



RUMINATIONS AND OBSERVATIONS

A Periodic Overview

January 2010

The ABCs of Investing: Anything But Cash

The interest rates currently received on money market funds, CDs, U.S. Treasury bills, or other cash equivalents remain miniscule. The yields on cash equivalents have many a retiree recalling wistfully the days when S&Ls gave dutiful savers high double-digit yields and a free toaster to boot. Corporate treasurers, flush with cash, scrounge for modest returns and still cower from all but the safest of credit risks. CFOs are seizing the opportunity to satiate the ravenous demand for risk assets from institutional and individual investors by issuing debt of longer dated maturities and interest rates of which they could only dream a few years ago. Seeking higher returns, investors have been extending their maturities of both higher-rated and junk debt in an effort to gain a little more yield.

With interest rates remaining low by historical standards, equity investors, having weathered last year's cataclysmic first quarter, pushed stock prices higher in 2009 in anticipation of a global economic recovery. Double-digit returns were achieved in equity markets and indices around the globe. Sri Lanka was the star of 2009, returning 128% as its long-running civil war with the Tamil Tigers ground to an end. However, as rewarding as the equity market recovery in 2009 was, the last decade was one of the worst on record to own stocks as measured by some key indices. Stocks have essentially declined somewhat or have gone sideways for ten years. In late 1999, the S&P 500 traded at 44 times estimated earnings—an all-time high. In 1982, when the multi-year bull market began, the S&P traded for about eight times earnings. Today, it trades at about 20.1 times 2009 earnings.

What lies ahead for 2010? We believe long-term bonds, in particular, will continue to struggle while equities forge their recovery. After soaring 14% in 2008 in the face of a freeze in credit markets, U.S. Treasuries fell 3.72% on average in 2009. For bonds, it is becoming increasingly apparent that the great bull market of the last three decades is history. It is difficult to conceive of interest rates dropping significantly below present levels across the maturity spectrum, absent a severe depression. The global and explosive monetary expansion and government expenditures of the last 15 months have certainly led to an intoxicating period of very low interest rates and a corresponding move into risk assets such as stocks and commodities. In coming months, the focus will be increasingly on the timing and extent to which central banks, especially the Federal Reserve, begin the process of reining in the monetary stimulus.

Some central banks, Australia and Norway for example, have already started the process of squeezing the monetary sponge of excess liquidity by raising interest rates. A possible risk for the Fed and other central banks is that they may underestimate how difficult it will be to move from quantitative easing toward monetary tightening without hampering still fragile recoveries. Further complicating matters for central banks is maintaining the delicate balance between an environment with low rates to stimulate economic growth and, at the same time, protecting against overinflating assets as evidenced by recent increases for industrial and agricultural commodities. Short-term interest rates hovering only slightly above zero have led to a push into stocks, commodities, precious metals, and ABC—anything but cash. While asset prices may appear to be speculative to some observers, their rise is the inevitable consequence of a near zero rate of interest along with government stimulus, funded by increasing levels of debt as a percentage of GDP.

While the ABC mindset may have led to some asset classes of the investing world becoming overpriced on a near-term basis, the monetary and fiscal stimulus engaged in by bankers and governments still has to be fully reflected in overall economic activity. And, again, with high unemployment around the world and excess industrial capacity, inflation should not be a major impediment to equity markets in 2010. As a reference, excess capacity, or the output gap, created in 2002 allowed for five years of non-inflationary growth. Today's output gap is three times larger than in 2002. Interest rates will continue to remain low, and many major economies are still recovering from a once-in-a-generation bust. We are a long way from an economic boom that would precede a significant decline in equities. Rather, cash reserves will continue to flow into financial markets. Just as the background for bonds will be less positive as a source of total return from price appreciation and coupon income, equities and commodities should continue to benefit from positive cash flows.

In the U.S. alone, the Investment Company Institute estimates that there is still \$3.3 trillion in money market accounts, compared with \$4.0 trillion in February 2009. This figure is 27% of the value of the Russell 3000, which is \$12.1 trillion. American corporations are also sitting on very large cash positions, nearly 10% of corporate assets—55% above normal levels. The ABC mindset is sure to show itself as investors review these large cash and near cash positions that are generating very little, if any, yield. Obviously, not all of these funds will move into stocks. But will it head to real estate, art, antiques and other collectibles? Perhaps some will, but only a small percentage of available cash will flow to vehicles other than securities and commodities. And as the economic recovery continues to gain traction, investor appetite for more risk will only increase.

Another factor that will play an increasing role in investors' outlook, not only in the U.S., but also throughout the world, will be the midterm elections for the U.S. Senate and House of Representatives, as well as some key governorships. Although November is still ten months away, it appears that the lurch to the left at the national level has created a great deal of unease among independent voters. Any sense that the expansive role of the federal government can be

restrained through legislative gridlock in a somewhat more balanced Congress would alleviate some of the fear of big government held by investors.

We all know that investors look ahead. Sometimes they seem to be using a telescope when they would be better served with opera glasses. One can worry endlessly about future, distant possibilities, while losing sight of near-term reality. Given the experience of the recent downturn, investors are more inclined to latch on to possible negative developments and overlook the positives. This decision-making process rarely provides optimal results. Again, interest rates will remain low by historical standards, especially short-term rates. Bank balance sheets and profits will continue to grow, leading to greater lending. Unemployment numbers should begin to recover, a key to stimulating consumer spending. The efforts of businesses around the globe to cut costs have been highly effective, leading to an improvement in profit margins. Companies in the S&P 500 should report a very significant increase in corporate profits in 2010, on the order of 20% to 25%.

Along with growth in the U.S., a number of emerging markets should produce even stronger economic growth. China, Brazil, and India have seen significant improvements in their GDP and profits. A large number of companies in client investment portfolios benefit from their exposure to international markets, in some cases generating foreign revenues as high as 60% of their total. Also, our clients own companies that are incorporated outside of the U.S. and receive all or most of their revenues from non-U.S. sources. While the U.S. will maintain its position as the largest economy in the world, we continue to expand our horizons to foreign markets through direct and indirect investments.

In addition to the economic forces previously cited, 2010 will see increased merger and acquisition activity that will further bolster stock prices. This may be especially evident in the sectors of Materials, Consumer Discretionary, Healthcare, Technology, and Energy. While we are positive about the outlook for all of the holdings in client portfolios, we believe a number could also be beneficiaries of M&A activity.

We find ourselves agreeing with the contrarian economist, Marc Faber, known for his newsletter, *The Gloom, Boom & Doom Report*, in which he succinctly states, "The impact of a super-charged tidal wave of liquidity and zero interest rates on asset markets should not be underestimated." Our economic telescope will certainly be focused on some of the potential problems of the investment universe. However, the near-term horizon is one filled with a wide array of opportunities in what should prove to be another year of positive equity returns as bond investors struggle to avoid losing ground.

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