

The Capital Management Corporation INVESTMENT COUNSEL

INTEREST RATE CHANGES:

CENTRAL BANKS CONTEMPLATE WHEN TO RAISE RATES

- ◆ Around the globe, many central banks cut interest rates to record lows, printed money, and purchased bonds. Coordinated monetary policy of this scale was unprecedented. With signs of a global recovery, central banks are studying how to unwind their massive actions. Emerging markets like India and commodity rich countries, such as Australia, may increase interest rates before year-end.
- ◆ China has already ordered domestic banks to cut back on lending, as its stock market appears to be extended from speculators investing borrowed funds. Meanwhile, despite raising questions about US bonds, China remains the largest foreign owner of US government bonds and has continued to be a buyer in 2009.
- ◆ Five other central banks have printed money for the sole purpose of buying bonds. The Bank of England alone has purchased half of the new bonds issued by its government this year. In the US, the Federal Reserve has extended its purchase of US Treasuries and continues (with China) to buy record amounts of agency debt.
- ◆ Not everybody benefited from massive monetary easing. In 2008, 1,471 hedge funds closed down. Another 668 closed in the first half of 2009. Likewise, regulators have seized the most banks since the S&L crisis of the early 1990s. 25 banks failed last year, another 94 were closed by regulators in the first nine months of this year.

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ECONOMIC OUTLOOK: CURRENCY, INVENTORY, ORDER TRENDS BECOME POSITIVE

- ◆ During this recession the US federal government (including the FDIC and Federal Reserve) allocated \$16 trillion over at least 30 different programs to resuscitate the economy. Luckily, so far only \$3 trillion of this has been used. While some of this stimulus will still be spent in the future, other forms will end. The first-time homebuyer credit ends in November. Cash for Clunkers started then ended almost immediately. Some TARP funds have already been repaid. Money market and bond guarantee programs are ending.
- ◆ Low inventory levels across the economy combined with massive stimulus has actually led to some shortages and a recall of some laid-off workers. Unemployment (a lagging indicator) is expected to peak above 10% in early 2010. Regretfully, jobs may not rebound as fast in the expected recovery. Small businesses tend to create the most jobs, but many firms are refused loans from banks, which would rather purchase government guaranteed agency debt instead of making loans.
- ◆ Uncertainty in Washington from pending legislation, such as “Cap & Trade” and healthcare reform, can also result in delayed hiring in the private sector. Offsetting some of this is growth in the federal government and initiatives which need many new hires. As politicians campaign for re-election in 2010, expect Congress to temporarily move toward the middle, resulting in less legislative action and more certainty.
- ◆ Recent economic trends have been positive. Order rates are rebounding, some idled manufacturing is returning to use, and global trade is recovering. However, there will be pockets and lumpiness throughout the recovery. For example, the Cash for Clunkers program created a shortage of economy cars on some retail lots resulting in new orders for cars and car parts. Once that inventory is replenished, if car buying does not rebound to previous levels, some production lines may once again need to shut down.
- ◆ The US dollar has reached a new low for the year, making US goods and services more attractive to foreign buyers, resulting in faster profit growth at US-based multinationals as they repatriate foreign earnings.

 FINANCIAL MARKET OUTLOOK: ASSET INFLATION IN 2010 AND BEYOND

- ◆ In just six months, sentiment has started to recover from the depths of doom during the first quarter, and the stock market is mending from the worst bear market since the 1930s. Economists expect that the US is exiting the longest recession since World War II. With money market assets still near a record high (earning a record low 0.01%), many have asked the question, where is it appropriate to invest going forward?
- ◆ The Y2K printing of money that led to the technology bubble and the low interest rates that led to the housing bubble are dwarfed by recent Federal Reserve activity. In addition to printing record amounts of money and charging banks close to 0% interest, the US central bank is expected to purchase \$1.25 trillion of agency mortgage backed securities through early 2010 (in addition to \$500 billion in treasury and agency bonds). This massive bond buying has resulted in lower interest rates across the yield curve. The result in future years should include higher interest rates and inflation in the form of asset valuation.
- ◆ In such an environment, long-bonds should underperform as inflation and interest rates rise. On the other hand, some stocks and commodities will greatly benefit from the increase in asset prices and flow of funds. Much of the \$9.6 trillion of overnight deposits and money market funds in the US will not be content earning zero returns. When factoring in any inflation, this cash is actually earning a negative return. As funds are invested, incremental buying will increase prices of certain stocks and other assets (i.e. asset inflation).
- ◆ In 2010, other factors should also support the stock and commodity markets, such as delayed federal stimulus spending and the central bank keeping interest rates too low for too long. By the second half of 2010, a declining unemployment rate and an election that lessens one-party power should further aid the markets.
- ◆ While September and October are historically the weakest months for stocks, November and December have been the strongest (followed by January through April). Through history, as investors look forward to the next year, they typically see growth. In 2010, many see above average growth due to very easy economic comparisons. Economic growth of 3% will not return the economy to where it was in 2007, but it is much better than two years of contraction. As extreme pessimism wanes, the markets should continue to rise.

 FUTURE GROWTH: ROTH CONVERSION & INTERNATIONAL EXPOSURE

- ◆ Starting in 2010, all traditional IRAs (and rollovers) can be converted into Roth IRAs. Before 2010 there were income limits. In 2010, there is a one-time benefit of deferring the taxes over 2011 and 2012. Primary advantages of a Roth include no mandatory distributions and tax avoidance on future growth and income.
- ◆ Consider discussing with your tax advisor whether converting to a Roth IRA in 2010 makes sense for you. It may be appropriate if tax rates rise in the future and the funds are not being used for decades. Accounts intended for heirs fall into this category. A partial conversion is a way to hedge this decision. To maximize the Roth benefits, taxes incurred from conversion should be paid from a taxable account (not from the IRA).
- ◆ Periods when the Federal Reserve prints money or the federal government accelerates its indebtedness can be followed by years when the US dollar falls in value and inflation increases. A primary beneficiary can be US-based companies with foreign exposure. A falling dollar makes their foreign operations and assets worth more. Foreign sales can also become more profitable. Exports can become more competitive due to the weaker dollar. In upcoming years, investors should benefit from owning stocks of US-based multinationals.
- ◆ Typically, bond investors want income to be in their home currency. Bonds paying coupons and maturing in dollars are preferred when your future expenses are also in dollars. Two of the best inflation hedges for bond investors are inflation-protected bonds and bonds with short (to intermediate) maturities. During times of rising inflation, short-term bonds can be reinvested at higher interest rates when they mature. Stocks increasing their dividends each year are also an attractive source of income and can be an inflation hedge.

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We welcome your comments and client referrals.

