

The Capital Management Corporation INVESTMENT COUNSEL

INTEREST RATE CHANGES: EXPECT HIGHER RATES

- ◆ The Federal Reserve will be under political pressure to keep overnight interest rates close to zero before the mid-term elections, keeping money market interest rates near historic lows. Other central banks, however, are expected to increase interest rates.
- ◆ The Federal Reserve has announced it is no longer buying long-term US Treasury bonds and expects to stop buying mortgage backed securities in 2010. Surprisingly, the central bank wants to start paying banks attractive interest rates to hold excess reserves for determined periods of time. This new Federal Reserve strategy might control future inflation by locking up cash which might otherwise be lent to homebuyers or small businesses. Such action would deter economic growth and work against the efforts of many politicians.
- ◆ Congress has raised its debt ceiling to \$12.4 trillion and the Administration has eliminated caps on US Treasury aid to Fannie Mae and Freddie Mac for the next three years. Fannie and Freddie are expected to report heavy losses thru 2010 as they own or guarantee almost half of the \$11.7 trillion in US residential mortgage debt.
- ◆ With federal government debt levels increasing and central banks globally slowing their bond purchases, long-term interest rates are expected to rise. This should be visible in mortgage interest rates after the Federal Reserve completes its mortgage backed securities purchase program at the end of March.

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ECONOMIC OUTLOOK: A SLOW RECOVERY WITH INFLATION

- ◆ Deflation concerns subsided once economists predicted the US recession ended in the second half of 2009. Current US inflation lingers between 1% and 2%. It is unusual to have any inflation given excessive idle capacity in the economy (70% factory capacity utilization, 10% unemployment and over 10% housing vacancy). The massive printing of money, stimulus spending and new debt issuance created enough asset inflation to offset deflationary pressures. Treasury bond sales were a record \$2.1 trillion in 2009 and may surge 17% in 2010.
- ◆ The largest year-over-year deflationary force in the first nine months of 2009 was energy. Oil prices were \$60 to \$80 per barrel vs. prior year levels of \$100 to \$147 (a 40% to 46% decline). Today, oil is \$79 vs. \$34 a year ago (a 132% increase). The largest deflationary force for most of 2009 is now a significant inflationary force. Higher energy prices will increase home heating expenses (limiting consumer discretionary spending) and increase transportation costs of most items on store shelves (either raising prices or lowering profit margins).
- ◆ Typically, higher prices are the result of overheated economies and wage-based inflation. Today's high commodity prices are the result of too much currency being printed worldwide. As the US dollar fell in value in 2009, China's Yuan fell by the same amount, as its exchange rate has been fixed to the dollar since July 2008. Thus, the falling dollar made both US and Chinese exports more competitive. This encouraged other countries to print their own currencies and sell them in exchange for dollars in order to stabilize their currencies relative to their two largest trading partners. The proceeds of this currency printing were invested in Treasury bills and commodities (keeping short-term interest rates low and elevating commodity prices).
- ◆ With currencies being printed worldwide, too much money will chase certain goods, resulting in more asset based inflation. Meanwhile, the real economy has signs of mixed growth. Government figures show more areas of growth than areas of contraction. Most growth in 2010 will be due to easy comparisons against a weak economy in 2009, with inflation causing nominal growth rates to be higher. 2011 may continue to be a slow year as rising healthcare costs and higher taxes, both on dividends and capital gains, will hinder domestic economic growth.

FINANCIAL MARKET OUTLOOK: HISTORY PROVIDES POSITIVE INDICATIONS

- ◆ While there is no guarantee that history will repeat itself, since World War II the second year of a bull market has provided an average annual return of positive 15% for stocks (with no down years). A weak economy could lower these expectations. However, a huge amount of money market assets (earning a measly 0.01%) may move into asset categories with anticipated positive returns. This could boost equity returns.
- ◆ Because unemployment and loan defaults tend to peak (up to) one year after an economic recovery begins, negative news headlines should continue. Every recovery is different in magnitude and underlying component strength. For example, stocks of brokerage firms tend to perform well in a bull market, but if certain brokerage firms are sued for actively shorting securities they helped to create and sell to clients, then those stocks could underperform. Likewise, banks with rising loan default rates should be avoided.
- ◆ The bond market should provide mixed results. Short-term debt may benefit from the Federal Reserve delaying interest rate increases until later in the year, while long-term debt should be pressured from increased US Government debt issuance. The issuance of new 10 and 30-year bonds may require higher interest rates to attract enough buyers. Investors should avoid long-term Treasury bonds at current levels.
- ◆ Different types of bonds could move in different directions. Corporate bonds may benefit from increased corporate profits and healthy balance sheets. On the other hand, mortgage backed securities face uncertainty once the Federal Reserve stops buying these securities at the end of March. Thus, mortgage interest rates could rise, while corporate bond interest rates continue to fall. This would help corporate bond holders as bond prices tend to move in the opposite direction of interest rates.
- ◆ Politics can affect the markets, as reflected by the performance of healthcare stocks in the Fall of 2009. Interestingly, little tends to be accomplished by Congress in election years as politicians focus on getting reelected and avoiding contentious votes. The stock market benefits from less activity in Washington. The markets may be the main winner of the November 2010 elections as a more evenly split Congress provides fewer new laws. The resulting inaction creates a sense of stability, certainty and predictability to investors.

FUTURE GROWTH: COMPANIES WITH ACCESS TO CASH WIN MARKETSHARE

- ◆ Before the bear market, debt securitization represented about 60% of US credit in many forms like student loans, mortgages and commercial leases. The Federal Reserve tried to stabilize this market through several means including buying over \$1 trillion of mortgage backed securities (representing over 80% of Fannie Mae and Freddie Mac's MBS issuance in 2009). As these programs wind down, higher interest rates may attract other buyers to these securities, but it will be a long time until debt securitization returns to prior levels.
- ◆ In 2010, \$50 billion of securitized commercial property loans mature. When the borrower owes more on the property than it is worth, it is actually easier to walk away from a commercial property than a house. Expect banks to realize another round of losses in 2010. Regulators actually see this event in advance and are making banks issue capital (new shares) so they can absorb the expected future losses.
- ◆ Small companies and entrepreneurs are at the mercy of bank lending, but many banks want to improve their own balance sheets in order to avoid political scrutiny and pay back the US Treasury. Thus, many small businesses cannot get loans to hire employees, replace outdated machinery and grow profitable units.
- ◆ Conversely, corporate debt markets are healthy, providing large companies the ability to borrow at attractive interest rates. Having funds to invest provides large companies a competitive edge. This is reflected in the recent increase of merger and acquisition announcements by publicly traded companies.
- ◆ The biggest winners in this environment should be companies that internally generate their own cash. Moreover, these "cash cows" will be primary beneficiaries of the inevitable rise in interest rates.

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