WOODSTOCK

QUARTERLY NEWSLETTER

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Cruising on the QEII

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The U.S.S. QE II - cruising into the 3rd year of a Presidential term

The verdicts are in – the stock market likes quantitative easing (QE). Whether it be QE I (Sept 2008-March 2010) or QEII (Nov 2010-June 2011), the stock market has voted thumbs up. The S&P 500 advanced +60% during QE I and has tacked on another 20% since QE II was tipped in August 2010. Instant gratification is always better than deferred gratification (in a present value sense) but why QE II and will it work? What is it intended to accomplish and where will the nation and the economy be in the second half of 2011 after its scheduled completion next June? (Chairman Bernanke has said that there could be a lot more firepower behind the initial $600 billion contemplated. And he is used to big numbers as QE I was about $1.75 trillion). The 3rd year of a Presidential term also just happens to be the best of the four years as evidenced on the chart insert This historical seasonal influence coupled with the old saw of "don't fight the Fed" has boosted the S&P 500 22% during 2H 2010 and a similar gain in 2011 is quite possible. $90 to $100 of S&P 500 EPS are being forecast for 2011 with 15x the top end of that range producing a 1,500 S&P 500, within sight of the October 2007 high of 1,565. Higher market prices are nice but the higher the market climbs without tangible signs of economic improvement the more vulnerable the market will be later on down the line.

Why the need for QE of any version?

The U.S. economy has been, by most accounts, under-performing economic history in terms of its rebound characteristics since the eighteen month recession ended in June 2009. Whatever the intended multiplier was for the $800 billion fiscal stimulus effort it has been disappointingly low much to the dismay of the unemployed and the politicians who advocated the idea. In several of the recent quarters, inventory building (accumulation) has accounted for 50% or more of our real GDP growth rate. The old school "oomph" from early cycle industries, such as housing and autos, has not been present this cycle because of the asset bubble related deflation of associated mortgage debt. And its lingering effects continue with this economy. Consequently the latent demand for cars and houses has not been a significant pent-up demand buying influence in this expansion cycle. And while both have recovered somewhat neither is expected to contribute meaningfully to real GDP growth any time soon.

In monitoring U.S. and global economic conditions the Federal Reserve must have seen a U.S. economy struggling to stay in recovery mode when it should have blossomed into expansion but the usual economic recovery multipliers have not been present this cycle. The Fed also had to consider the mess in Europe with Portugal, Greece, Ireland, Italy and Spain each dealing with banking sector and sovereign debt issues. Fiscal austerity, never a hot consumer product, is being imposed with obvious economic drag consequences on the rest of the world. Of more concern to the Fed would be China's targeting a slower growth rate as a result of rising inflation pressures (5% in the latest reading), particularly on the food side. So with U.S. fiscal policy literally spent and worries around the globe, the Federal Reserve observed a domestic economy that was approaching a tipping point. A double-dip recession outcome would have nasty deflationary consequences. These have to be avoided at all cost. While achieving its dual mandate (stable prices and low unemployment) is always cited by the Fed for its pursuit of QE II the unstated reason is that nearly 40% (18/46 months) of the way into a typical recovery cycle the U.S. economy has lost 100,000 jobs.

With only 28 months until the next cycle peak QE II was seized upon as a way to jumpstart the

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economy by getting stock prices up, interest rates down and boosting consumer's confidence in the future. Thus far they have been partially successful, stocks are up 20% plus ($2-$3 trillion), forecasters have raised GDP forecasts by ½% - ¾% for 2011. Unintended consequences have been a rising dollar (+2%) and higher interest rates with the 10-year Treasury up over 3.4%, a full percentage point off its low. Inflation expectations have risen to the 2.2% level (vs. 1.5% at the end of August) which is about where the Federal Reserve is targeting inflation. It is feasible that the U.S. dollar has rallied because of the European debt crisis & the Korean peninsula flare up. Inflationary expectations could have risen based on accumulating evidence that Congress will never get serious about debt reduction, as evidenced by the addition of $860 billion of debt as a result of the pre-Christmas tax/stimulus package less than a month after the President's deficit commission report on entitlement and spending reform by Erskine Bowles and Alan Simpson.

