FOCUS

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Economic Comments

The Capital Management Corporation

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INFLATION: A SPIRAL OF RISING PRICES

- The industrialization and urbanization of Asia is increasing the demand for raw materials, energy sources, and higher-end foods causing a major ripple effect. For example, increased demand for meat requires increased levels of grains to feed the additional herds of animals.
- Any disruption in commodity supply results in commodity price spikes. Floods in Australia and droughts in China and Russia have limited grain supplies. Earthquakes from Chile to New Zealand and Japan have created various shortages from copper to electronic components.
- Higher energy costs are affecting many areas from home heating & cooling to gasoline For automobiles. As an input in manufacturing processing, packaging materials, and shipping, rising energy prices also effect business costs. Inflation is higher in emerging markets than in developed nations due to a higher proportion of their spending in food and energy.
- Already this year Brazil, India, Malaysia, Peru, Poland, South Korea, Thailand and Vietnam have raised interest rates in order to help control rising inflation rates. Rising prices and food shortages in the Middle East and North Africa have added to civil unrest. Some countries, like Saudi Arabia, try to use oil riches to subsidize prices and provide extra cash to the masses. Other countries do not have this ability due to decades of corruption, lack of wealth and unemployment levels over 20%.

ECONOMIC OUTLOOK: SLOW OVERALL GROWTH FROM A LOW BASE

- Growth tends to feel slow at the beginning of economic recoveries because many parts of the economy can lag. Some manufacturers and businesses have seen improvements; however, they do not want to hire workers until absolutely necessary. Hence, employment is one of the last areas to show improvement. Unemployment remains high, but has started to fall while sentiment is slowly recovering.
- The low interest rate environment has helped borrowers and penalized savers. Some larger businesses are wisely issuing new bonds at 10-year and longer maturities, locking in these historically low rates. Regretfully, the US government has done the opposite and will have over half its debt mature in the next four years. Domestic interest rates should rise this June when the Federal Reserve stops buying US Treasury bonds.
- Low interest rates have helped some parts of the economy, yet banks remain hesitant to make or renew loans. Banks will lend to those with pristine balance sheets and strong recurring income, but those companies and individuals tend not to need bank loans.
- Rising energy prices will also restrain economic growth. Every $10 increase in the cost of a barrel of oil corresponds to a 25 cent increase in a gallon of gas, slowing overall economic growth by ¼%. Thus, this economic recovery may be slower than typical for US economic cycles.
- Historically, population growth has a meaningful impact on economic growth. Most economies without population growth find it difficult to achieve meaningful economic growth. This will hinder parts of Europe, Japan and some Northern US states. In the most recent US census, there was a large population shift from higher tax states to lower tax states. This should lower the growth rate of high-tax states prolonging their fiscal strain. The aging of a population also affects economic growth. Again, Japan and Europe's growth will suffer disproportionately as retirees represent a larger portion of their populace than in the US.

FINANCIAL MARKET OUTLOOK: LONG-TERM CYCLES BENEFIT CERTAIN STOCKS

- While the stock market tends to lead economic growth by six months, employment trends can lag economic growth by up to twelve months. Unemployment remains near peak levels due to a plethora of part-time workers seeking full-time positions and recent college graduates who are not eligible for benefits, but are competing for job openings. Unemployment has started to fall; yet, it should be many years before unemployment levels approach the post-World War II average of 5.7%. Historically, equity bull markets tend to peak after unemployment bottoms, suggesting stocks remain early in their cycle.
- The US appears to be at the beginning of a 10-year economic cycle, the end of a 30-year interest rate cycle and in the middle of a currency cycle. Each of these items greatly affects how economic sectors and individual securities perform in the years ahead.
- Low interest rates allows bad operators to survive resulting in bad balance sheet decisions. A rising interest rate environment will reward better managements and more conservative companies. Stocks of companies with large cash balances and strong free cash flow should outperform weaker competitors.
- The stock market has additional cycles. Value outperformed Growth in the previous decade; however, the extended trend has started to reverse. Similarly, small-capitalization stocks trounced large-caps as a category over the last twelve years. In upcoming years, small-caps will benefit from the beginning of the business cycle and from cash rich large-caps acquiring smaller competitors. The economic trends noted at the top of the page combined with global growth will provide many large US based multinational firms with strong revenue and earnings growth.
- Despite the most severe global recession since the 1930s, many emerging markets have logged several years of growth with some not technically entering a recession. Rising inflation and interest rates have started to negatively affect some emerging stock markets. Countries are under pressure to maintain corporate strength and high employment so the populace does not have idle time to ponder their higher cost of living and their government. To achieve this, some governments will intentionally create excess manufacturing capacity.

FUTURE CHANGES: SAVERS MIGRATE FROM BONDS TO STOCKS

- As the baby boomers consider retirement, they may find their savings to be inadequate if CDs (certificates of deposit) are their only option. With inflation arriving, the largest wave of retirees in US history will be forced to look at categories other than bonds and bank savings accounts. Stocks that pay dividends (especially stocks that tend to raise their dividends each year) will become increasingly attractive to those who want to beat inflation and enjoy a long retirement without depleting their savings.
- In a period of slower than usual growth, stocks of companies that can achieve double digit EPS (earnings per share) growth rates will command valuation premiums. Companies that use pricing power to maintain profit margins should provide an inflation hedge. Due to higher input prices and global competition, the average company will not experience double-digit earnings growth. Hence, the performance dispersion underlying the index averages will be substantial, allowing some active managers to outperform the S&P 500 by an extraordinary amount.
- High levels of market volatility should provide attractive entry points into stocks of companies with strong prospects. Recent coups in North Africa, riots in the Middle East and earthquakes and tsunami in Japan resulted in a 6.4% correction in US stocks. Some sectors and industries performed worse than others, providing buying opportunities. In this environment, there should be a preference for growing US based multinationals having purchasing power, dominating a niche, and producing excess cash. Additionally, investors approaching retirement should add holdings that pay a rising stream of cash dividends.

For more information, please contact Ken Walker, Preston Smith, Scott McFadden or Tim Call.
The Capital Management Corporation, 4101 Cox Road, Suite 110, Glen Allen, VA 23060.
Feel free to view our website at http://www.cmcva.com or contact us at (804) 270-4000.
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