%; 1-year—0.21%; 2-year—0.36%, 10-year—2.5%; 30-year—3.9%. Conversely, the earnings yield** on the S&P 500 is presently about 5%. In other words, the earnings yield on the S&P 500 is conservatively estimated to be at least 20 times that of the 1-year Treasury. The earnings yield on the S&P reached 3 times that of the 1-year in the mid-1980s, but at 20 times today, it is the highest ratio it has been since 1959!

** The **earnings yield** is the annual earnings per share divided by the share price (the inverse of the P/E ratio). Thus, if a company earns \$2.00 a share, and its stock is \$20 per share, its earnings yield is 10%. The **dividend yield** is the annual cash dividend paid divided by the price per share. If a company pays a \$1.00 annual dividend, and its stock is \$20 per share, its dividend yield is 5%.

Today, there is a vast universe of stocks both large and small with strong balance sheets, stable cash flows, and healthy earnings, and which include a sizable number with earnings yields well over 5%. Many will be raising their dividends in future periods. No Treasury Secretary or corporate finance officer will be notifying bond buyers that they have decided to raise the coupon rate on their bonds. The ownership of common stock is an interest in an actual, operating business that will distribute to its shareholders the fruits of its enterprise. A corporation can reward investors with its excess capital in five ways. It can: (1) invest capital to grow its business, (2) acquire other businesses, (3) strengthen

its balance sheet, (4) pay dividends, and (5) repurchase stock. Investors can also reap a reward through the acquisition of their company by another corporation or investor group.

Investors are rushing pell-mell to lock up 5-year Treasury bonds that yield the grand sum of 1.13% a year. At the end of 5 years, an investor who purchased a 5-year Treasury will have increased his capital by \$57 before taxes. The purchaser of \$1,000 worth of stock with a dividend yield of 5% will collect at least \$250 in dividends over 5 years, and possibly more with dividend increases. Any capital appreciation will be icing on the cake.

For a myriad of reasons, investors have been channeling abnormally high inflows into bond mutual funds. On the other hand, equity mutual funds, have experienced significant outflows for some time. Yet, what may seem safe today carries risk over the long term. It is true that inflation as measured by the CPI remains low, and the Federal Reserve seems determined to keep interest rates low until the economy strengthens. (The Fed, with its recent, strongly worded hints of a new phase of quantitative easing will essentially be printing money in its efforts to give inflation and, in turn, economic growth a boost; we believe this would be an ill-advised move). Thus, while the CPI has been quiescent, commodity prices have begun to anticipate that higher inflation lies ahead. Inflation will lead to higher interest rates, which in turn will spell a rough road ahead for bond prices. As but one example, if in 2 years a 10-year Treasury bond, purchased today at a yield to maturity of 2.5%, trades in 2012 at a yield to maturity of 4.5% (an increase of 2 percentage points), the market value of the bond will decline 13.2%, more than

offsetting the income from holding the bond 2 years.

Yellow lights are flashing. PIMCO, the largest bond mutual fund firm in the world, shepherded by bond guru Bill Gross, is reducing its exposure to U.S. Treasuries. Warren Buffett recently warned that investors buying bonds now “are making a big mistake.” He went on to add that, “It’s quite clear that stocks are cheaper than bonds. . . . I can’t imagine anyone having bonds in their portfolio when they can own equities.” One does not have to manage billions or be an investment maven to examine the many signs of an imbalance between the actions of the herd of investors—who, out of their fears, are flocking to what may seem safe as they seek an investment outlet in the wake of the investment turmoil of 2007-2008 and such nerve-wracking events as the flash market crash of May 6 of this year.

We are aware of the many key issues facing investors in this global economy. Employment in the U.S. and parts of Europe remains anemic. Deficit spending is creating strife in a number of countries. Currency wars are being waged, which raises the threat of protectionism. Terrorism and nuclear one-upmanship gnaw at the underbelly of modernity. Here at home, the forthcoming election, which is, in its simplest terms, a referendum on statism, while holding the potential to slow down the lurch to the left, may also result in creating even more intense battles over the direction of fiscal policy.

Regardless of the uncertainties that lie ahead, we have weathered the tumultuous period of 2007-2008. The domestic and global economies are on

the mend. Most observers are anticipating a period of slow growth in the U.S. and stronger growth in the emerging world. The turmoil in European markets and the anticipation of a double-dip recession were key factors in the downturn in the equity markets in this past May and June. These fears and other concerns have also been driving investors to increase their bond holdings. Individuals today own the highest percentage of bonds yielding less than 3% at anytime in the last 23 years. From our perspective, bond investors appear to be moving forward using a rear window view. However, we do not anticipate a “lost decade” for the equity markets, nor do we expect a continuation of the bond bull market. We believe asset allocations today should favor stocks over bonds.

Again, we urge you to review the upcoming *DecisionMaker* to gain further insight as to why we believe the choice for investors is far more promising and apparent than many investors believe. Even if the U.S. economy does grow at a below par rate, corporations will still be making significant profits, especially those that can benefit from their international exposure. For investors, the dollars invested in shares of those companies will be far more rewarding than those taking refuge in the bond market. And the very real possibility that growth may be greater than the consensus expects will lead to even better gains in the equity markets over the next few years. The ride will not be smooth, but it should be on an upward trajectory, while that of the bond market eventually may well be a slow, and sometimes rapid descent into a sea of red ink.

King Investment Advisors, Inc.