What could go right?

The economy starts adding 200-250,000 jobs per month early in 2011. Slowing labor productivity and a high level of corporate profitability are the two most compelling leading indicators for why this might happen. The perception of a less hostile attitude toward business in Washington could spawn a period of improved job growth which would increase consumer confidence, in turn reinforcing improving business confidence with capital spending picking up and reinforcing a virtuous cycle. While everyone understands this scenario is possible, there is a nagging sense that the "new normal" case has legs and that a rising decade or more of debt leverage in the U.S. economy is not going to be corrected with the recently concluded eighteen month recession. Several more years of sluggishness is more likely.

What could go wrong; the worst unintended consequence.

Despite policy maker intentions, job growth remains muted over the next few years. Overall business uncertainty, rising employer health care costs and, until recently, tax rate uncertainty were important head winds against hiring. A headwind to job growth in 2011 remains what happens to state and local government head count given the amount of fiscal stress these levels of government are incurring. Total state and local head count a year ahead seems likely to be down - and perhaps considerably. Also, the financial services industry, an important job growth driver in the decade preceding the last peak in December 2007 has already been an important contributor to the 7.3 million jobs lost in the last recession. Not only is it unlikely to be an important driver of job growth moving forward but it could see significant additional job shedding as a result of the financial reform legislation which commercial and investment banks will be implementing over the next few years. Less risk taking, less leverage, reformed business models for several lines of business for these firms could well entail lower head counts than seen in the past.

What could really backfire in terms of QE II's fallout would be if stock prices are 20%-30% higher in the next twelve to eighteen months and job growth remains anemic. Tired of hoarding the nearly $2 trillion of cash on their balance sheets earning minimal interest, companies might go on a merger & acquisition binge primarily designed to boost earnings by cutting costs. The S&P 500 could rise to its October 2007 high of 1565 based on the continuation of corporate earnings growth. Higher share prices might provide further fuel for an acquisition boom. Another round of cost cutting (head count and fixed asset) would prolong the bleak job growth trend and extend the period of recovery for the commercial real estate market. In the end, stocks may rise, but the real economy could be worse off. Higher stock prices require validation of improved or improving fundamentals.

A look at past cycles

For some period after a financial panic (fall 2008/ spring 2009) it would seem normal to feel like one is in unchartered territory. Although that is the case today, a look back at the eleven recessions since WWII shows just how true this may be.

The severity of the jobs lost (7.3 million) experience and the last recession being only the second (1981-1982, 2007-2009) time that the recession job loss exceeded the previous expansion's job gains are certainly flags for a "this time it is different" view of the future. Without advocating for a "new normal" versus "old normal" economic cycle point of view we thought it interesting to simulate the job growth and unemployment rate experience over the next several years assuming that some version of the median experience of the last sixty-two years transpired. This range of outcomes is seen in attached table.

The median forty-six month (see table insert) expansion from the June 2009 trough yields an

