

## The Capital Management Corporation INVESTMENT COUNSEL

### INFLATION: SHORT TERM COMMODITY PULLBACK

- ◆ Constant gains in raw material prices over the last year encouraged manufacturers and investors to stockpile inventory. This hoarding fueled further price increases. However, manufacturing disruptions, rising margin requirements for derivative traders, and higher foreign bank reserves resulted in a steep decline in many commodity prices this spring. The pull-back in raw material prices could moderate short-term inflation.
- ◆ At 3.6%, the US annualized inflation rate in May is low by global standards. The US inflation rate is even lower when the government excludes food and energy prices. Rents which had been declining in previous years are now rising. Apartment rents are up 2% and represent about 40% of the US Consumer Price Index (CPI). As the government only updates rent assumptions twice per year, reported CPI will lag actual inflation.
- ◆ Suffering from higher inflation, the BRIC nations (Brazil, Russia, India & China) have each recently raised interest rates in order to slow their economic growth. India and China are both trying to slow their economic growth to 8% per year. If China slows its growth rate too much, unemployment will rise providing potential for civil unrest. While concerns over slowing growth added to the decline in commodity prices, 8% economic growth still remains significant. With overall inflation rampant in emerging markets, locals have less faith in their own currencies. India and China are now the world's largest and second largest buyers of gold. This trend is expected to continue.
- ◆ Low domestic interest rates have helped finance US government debt and allowed corporations to refinance at attractive rates. The recurring EU difficulties with Portugal, Ireland, Italy, Greece and Spain sent some European bond investors to the US, pushing the ten-year US Treasury bond yield to 2.9% and the two-year below 0.4%. After inflation, investors appear to be locking in a negative return. Meanwhile, this year's largest buyer of Treasury bonds, the Federal Reserve, is scheduled to significantly slow its purchases in July.

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### ECONOMIC OUTLOOK: LOW (1% TO 2%) GROWTH RATES NEVER FEEL GOOD

- ◆ Due to population growth, the US needs 3% economic growth in order for unemployment levels to decline. As growth has appeared to slow to 2% or lower in the second quarter, the US unemployment rate rose to 9.2% in May. This is the main reason why 1% to 2% domestic economic growth still feels like a recession.
- ◆ Three factors suppressing economic growth in this cycle are lack of construction spending, sparse new bank lending and budget cutbacks at every level of government. This is despite a 9% increase in some state revenues and record low interest rates. Limited spending and lending should continue to subdue overall growth.
- ◆ The lack of excesses in this slow economic expansion should serve to extend the length of the recovery. The average economic expansion since WW2 has lasted 58 months. July marks the 24th month of this recovery.
- ◆ The US consumer pulled back this spring on higher gas prices. With gas declining about 20% in recent weeks, expect some consumer spending to migrate to other areas. A 50 cent decline in gas prices can increase economic growth by 0.5%.
- ◆ Japan impacted global sentiment with Japanese industrial production falling by over 15% in March. Despite continued power disruptions, Japan experienced a slight increase in April industrial production and almost 6% growth in May. Global manufacturing supply dislocations should diminish this summer in time for seasonal inventory stocking.

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**FINANCIAL MARKET OUTLOOK: LOW VALUATION FOR US LARGE-CAPS**

- ◆ Politicians continue to make themselves easy targets. Federal debt ceiling limit negotiations could continue into August. Expectations for Washington DC remain low. Thus, a long-term agreement to lower the government's growth and contain the escalation of debt may be met with a relief rally in US markets as global investors move from areas with higher inflation to an environment perceived to be more stable.
  - ◆ A successful debt ceiling negotiation should end with both parties claiming victory. One side will claim tax rates did not rise, while another will state that energy producers, jet owners and hedge fund managers will now pay higher taxes. Similarly, social programs will be trimmed in order to save them for future generations. While the financial markets could receive relief, the political rhetoric will only escalate into 2012.
  - ◆ In aggregate, large corporate balance sheets are clean as opposed to consumer and government balance sheets. Combined with strong cash flow, corporations are likely to accelerate merger & acquisition activity, dividend growth, share buybacks and global expansion. Many companies will use their foreign cash to expand globally rather than in the US, in order to avoid the double taxation that occurs when foreign earnings are repatriated.
  - ◆ The most uncertain item in the debt ceiling discussions is a tax cut on repatriation of foreign corporate earnings. The last time this tax was temporarily lowered, tax revenue increased and the private sector grew. However, the Congressional Budget Office (CBO) scores tax cuts as detrimental to tax revenue. Thus, an easy move to return cash to the US economy and markets will be difficult to package into CBO scored legislation.
  - ◆ Small-capitalization stocks (Russell 2000) reached a record high this spring. Larger companies are expected to report another year of double-digit earnings growth, yet large-cap stocks have greatly underperformed small and mid-caps. Large-cap stock valuations remain modest.
  - ◆ Traditional measures to compare stocks to bonds uses the corporation's earnings yield and cash flow yield measured against the corporate bond yield. Not only are stock earnings and cash flow yields greater than bond yields, but the difference is near a 50-year high. Thus, some stocks appear attractive relative to bonds.
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**FUTURE CHANGES: WHERE TO INVEST IN A SLOW GROWTH ENVIRONMENT**

- ◆ European debt crisis will continue with another troubled country needing to refinance maturing debt every few months. Other issues like earthquake and weather disruptions will be transitory. Meanwhile, emerging market regimes are focused on maintaining employment and limiting inflation in order to avoid popular uprisings.
  - ◆ With a frustratingly slow economic recovery and more immediate news coverage of negative events than ever before, the stock market has been climbing a wall of worry. When there are more items to worry about, the market tends to be inexpensive and it is time to add to long-term investments. The time to trim investments is when everybody else acknowledges the market is the best place to be, with cheerleaders abounding.
  - ◆ In a slow growth environment, it is important to invest in stocks of companies that grow faster than the economy. Companies with protected market niches, increasing market share in growing categories and global expansion should achieve revenue and earnings growth. Additional mandates for holdings should include rising cash flow generation and clean balance sheets resulting in a portfolio that can reward investors with dividend growth, earnings growth and valuation multiple expansion.
  - ◆ Stocks with low valuations, clean balance sheets, strong cash flow and rising earnings remain attractive long-term investments. In balanced portfolios, investors should lower duration by selling the longest maturity bonds. Investment grade corporate bonds are more attractively valued than government bonds.
  - ◆ Long-term return objectives and risk constraints should be discussed with your investment advisor. If there is a need for more portfolio cash generation, dividend producing stocks can be used to enhance the portfolio.
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