FOCUS

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Economic Comments

The Capital Management Corporation
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Interest Rate Changes: Reversal in Monetary Policy

- During the first quarter, the Federal Reserve raised its discount rate (the rate for loans from the Federal Reserve to other banks) to 0.75% from 0.50%. As the first rate increase since 2006, this marks a major reversal in the central bank's stance. The Federal Reserve is removing monetary stimulus by shutting down other programs. For example, the bank stopped purchasing mortgage-backed-securities (MBS) at the end of March. This may result in rising 30-year mortgage interest rates.
- Several other central banks (including Australia, China and India) have also started increasing overnight interest rates in an effort to stem rising inflation rates. Historically, interest rate changes by central banks start to impact economic growth about nine months later. As such, some of these rate increases may slow global economic growth (and inflation) in 2011 and 2012.
- Overseas, some basic consumer necessities such as food and energy have experienced double-digit price increases. Industrial businesses also face cost pressures from rising commodity and transportation prices.
- On the other hand, the US government is reporting low consumer inflation. This year it changed the calculation for Consumer Price Index (CPI) to include vacation homes, which have been falling in price. It also increased its use of "unsampled" data, leading one to question the validity of CPI figures. Meanwhile, US industrial inflation is increasing at alarming rates (The US Producer Price Index increased at 4.4% and 28.6% year-over-year for finished and crude goods). This may eventually add upward pressure to actual consumer prices.

Economic Outlook: Easy Comparisons in 2010 Followed by Higher Taxation

- Domestic economic growth should be stronger this year, but slow in 2011 as comparisons get harder through the year. Automatic capital gains, dividend and estate tax increases occur at the beginning of 2011, and new healthcare taxes will be phasing in starting with a 3.8% Medicare tax on all taxable income over $250,000 for a couple and $200,000 for an individual. Higher taxes tend to dampen overall economic growth.
- Corporate orders, inventories, revenues and profits have easy comparisons in 2010 relative to 2009. This is due to excessive weakness in the two previous years, rather than great strength this year. Like clockwork, the stock market bottomed about six months before many economic trends. The stock market low was in March 2009, while the recession ended in mid-to-late 2009. Later this year, the National Bureau of Economic Research (NBER) should proclaim exactly when the recession ended in 2009. However, many economic trends such as employment and loan defaults tend to lag economic growth by up to a year. Consequently, the unemployment rate and consumer spending may not materially improve until the second half of this year.
- Some states are finally seeing an uptick in sales tax revenue. This serves as a coincidental indicator of economic growth as well as a sign that some have weathered the worst of their budget crisis. The recovery is not consistent by region and some states have broken budgets. Illinois' spending is almost twice as much as revenues. Due to predecessor's actions, the new governor of New Jersey has been informed that laying off state employees could actually worsen the state budget. New York appears to be without a head of state. Recent healthcare legislation may add 16 million to the roles of Medicaid, adding to states' expenses. Investors should avoid the municipal bonds issued by states that have not been able to balance their budgets.
- While there is plenty of negative news for the media to report, economic growth is quietly occurring. Despite a large part of the East Coast spending weeks under record snow, the US economy should report solid gross domestic product (GDP) growth in the first quarter of this year (government report released in late May).

Financial Market Outlook: Volatilty Provides Opportunities

- Last autumn, many healthcare stocks dipped to ten-year low valuations (relative to earnings, sales and cash flow). Early this year semiconductor stocks fell on the fear of a double-dip recession. Currently, stocks with European exposure are under pressure due to budget crises in Greece and other Mediterranean states. These and other market rotations have created attractive long-term entry points in many growth stocks. Likewise, when Wall Street falls in love with a sector or sub-industry, stocks can be sold at high valuations.
- The global bond market should shift its focus to defaults and inflation (rather than deflation). This could cause bond yields to rise. Since bond prices move in the opposite direction of yields, long-term bonds could lose value in the year ahead. One strategy to take advantage of higher future interest rates is to stay in short-term bonds, then reinvest at higher rates in the future as the short-term bonds mature.
- China has already affected many changes this year. While it has raised its own interest rates and deterred surging bank loans, it is also cutting its ownership of US Treasury bonds and is no longer the largest foreign owner of Treasury securities. China could possibly invest the proceeds into metals and corporate equities.
- China has also changed some of the rules for Chinese investments. Loan defaults are surging in China, and many loans had the full backing of local municipalities. China realized that rising default rates would hurt local governments, so it made those guarantees null and void, leaving bond and loan investors with little recourse. In China, the financial community and economy serve the government's goals first.
- Politics can add to financial market volatility. The passage of healthcare, financial and stimulus bills as well as tax increases should occur this year. As politicians focus on the November elections, less will be accomplished in DC. If the next Congress is more politically balanced, expect fewer legislative changes and more certainty, which is good for stocks.
- Recent healthcare legislation will have many effects, including tax (and levy) increases, a surge in the number of Medicare and Medicaid recipients, and lower reimbursement. Already, some physicians, pharmacies and hospitals have stated they will not accept new Medicare and/or Medicaid patients as they are unprofitable. The rising healthcare volume will benefit some firms, but price controls and lower profit margins will hurt others. Investors need to be highly selective in this area.

Future Growth: Innovators can Overcome Rising Taxes & Regulation

- Over long periods, 10% of publicly traded companies file for bankruptcy, another 50% of stocks also underperform the broader indices, and 40% perform better than the indices. Expect a narrowing of the better performing stocks in future years as higher taxes and increased regulations hinder the average firm. This should make the upcoming cycle a better period for (good) stock pickers than for general index funds.
- Investors should focus on companies that command an innovative niche protected from competition (by patents or economies of scale). Avoid companies with products and services that are easily duplicated, could face new entrants, or have intense rivalries. For example, too many car manufacturers and airplane companies led those industries to be very price competitive and unprofitable for long-term investors.
- As inflation returns, focus on companies able to raise prices and contain costs. Companies in competitive fields will lose unit volume when trying to raise prices. The combination of rising input prices like materials and energy with the inability to raise end-product prices could result in a bad investment.
- Companies with leading technologies, a lock on patents or resources, and niche leadership should have increasing market share, the ability to raise prices, domination of their category and a rising stream of excess cash flow generation. In turn, corporate managements should reinvest cash into growing the firm and creating future products. Excess cash should be used to pay down debt, raise dividends and repurchase shares.

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We welcome your comments and client referrals.