

### **Seeing the Forest Through the Trees**

With the overall equity market declining over 10% in a week, coupled with the implications from a downgrade of U.S. debt over the weekend, investors are understandably nervous. We do not see an easy solution to the world's problems, but we do see some potential long-term benefits emanating from today's crises. Issues facing the world economies and markets are serious, but the seeds for a solution may be ready for planting now that the world has taken notice. Solutions to major economic and policy challenges in the past led to great periods of prosperity and growth. This was evident following 1974 when the U.S. transformed into one of the most productive countries in the world and in 1980 when expansive revisions to the tax policy led us into a lengthy period of prosperity and enhanced productivity. Essentially, problems create anxiety, which in turn attracts the attention of the voting public. Voter anxiety produces an outcry that the politicians cannot ignore. Markets recognize this, and once the selling becomes exhausted, equity prices begin to recover.

There is no doubt that the markets will remain volatile. A substantial amount of damage has been done, most of which is psychological and comes in the form of a loss in confidence by investors. The credit worthiness of the United States has never been previously downgraded by S&P; we can surmise what might unfold over the next several quarters by reviewing several previous periods of despair. Historically the downgrade of a country has resulted in a near-term volatile environment, but one where equity prices, on average, tend to rise significantly in the following year. It should not be underestimated that governments, when challenged, often fight back.

No longer can we consider the U.S. and Europe in isolation; the world is increasingly global. In fact, over 45% of the S&P 500 Index's constituent profits are derived from outside the U.S. The three largest sectors (with more than 50% of their sales from abroad) are Technology, Materials, and Healthcare. The globalization of Corporate America may be one of the key reasons why profit margins have continued to confound the most bearish of investors over the last few years. It is true that profit margins are approaching all-time highs, most U.S. companies have realized that margins don't have to revert back to the mean quickly, if they broaden their horizons outside their own home markets.

With an increasing share of U.S. corporate profits earned overseas, a more serious debate might emerge regarding whether or not the U.S. should revise an antiquated corporate and international tax structure. Other countries across the globe are reducing tax rates on corporate profits and streamlining regulations in an effort to attract capital to their shores. The U.S. has lagged behind these developments and today has the second highest corporate tax rate in the industrialized world, behind Japan. Even taking effective rates into consideration, the U.S. is still the second highest. The U.S. is also the last remaining country to double tax foreign sourced profits repatriated into the country. As global competition for capital intensifies, the U.S. may be

forced to lower its corporate tax rate in order to compete in this global environment. Long term, this would be an important move for U.S. and corporate profits; in turn, and U.S. job growth would benefit.

We have a structural problem in the U.S. as far as manufacturing jobs are concerned. A solution (in addition to the idea of lower corporate taxes), is the birth of jobs via outsourcing; a very counterintuitive concept. Essentially, developed economies are outsourcing and giving jobs to emerging countries (such as China, India, Brazil, Vietnam, etc.). In exchange, we purchase products produced by these countries, and those cash flows revert back to U.S. and European countries in the form of corporate earnings. In July, the New Export Order index rose to 54.0 from 53.5 in June. That marks the 25<sup>th</sup> consecutive month of growth in this index. As these cash flows build up in U.S. and European companies, a catalyst emerges for job creation, merger and acquisition activity, share repurchases, and increased dividends. We believe that we are somewhere in this last phase of the cycle, as evidenced by some M&A, increased dividends, and share repurchase activity that we are observing. In fact, corporate balance sheets are the strongest they have been since the 1950s (which is very unlike most recoveries). Of KING's top 30 holdings, 20% have at least 20% of their market cap in cash, and 10% have 30% in cash. Job creation should be occurring, but the fear of corporate regulation and socialistic tendencies of the current administration is keeping corporations from pulling the trigger on hiring. The current crisis may cause our government officials, both Republicans and Democrats, to look more positively at the benefits of a pro-business environment.

