

The Capital Management Corporation

INVESTMENT COUNSEL

ANOTHER ROUND OF QUANTITATIVE EASING (QE)

- ◆ Fear that Greece could cause the downfall of the European Union (EU) and the end of global growth has resulted in negative investor sentiment. The pundits forget to mention that Greece only represents 2% of the EU economy. A year ago, the bears were frightened by Ireland's economic turmoil. Today, Ireland's banks have been recapitalized, ten-year Irish government bond rates have fallen below 8%, and Ireland has a current account surplus (i.e. exports are greater than imports) for the first time in over ten years. Apparently, Greek troubles sell more newspapers than articles on Ireland's recent stabilization.
- ◆ In September, thirteen European countries ratified a plan to bolster the EU bailout fund lending capacity by €190 billion. This enables pre-emptive loans to be made to both banks and governments and extends the previous bond purchase programs. Some compare this extension to the TARP program which made loans to US banks.
- ◆ Not to be outdone by the Europeans, the US Government provided great turbulence to the financial markets. During the summer, US Treasury debt was downgraded from AAA by one credit rating agency as politicians negotiated a debt ceiling increase. Debt talks are ongoing and now include a budget for the fiscal year beginning October 1st. Amidst the negativity, two states, Florida and Ohio, had their bond ratings quietly upgraded. Both states elected new governors in 2010 and enacted significant legislation to improve state finances.
- ◆ The US Federal Reserve made several unprecedented announcements. It intends to keep short-term interest rates near 0% for two more years. The bank will also buy 30-year US Treasury bonds, Federal agency debt and mortgage backed securities. This bond purchase program ends four months before the Presidential election.
- ◆ Meanwhile, responsible countries have had their currencies appreciate to the point that their goods become too expensive to export. Both Switzerland and Japan have tried to counter currency appreciation by printing money. Several other countries, like Norway and Sweden, might soon follow. With so many countries buying bonds and printing money, historians might look back at this summer as the beginning of global QE3.

Inside this Issue:

- ◆ Global Printing of Money
- ◆ Inflation greater than interest rates
- ◆ Financial Market Outlook
- ◆ Future Changes

ECONOMIC OUTLOOK: LOW INTEREST RATES INCENTIVIZE INVESTORS TO TAKE RISK

- ◆ Domestic economic growth remains meager. When US economic growth is less than 2%, unemployment actually rises and recessionary feelings linger keeping sentiment and confidence low.
- ◆ While the US consumer's balance sheet is slowly improving, the average large corporate balance sheet is strong. Excluding the financial companies (i.e. banks), S&P 500 companies have increased their cash reserves over the last three years to \$1 trillion. Overall US corporate cash balances are at a record \$2 trillion.
- ◆ Corporations and retirees can invest their cash in ten-year US Treasury bonds yielding less than 2%. After 4% inflation and federal taxes, the effective interest rate is negative and inflation adjusted wealth deteriorates. If any of the interest income is spent, then wealth deteriorates even faster.
- ◆ The Federal Reserve's recent actions serve to further lower the incentive to buy US government bonds of any type providing incentive for investors to move into riskier assets. The direction of these actions is typical for a central bank at the end of a recession, but the magnitude of the current moves remains unprecedented.
- ◆ History suggests that as economic growth eventually recovers, inflation will become a larger issue.

FINANCIAL MARKET OUTLOOK: COMPARISON TO THE MARCH 2009 LOWS

- ◆ March 9, 2009 marked a 12-year low for the major market indices. The economy was shrinking and investor confidence did not exist. Yet, it is in despair that market bottoms are formed. Over the subsequent 25 ½ months, the S&P 500 index more than doubled. Just as in early 2009, many investors do not see a catalyst for change. However, the financial markets tend to look forward at least six months.
 - ◆ There are plenty of other similarities to 2009. While today's economy is growing and is stronger than the economy in early 2009, stock market sentiment is low today as it was in early 2009. Also bond sentiment is high, just as in early 2009. US Treasury bond demand is so high today that the 10-year interest rate reached an all-time low of 1.72% on September 22nd, more than a full percentage point below its level on March 9, 2009. The 30-year Treasury bond rate is currently below 3% despite annual US inflation averaging over 3% since 1900. Today, the government claims inflation is 2% excluding food or use energy (otherwise it is 4%).
 - ◆ In 2009 the off-year elections provided significant change for Virginia and New Jersey. This November marks that two-year anniversary and shows whether the new governors will be able to win party seats in their statehouses. One-third of the Senate and the entire House of Representatives will see this November 8th as an indicator of their reelection prospects for 2012. Combined with low poll ratings, Congress will be motivated to create reasonable spending budgets and pass popular laws. Expectations for positive legislation are extremely low, meaning there is significant room for a positive surprise from Washington DC this winter.
 - ◆ This is only the second time in the history of the S&P 500 (created in 1957) that the index stock dividend yield is greater than the 10-year US Treasury bond yield. The only other time this happened was in late 2008/early 2009. US stock valuation levels using Price to Earnings (PE) and Price to Cash Flow (PCF) are also similar for both periods. One of the biggest differences between the two periods is that corporate balance sheets are much cleaner today. Corporations have less short-term commercial paper outstanding and have much more cash on hand. Today, many executives and corporations are using cash to purchase their own depressed stock.
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FUTURE CHANGES: DIVIDEND GROWTH TO REWARD LONG-TERM INVESTORS

- ◆ Three important factors for stock investors are recurring earnings growth, cash flow generation and valuation. If a company's valuation (PE) remains constant, then the stock's value will rise at the rate of earnings growth. If the stock was bought at a discount to its normal PE, then the stock price can rise even faster if the PE returns to prior levels. Companies can use excess cash generation to reinvest in their future growth as well as return money to shareholders through dividends and share buybacks.
 - ◆ As the baby boomers retire, they can put their savings in a bank to earn a low level of fully taxable interest. These investors hope that there is never any future inflation. Another option is to invest in dividend paying stocks. Of course, a portfolio of above-average yielding stocks that have potential to raise their dividend each year might be the most attractive option. At today's prices, investors can create a portfolio of growth and income stocks that have an average yield above 4%.
 - ◆ Select stock portfolios have the potential to reward long-term investors with compounded earnings growth, valuation multiple expansion, above-average dividend yield and dividend growth. Combining these features might enable savers to beat inflation and have cash generation to enjoy retirement.
 - ◆ Dividend paying stocks help diversify an income generating portfolio. Other recommended income investments include (all investment grade) short-term corporate bonds, variable rate corporate bonds and municipal bonds, preferably general obligation and triple tax free.
 - ◆ Investors should meet with their portfolio manager to discuss growth and income objectives and time horizon.
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We welcome your comments and client referrals.

