

The Capital Management Corporation INVESTMENT COUNSEL

INTEREST RATE CHANGES: RATES LOW AS EU PRINTS EUROS

- ◆ In early June, Canada's central bank doubled its overnight interest rate to 0.5%, marking its first increase in almost three years. Several other countries, including Australia, China, India, and Singapore, have taken similar tightening actions ranging from increasing bank reserves to raising currency exchange rates in order to prevent their strengthening economies from producing too much inflation.
- ◆ In the US, both the Administration and the Federal Reserve want to see a stronger recovery before tightening monetary policy. There is substantial political pressure to prevent interest rates from rising before the November elections.
- ◆ Europe returned to quantitative easing this summer with the European Union (EU) stating it will print the equivalent of \$1 trillion in Euros (€) to help save Greece and others who are having trouble issuing debt. Once these funds are used, and Portugal, Italy, Greece and Spain (negatively referred to as the PIGS) continue to have funding problems, one should expect the EU to begrudgingly print another trillion €.
- ◆ The excessive printing of currency made the Euro fall to a four year low against the dollar (about \$1.20 to 1€). Speculators anticipate that another round of quantitative easing later this year could send the Euro even lower. Outside of the EU, in just one month, Switzerland's central bank increased its currency exposure by 50% in a failed attempt to stabilize its currency vs. the Euro. Surprisingly, proud Europeans are not complaining much about the weak €, as it has made European exports more competitive.

Inside this Issue:

- ◆ Quantitative Easing Continues
- ◆ Corporations are Cash Rich
- ◆ Financial Market Outlook
- ◆ Future Growth

ECONOMIC OUTLOOK: SLOW LENDING, STRONG CORPORATIONS

- ◆ During the early stages of an economic rebound, it is normal to focus on negative news like high unemployment. This is a lagging indicator as a weak economy eventually results in lower employment and vice versa. Government data continues to be mixed with the Administration claiming job growth while, conversely, IRS monthly data shows lower payroll tax collections through May. Inflation data is similarly mixed. The government states that lower home equivalent rents and energy prices have resulted in almost zero inflation, yet businesses have been reporting higher energy costs and REITs are having success raising apartment rents.
- ◆ Bank lending data is skewed. Some large banks show loan growth on their balance sheets because they were recently forced to bring off-balance sheet loans and partnerships onto their books. Excluding this effect, loan growth is estimated to have been negative 5% in the first quarter of this year. Small businesses and individuals are having a hard time finding loans, which deters their ability to refinance, expand and hire. On the other hand, larger corporations are issuing bonds at low interest rates for ten to thirty year periods. The Federal Reserve reports that corporate cash (and cash equivalent) levels rose 26% to almost \$2 trillion by the end of March. In June, cash was estimated to be 11% of all corporate assets, a 60-year high.
- ◆ Higher levels of cash at large corporations allows for increased capital spending and acquisitions. Smaller, family-owned businesses are considering selling themselves before tax rates rise at year-end. This combination is resulting in a rebound of investment banking activity. Many healthy companies are raising dividends and repurchasing stock.
- ◆ Large companies are benefiting from exposure to Latin America and Asia. Many emerging markets were able to grow through the last global recession and continue to expand. Moreover, emerging market consumer spending has recently exceeded US consumer spending for the first time. Your investment manager can provide a list of your stocks with foreign exposure, increasing dividends and a shrinking share base.

FINANCIAL MARKET OUTLOOK: MARKET CORRECTION PROVIDES OPPORTUNITY

- ◆ From excessive 12-year market lows on March 9, 2009 to the recent market highs on April 23, 2010, the S&P 500 and Dow Jones Industrial Average surged approximately 80% and 71% without a typical 10% pull-back. However, from April 23, 2010 to June 7, 2010 these indices fell 16% and 14% respectively. While this appears to be a normal correction in magnitude, the decline was fast by historical standards.
- ◆ Worries over Greece's weak economy and huge debt burden have added to market fears, yet Greece only represents 2% of the EU economy. Contagion from Greece should be limited by the massive printing of money by the EU central bank. From communication with various corporate executives, it appears that northern Europe continues to rebound from the recession. Many industrial CEOs state that June orders are on track and in many respects, activity in England, France and Germany appears to be at pre-recession levels.
- ◆ Market volatility can occur near the end of the quarter, as this is a quiet period for most companies. Executives limit comments before their earnings announcements in mid-to-late July. It would be improper for them to provide guidance to some investors and not others. Thus, information is scarce until earnings releases and conference calls occur. However, if a company has bad news, they may decide to release that information ahead of schedule (late June or early July) in a press release. The timing and nature of these announcements can cause market jitters going into earnings season, followed by more certainty and alleviation afterward.
- ◆ Many earnings announcements in late July 2010 should be positive. After massive expense cuts in 2009, corporate America should profit from any rebound in customer orders and inventory replenishment.
- ◆ Only 9% of US corporate income is derived from Europe, with less than a third of this from southern Europe. Strong global activity in Asia, Latin America and the Middle East should more than offset weakness from the Mediterranean states. US companies with exports or sales to countries like Brazil, China and India should report strong revenue growth as they benefit from the expanding middle class of the emerging markets.
- ◆ Corporate earnings announcements should reassure investors by late July, but the cycle recurs at the end of the third quarter. There could be volatility in September and early October, followed by earnings announcements again in mid-to-late October. Initially, voters tend to like who they vote for, which could lead to a stronger market near year-end. November and December are historically the strongest two months for US stocks.

FUTURE GROWTH: LIMITING RISK AND RAISING RETURNS

- ◆ News headlines are almost always negative, especially during recessions and their recoveries. Regretfully, stories of Greek riots, the Gulf oil spill, and high unemployment will continue. In this environment, politicians will have a hard time raising their ratings before the November elections. Yet there are some positive trends.
- ◆ Earlier this year, the global composite of leading indicators made a new 30-year high. Bank lending and consumer spending continue to expand at high rates in most emerging markets where the middle class is growing in size and power. In the US, personal consumption growth turned positive and layoff announcements are declining. The end of long-term (99 week) unemployment checks should help fill lower paid job openings. Other signs of economic activity (at port terminals and in truck loads) are rebounding.
- ◆ Investors should focus on benefiting from these trends while limiting their risks. In order to gain international exposure, stocks of US-based multinationals can be purchased instead of foreign companies which have different accounting standards, regulators, and home currencies. To increase cash income, investors can focus on stocks that pay dividends and are expected to increase their dividends each year. By owning companies that repurchase their own shares, investors' ownership stakes can increase without making additional transactions.
- ◆ In times of uncertainty, stock investors should focus on companies that produce excessive and growing amounts of cash. Bond investors should emphasize quality and limit maturities to one to ten years.

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.

We welcome your comments and client referrals.

