

The Capital Management Corporation INVESTMENT COUNSEL

INTEREST RATE CHANGES: RISING INTEREST RATES

- ◆ Strong global economic growth has led to greater than expected inflation spanning from over 3% in the United Kingdom to 5% in Asia. Food and commodity inflation is hitting the emerging markets especially hard. The traditional way to fight inflation is to raise interest rates. In the last three months Australia, China, India, South Korea and Thailand have increased rates and Brazil indicated it expects to raise rates soon.
- ◆ Loan growth of 23% has forced Indian banks to raise three-month CD rates to over 9% (in their currency, Rupees). The lending and deposit rates in China have risen to 5.81% and 2.75%, leading one to wonder how long the US can maintain rates close to zero. Meanwhile, the US government continues to claim that inflation does not exist.
- ◆ Quantitative easing (the excessive printing of money to buy bonds) by Europe, Japan and the US is being blamed for the influx of new capital investment and inflation in the emerging markets. Governments are responding with forms of financial protectionism. Brazil, South Korea and Thailand are moving to raise taxes on foreign investors' bond income. Brazil and China are increasing margin requirements and related taxes. These moves could slow the influx of investment and moderate economic growth in those countries.
- ◆ Gold appears to be winning the global currency wars. China increased gold imports by 500% through most of 2010. In just a ten month period, China purchased 210 tons of gold. China has also increased its purchase of European government bonds, as it wants to ensure that major trading partners (i.e. customers) remain solvent.

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ECONOMIC OUTLOOK: TAX RATES MAINTAINED & UPCOMING SPENDING CUTS

- ◆ Federal dividend and long-term capital gains tax rates will remain at 15% for top wage earners through 2012. A "patch" lessens the number of people hit by the alternative minimum tax (AMT) in 2011. 2011 will also see a temporary 2% cut in payroll taxes, to be reversed in 2012; then as part of the new healthcare legislation (Obama-care) an additional 2.35% Medicare payroll tax will hit workers starting in 2013. Also in 2013 several other tax rates are expected to rise, including a 3.8% healthcare surtax on "net investment income" which includes dividends, interest, rents, royalties, business income, passive income and net sale proceeds.
- ◆ High earners can still convert all or part of an IRA to a Roth IRA in 2011. This makes sense for long-term funds when tax rates are expected to rise in the future, and after-tax savings can pay the conversion tax.
- ◆ States with low income tax rates experienced the most population growth in the last ten years. The census showed above average growth in Florida, Texas and Washington; these three states have no income tax and will gain a combined seven Congressional seats (of 12 seats that are moving), while higher tax states like New York, Illinois, Massachusetts, Michigan, New Jersey and Pennsylvania will lose a combined seven seats.
- ◆ Federal aid to municipalities will plummet in 2011. States will only receive \$6 billion of Federal stimulus (down from \$59 billion in 2010) and local governments will receive \$10 billion less in Federal aid. Many states can overcome these cuts as they plan expenditure and expense cuts of their own; also, some sources of state tax revenue (like sales tax) have started to increase. However, a few states are technically insolvent. California and New York have insurmountable pension costs while Illinois spends twice as much as it has in revenue. The largest state municipal bond issuers tend to be in the worst predicaments. These high risk issuers' debt comprise a large component of many national tax-free funds. Investors should consider selling national municipal bond funds and money markets in favor of high grade single state or corporate bonds and money markets.

FINANCIAL MARKET OUTLOOK: STOCKS TO WIN FAVOR OVER BONDS

- ◆ Corporate profits have rebounded and should record a new high in 2011 (overcoming the prior 2006 peak). The quality of profits is also improving. In 2006 the financial sector provided more profits than any other sector; the technology sector should be the most profitable in 2011. The technology sector also shows leadership in cash flow generation and clean balance sheets (with many tech companies having no debt).
 - ◆ Overall US corporate balance sheets are strong with cash balances (as a percent of the balance sheet) at a 60-year high. Profit growth and cash generation are funding dividend increases, share buybacks and mergers & acquisitions at growth rates of 9%, 221% and 124%, albeit from depressed levels.
 - ◆ At the same time, government balance sheets are stretched and cash flow is strained. Some local governments were able to use the Federal subsidized Build America bond program to issue new debt in 2010 to fund their budgets, but this program expired at year-end. Expect Federal, State and local governments to cut spending. This has a differing effect on companies. For example, Cisco Systems partially blamed its recent earnings forecast cut on lower government spending while Microsoft has increased its earnings forecast as individuals and corporations are spending money on a new product upgrade cycle that just started.
 - ◆ Overall economic growth will be aided by easy comparisons and temporarily lower than expected Federal tax rates. Offsetting part of this are higher prices (for food, energy, and other items) as well as lower government spending. While the stock market should benefit from many factors, investors need to be selective. Stocks in the same sector will deservedly have varied returns and there is heightened risk in the bond market.
 - ◆ Some bonds could provide negative returns as select states receive lower credit ratings and as economists dismiss deflation and refocus on inflation. Rising interest rates in 2011 and beyond would result in lower bond prices, hurting the longest maturity bonds the most. Investors should reduce exposure to long-term bonds (i.e. maturities over ten years) and to bonds issued by less solvent states and municipalities (e.g. Illinois).
 - ◆ While the US Treasury has the power to print money, it also has a funding problem. 60% of US Treasury debt matures in less than three years and unfunded entitlement obligations (mainly Social Security and Medicare) are estimated at \$46 trillion. Expect governments to eventually cut their long-promised pension and healthcare obligations through lower eligibility and benefit growth, and higher deductibles and taxes.
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FUTURE CHANGES: INCREASED INFLATION & PROTECTIONISM

- ◆ Last year was noted for the lowest bond yields and mortgage rates in a generation funded by newly printed money buying bonds and record investor interest in bond funds. Rising inflation rates and increased congressional scrutiny over the Federal Reserve and Treasury should lower bond demand going forward resulting in higher interest rates. In the ever elusive category of “what’s next,” inflation has arrived.
 - ◆ MIT created the Billion Prices Project monitoring daily price fluctuations of 5 million items sold by 300 online retailers in 70 countries; this methodology shows over 2% domestic inflation. The largest debtor in the world, the US government, has incentive to understate inflation. Yet, the government’s core inflation figures will start to reflect an upward bias as the CPI’s largest component, shelter (42%) is dominated by rental equivalents which are now rising. Thus, the biggest deflationary item in CPI is now inflationary. Food, heating, transportation, healthcare and import prices are also rising and the 2010 holiday season saw fewer discounts than in recent years. The government will either start reporting inflation or will reformulate the index again.
 - ◆ Many foreign countries are penalizing investors. Rising interest rates and new foreign investment taxes are in a growing trend. Some business leaders are persecuted in countries like Russia while accounting irregularities are appearing at firms in other regions like China. Investors need to focus on beating the rising tide of inflation while moderating their risk profile. As risks increase in long-bonds and emerging markets, investors should focus on attractively valued US-based multinational growth firms that can increase their dividends annually.
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We welcome your comments and client referrals.