Major headwinds abound, and pessimism and fear are escalating, long-term stock prices are always ultimately dictated by cash flows and healthy balance sheets. In that vein, there are a few fundamental positives today. For one, individual earnings estimates for 2012 remain solid. Full-year total earnings for the S&P 500 rose 45.6% in 2010, and are expected to rise by approximately 16% in 2011, then to grow by another 14% in 2012. Another consideration is the ratio of firms with rising to falling mean estimates. Currently, that ratio stands at 0.99 for 2011 and 1.12 for 2012 earnings estimates—very healthy levels.

From a technical perspective, the correction of the last few weeks has been very trying, to say the least. But when you look at various internal factors, it has characteristics often found at major turning points. Last week, for example, markets experienced all of the signs of a classic capitulation. For example, risk aversion spiked (via the jump in the VIX Index) and volume was the highest since the March lows. Also, by several measures, the market is more oversold than it was at either the October 2008 low or at the March 2009 low. Capitulation usually marks the beginning of a turning point for a battered market. This does not mean that we have necessarily seen the bottom, but it could indicate that we are in a bottoming process. If one takes a broader look at the market, we have been in a tremendous consolidation pattern over the past four years. Despite the fears and sell off over the last few months, the damage has been relatively minor for this market barometer. By some measures, when fear and pessimism rises to this level, coupled with an environment of loose monetary conditions, the average potential returns for stocks over the following 18 months can be in the range of 30% to 35%.

The P/E ratio on the S&P 500 has plunged below 12x. To put this into perspective, the multiple on the S&P 500 was 15.3x after the tech bubble burst and the stock market was rocked by several large accounting scandals (i.e., Enron and Worldcom). At the 2008 market bottom, it was just over 9x. A difference, however, is that today's P/E multiple is overstated due to the enormous amounts of cash on companies' balance sheets (versus 2008 when many companies were very leveraged). Unless one believes that a serious global recession is just around the corner and that emerging markets and high quality European companies are going to be impacted in such a way that global growth and corporate profits are about to fall off the cliff, then the current plunge is not logical. One could certainly argue that developed economies and the higher risk components within are at risk. But does this mean everything is about to come to a screeching halt, including those areas where growth is good and profits are both strong and of a high quality?

No sector has been unscathed from the sell-off, but commodities have been hit harder than most over the past seven days. In many cases, some stocks are down 20% to 30%. Even larger-cap "safe" stocks, such as Exxon and Schlumberger, have declined 10% and 15%, respectively, over the last week. We maintain our positions in various energy, coal, and agricultural stocks. Commodities have been the "darlings" this year of the hedge fund community and we believe that this sector has become oversold as margin calls have intensified. Long term, as more people participate in an increasingly global society that offers greater economic opportunity, living standards will undoubtedly rise, likely creating greater demand for all soft and industries commodities. Over the short term, this group is likely to remain volatile.

The financial crisis of 2007-2008 is very fresh in investors' minds. The crisis in Europe combined with the sovereign debt debacle is very concerning, but thus far, it does not appear as if this is developing into a financial contagion. In Greece, yields on two-year debt has skyrocketed to above 30%, in Italy and Spain debt rates have risen substantially above that of Germany. In the U.S., however, both corporate and LIBOR spreads are below those levels recorded last summer when the European financial crisis first broke. This data suggests that it is premature to make the assumption that this will become an overall global meltdown in the financial markets.

It is an unfortunate fact that most successful authors or market strategists who express their ideas in the media, know that the secret to strong market acceptance is to write or say what satisfies the psyche of the audience—the herd. So in today's world, you will see the media crowded with dooms-dayers kicking and screaming to get up to tell their story of gloom, or the demise of America. Between the numerous negative headlines are some fundamental signs that give us faith in the future. While the future of some heavily indebted nations remains in doubt, news that Italy is taking measures toward financial stability, such as the institution of a balanced budget amendment, is a clear positive. Friday's payroll number also surprised on the upside. An average of 78,000 monthly jobs were created in 2010. In 2011, that number has risen to an average of 133,000 per month; hardly a stellar gain, but nevertheless, it is a trend that is moving in the right direction. Average hourly earnings also rose 0.4% sequentially and 2.3% year-over-year, the most since October 2009. The U.S. debt downgrade plus other global distress factors

may force governments around the world to face their debt issues constructively, which could pave the path for a more healthy global growth environment. In turn, this should lead to a rewarding environment for equity investors.

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