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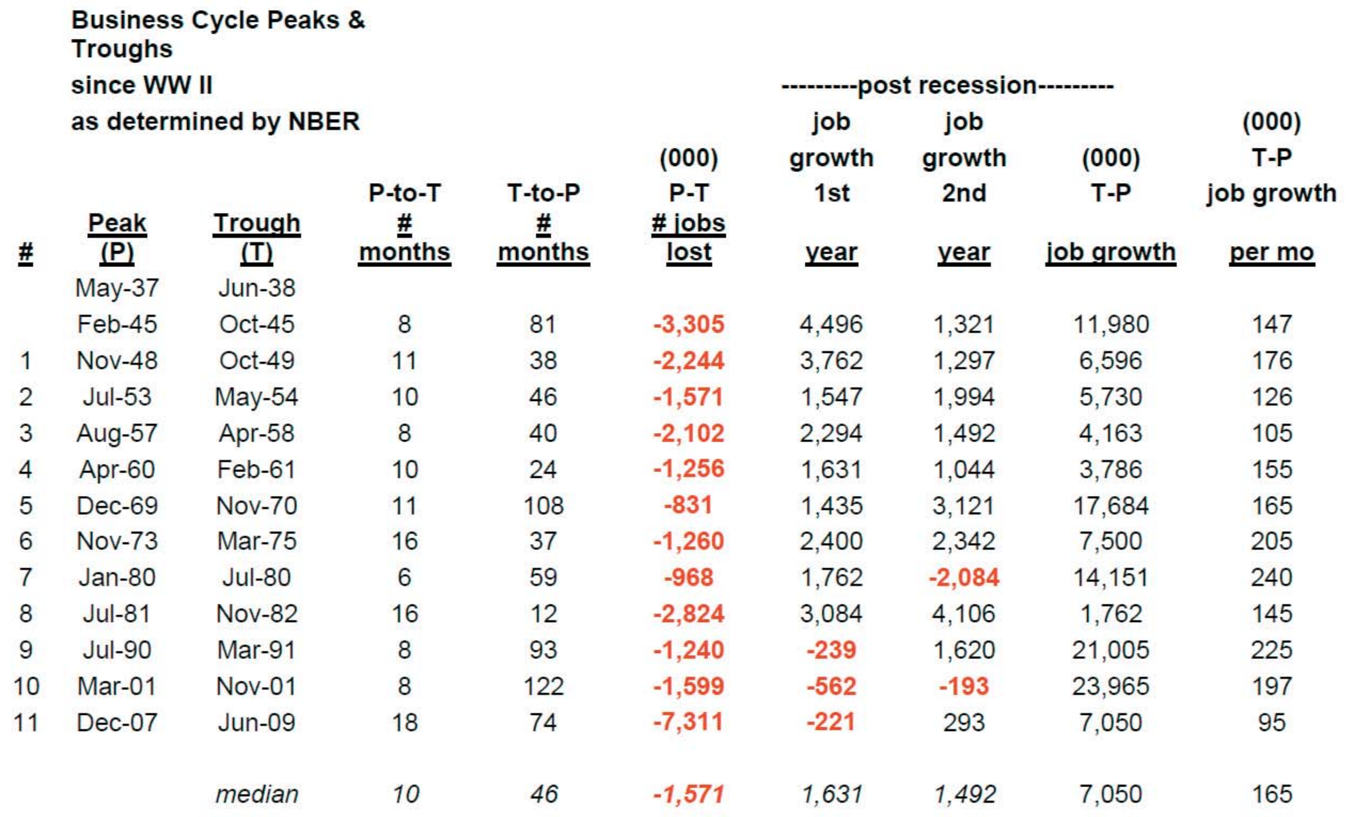
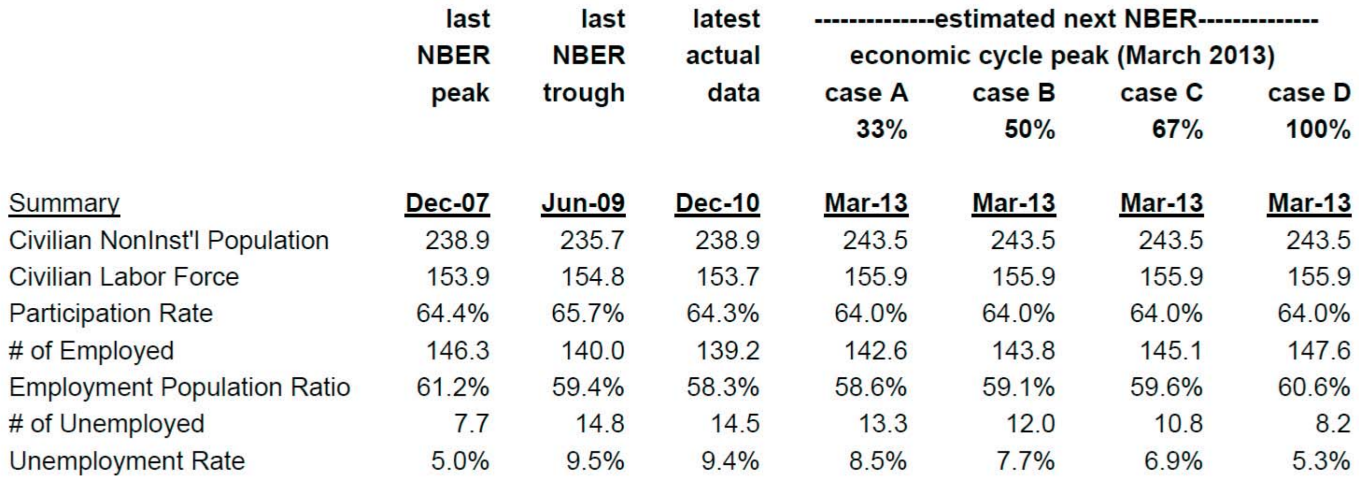


Business Cycle Peaks & Troughs
since WW II
as determined by NBER

						---------post recession---------			
						job	job		(000)
					(000)	growth	growth	(000)	T-P
			P-to-T	T-to-P	P-T	1st	2nd	T-P	job growth
	Peak	Trough	#	#	# jobs				
#	(P)	(T)	months	months	lost	year	year	job growth	per mo
	May-37	Jun-38							
	Feb-45	Oct-45	8	81	-3,305	4,496	1,321	11,980	147
1	Nov-48	Oct-49	11	38	-2,244	3,762	1,297	6,596	176
2	Jul-53	May-54	10	46	-1,571	1,547	1,994	5,730	126
3	Aug-57	Apr-58	8	40	-2,102	2,294	1,492	4,163	105
4	Apr-60	Feb-61	10	24	-1,256	1,631	1,044	3,786	155
5	Dec-69	Nov-70	11	108	-831	1,435	3,121	17,684	165
6	Nov-73	Mar-75	16	37	-1,260	2,400	2,342	7,500	205
7	Jan-80	Jul-80	6	59	-968	1,762	-2,084	14,151	240
8	Jul-81	Nov-82	16	12	-2,824	3,084	4,106	1,762	145
9	Jul-90	Mar-91	8	93	-1,240	-239	1,620	21,005	225
10	Mar-01	Nov-01	8	122	-1,599	-562	-193	23,965	197
11	Dec-07	Jun-09	18	74	-7,311	-221	293	7,050	95
		median	*10*	*46*	*-1,571*	*1,631*	*1,492*	7,050	165

NBER = National Bureau of Economic Research; P = Peak, T = Trough; focus on 11 cycles post WWII.
2nd year of current expansion only six months old.



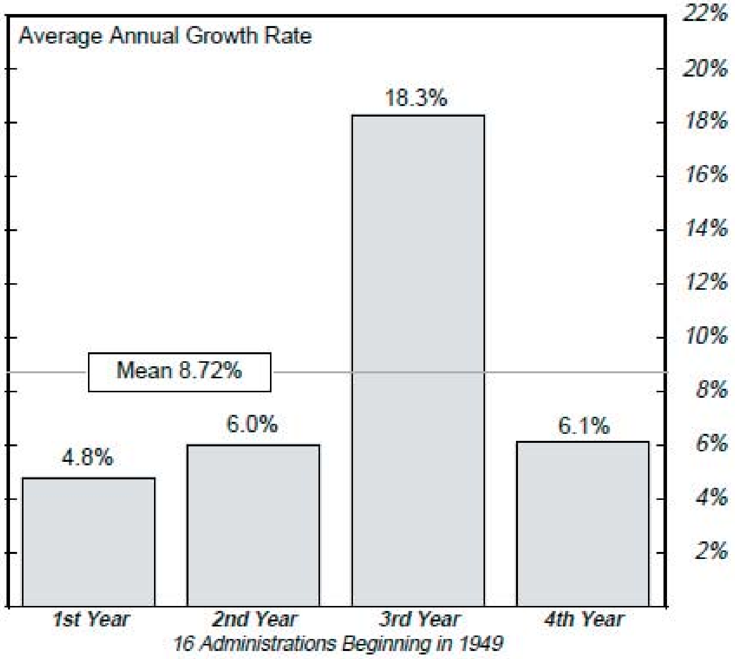
	last	last	latest	--------------estimated next NBER--------------			
	NBER	NBER	actual	economic cycle peak (March 2013)			
	peak	trough	data	case A	case B	case C	case D
				33%	50%	67%	100%
Summary	Dec-07	Jun-09	Dec-10	Mar-13	Mar-13	Mar-13	Mar-13
Civilian NonInst'l Population	238.9	235.7	238.9	243.5	243.5	243.5	243.5
Civilian Labor Force	153.9	154.8	153.7	155.9	155.9	155.9	155.9
Participation Rate	64.4%	65.7%	64.3%	64.0%	64.0%	64.0%	64.0%
# of Employed	146.3	140.0	139.2	142.6	143.8	145.1	147.6
Employment Population Ratio	61.2%	59.4%	58.3%	58.6%	59.1%	59.6%	60.6%
# of Unemployed	7.7	14.8	14.5	13.3	12.0	10.8	8.2
Unemployment Rate	5.0%	9.5%	9.4%	8.5%	7.7%	6.9%	5.3%

notes: four estimated peak cases shown: D = the median [100%] experience of the last eleven up-cycles;
A = one-third, B= one-half, C = two-thirds of the median pace of job growth in last eleven up-cycles.

PRESIDENTIAL ADMINISTRATIONS

By Calendar Year

Standard & Poor's 500 Stock Index



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Cruising on the QEII (continued)

estimated NBER cycle peak of March 2013. For comparison above are the last peak, trough and most recent data points. This median expansion also created 165,000 jobs per month. Were that to miraculously occur this cycle the unemployment rate would fall to 5.5% at the next economic cycle peak as seen in case D on the chart. If QE II played any part in seeing this feat achieved Chairman Bernanke would be hailed as a hero. That is the best (and most unlikely) case in our opinion. Our bias is toward case B (the 50% case or job growth of 82,500 per month). This would require 135,000 per month job growth over the remaining twenty-eight months since the first eighteen months have lost 100,000 jobs. With the headwind cited earlier of state & local and financial service jobs this feels like the best baseline economic path. An unemployment rate just under 8% at the next economic cycle peak is our best estimate. Although hard to link directly to a tight GDP forecast it would seem reasonably consistent with 2.0-2.5% annual real GDP growth for the next two plus years.

Outlook

We began 2010 worried about the timing of the Federal Reserve's exit strategy from all its QE I creations – when they would start removing the liquidity punch bowl, which was first served in late 2008 in reaction to the financial panic. The lack of any enduring recovery from the $800 billion stimulus package made fears of a double-dip recession realistic during the first part of 2010. But public discussion of QE II early in Q3 propelled the stock market 22% higher, closing at the highs for the year. Now there is very little talk of double-dip or deflation as non-housing related wealth has popped 25% and inflation expectations have risen near Chairman Bernanke's 2% target from zero at the beginning of 2009. The only obvious metric that QE II has failed to meet thus far is on ten year Treasury yields, which have not fallen but have risen 110 basis points (1.1 percentage points) from 2.4% to 3.5%. The incompatible objectives of raising inflation expectations but lowering interest rates has received little scrutiny because stock prices are up and investors are feeling better. The dollar has not cooperated either, rising 2% as a result of the European debt crisis and the flare-up of tensions between North and South Korea. (Despite its financial problems the dollar is a "go to" currency in times of international crisis). With the recent tax compromise and stimulus package resulting in trillions more in terms of future deficits, the dollar will inevitably resume its decline.

The ultimate test of whether QE II is successful will be measured in terms of job growth over the next few years. We're hoping for the best but believe that it will be just under 8% at the next economic cycle peak in early 2013. The stock market will discount this peak six to twelve months in advance (average is 7 months) yielding a stock market peak in August 2012 if not a few months earlier. The S&P 500 rose 13% in 2010 on top of 2009's 14% and 87% from the March 2009 lows. The clear momentum of corporate earnings growth, improving confidence and QE II should continue well into 2011. Expecting all the fiscal and monetary momentum to last beyond 2012 seems a stretch right now so valuation metrics will become critical in 2011. 1350 to 1500 seems like a reasonable S&P 500 expectation. Good news in the New Year on the domestic job growth front while avoiding sovereign debt crises in Europe and municipal debt crises here at home could generate the "rosy scenarios" necessary to achieve these higher market levels. But throughout the advance we will remind ourselves of the likelihood that this is cyclical, not secular, bullish behavior and that the country's long term economic ills remain to be dealt with.

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2011 Tax Update

Matthew G. Flynn

STANDARD MILEAGE RATES FOR 2011

The IRS has announced the 2011 Standard Mileage Rates used to calculate the deduction for business use of an automobile. Beginning in January 2011, the rates for use of a car, van, pickup truck or panel truck will be:

- 51 cents per mile for business miles driven
- 19 cents per mile driven for medical or moving purposes
- 14 cents per mile driven in service of charitable organizations

IRS ALLOWS INCREASED LIMIT ON MORTAGE INTEREST DEDUCTION

In a surprising move, the IRS has ruled that deductible home equity debt may exceed the $1 million limitation normally imposed on debt incurred by a taxpayer to acquire, construct, or substantially improve a principal residence. The Internal Revenue Code limits qualified residence interest to $1 million for acquisition indebtedness but also sets a limit of $100,000 for other home equity indebtedness secured by a qualified home.

The new ruling holds that residence interest exceeding the $1 million limit may still be deductible as home equity indebtedness.

TIPS FOR MAKING CHARITABLE DONATIONS
The rules for taking charitable contribution deductions have been tightened up significantly over the last several years. The IRS used to take it on faith that taxpayers were reporting charitable amounts accurately. Now, you must carefully document the amount of the deduction. Here are some important guidelines for claiming charitable contribution deductions.

1. Charitable contributions must be made to qualified organizations to be deductible. Qualified organizations are generally public charities, such as churches, schools, and service nonprofits. You can ask any organization whether it is qualified and most will be able to tell you.

2. Charitable contributions are deductible only if you itemize your deductions. You cannot take a charitable contribution if you use the standard deduction.

3. Cash contributions and the fair market value of property donated to a qualified organization can be deducted. For household items, including clothing, furniture, appliances, electronics, and linens, the items must be in good condition or better.

4. For donations of cars, boats, or other vehicles, you can deduct the amount the organization sells the vehicle for, or, you can deduct the fair market value on the contribution date. The IRS is scrutinizing vehicle donations carefully, so you need to document the value of the vehicle when you donate it.

5. If you make a contribution and receive something in return, such as a magazine, tote bag, or admission to a charity banquet or sporting event, you can only deduct the amount that exceeds the value of the benefit you receive in return. The charity sometimes will give you that value, but you also should be careful to note the approximate value of what you receive in return at the time of the donation.

6. Keep good records of any contribution, regardless of the amount. For contributions made in cash, there must be (1) a bank record, including a cancelled check or a bank or credit card statement, (2) a written record from the charity containing the date and amount of the contribution and the name of the organization, or (3) a payroll deduction record.

7. Deductions include credit card charges and payments by check in the year they are given to the charity, even if the credit card bill will not be paid or the bank account will not be debited until the next year.

8. For any contribution of $250 or more, you must have written acknowledgment of the gift from the organization to substantiate the donation. This written proof must include three things: 1) the amount of cash, 2) a description and good faith estimate of value of any property contributed, and 3) whether the organization provided any goods or services in exchange.

9. You must get an appraisal if you claim a deduction for more than $5,000 for a contribution of property. This type of deduction also must be included on the special IRS form.

2010 ENDNOTE: STEINBRENNER'S ESTATE BONANZA
Never one to pass up a good deal when he saw it, New York Yankees owner George Steinbrenner managed to time his death in such a manner as to save his estate an estimated $518 million. Congress had been dragging its heels in enacting any new estate tax legislation, and so, for 2010, there is no estate tax. The system has been overhauled, with a top rate of 35% and one exemption of $5 million per individual for estate, gift and generation-skipping taxes alike. For those who can stand to part with assets, it's now possible to shift large amounts of wealth. Expires: end of 2012. The annual exclusion for tax-free gifts remains $13,000 per donor. A giver may make an unlimited number of $13,000 gifts, as long as they are to different individuals. Gifts of tuition and payments for medical care also are exempt.

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