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Looking Ahead

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An average return decade for Equities would be just fine

2009's V-shaped stock market recovery over the last nine months of the year was the just-in-time reward and reinforcement for long term investors who may have come close to liquidating part or all of their equity exposure during the brutal 57% decline from October 2007 to March 2009. Judging by high money market fund cash balances, strong investor demand for bond funds and persistent liquidation of equity funds in 2009, there was material capitulation during the savage bear market and a lot of investors turned their backs on equities in the final two years of the last decade. Even in the face of the market's stunning rally in 2009 over $50 billion of equity mutual fund redemptions occurred. Some of this was for equity exchange traded funds [ETF's] purchases. It will take years of trumpeted investment success stories and favorable economic reports before the public returns to believing in long term equity investing.

Just having an average decade from an equity return standpoint would obviously require a reasonably positive outlook for the economy, corporate earnings, interest rates, inflation and the dollar. While these jigsaw pieces cannot be tightly linked together to form the total puzzle picture, we are hopeful that a positive scenario can unfold.

Entering 2010 most of the key fundamental drivers for equities appear to be in gear on the upside. The economy began a slow recovery in mid-2009, having registered negative real GDP rates of growth over the previous four quarters. Earnings, while also declining with lower economic activity, have been better than feared because of relentless cost cutting (headcount), asset rationalization (write-offs) and the influence of international business exposure on consolidated results. All this will continue in 2010 as nearly $400 billion of the $800 billion stimulus package is expected to enter into the economy this year.

Although small relative to a $14 trillion economy, the psychological benefit should not be minimized, particularly as it comes after early signs of recovery already are appearing in the economic data. At least for the first few quarters of 2010 a healthy contributor to growth will be the absence of inventory liquidation. And should economic expansion continue, an inventory building increment to GDP cannot be ruled out. Against a backdrop of 3%-4% real GDP growth forecast there will be operating leverage as businesses will experience a period of profit margin expansion because cost structures are much leaner.

While that is the good news and pretty well the consensus view, there is a concern that the economy will hit some kind of a wall before the end of 2010. This thesis is based on the identifiable growth factors playing out through 2H 2010 and both businesses and consumers remain cautious entering 2011 as marginal tax rates increase due to the expiration of the Bush tax cuts. Government policies until now have emphasized handouts, bailouts and spending measures designed to cushion a softening or sinking economy. There is little to point to that could be the catalyst for years of capital spending or employment-creating incentives which could power the economy forward in 2011-2012. It is precisely this lack of visibility of the intermediate term fundamental drivers that gives investors pause about the durability of the 2009 stock market rally. Investors wanting to be optimistic on the U.S. historical stock market statistics suggest optimism is well founded. Underpinning the improvement has been government as it had to step in the breech when the private sector failed. Seeing a future when government cedes influence to a revitalized private sector will be necessary to sustain growth throughout most of the next decade.

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Looking back to see the future

Even with the help of a 26.5% return in 2009, equities returned a -1.1% compound annual return for the decade ended December 31, 2009. Hence the term "the lost decade" for US equities. Additionally, there are predictions by some pundits of a second lost decade to come, as has occurred in Japan. A more adaptive economy and a younger population backstops our belief that the U.S. will not repeat the Japanese experience.

There have been only forty-two negative return rolling ten year (actually 120 monthly periods) periods since January 1926. This is less than five percent of the 889 total rolling decades during this period. This past decade's -1.1% annual return places it in the fifteenth percentile of all periods and accords it a -2.1 standard deviation statistic, both of which figures are at the low end of data series extremes, and catalysts for thinking that things can only get better. "Reversion to the mean" is a sound basis for optimism. The average and median rolling annual return from equities over this entire period was 10.9%. Thus, getting back to just an average decade would be an annual return swing of 12.0% for equities. Investors would be quite pleased come December 2019 should that be anywhere near the record.

One quarter (25%) of the forty-two negative return readings have occurred in the last fourteen months (November 2008 to December 2009). As one might expect negative rolling 120 month return periods occur in clusters. The other twenty-nine (or 75%) negative return observations occurred between March 1938 and February 1941. The record low annual return reading was -4.9% in August 1939. The other significant low since then was in September 1974 when the decade annual return was +0.5%. While the statistical significance of these two observations may not be overly persuasive (the number of observations may be too few) to some, the returns over the subsequent decade were positive in both instances. Stocks returned 9.2% a year compounded to August 1949 and 15.6% a year compounded to September 1984. So if one wanted to unburden themselves of forecasting the economy, corporate profits, interest rates, inflation and P/E's, one could seek refuge in market history and adopt a positive investment outlook.

Elections

As everyone knows mid-term U.S. elections occur November 2010 and that means Congress will want to demonstrate that they are problem solvers extraordinaire in order to impress the voters. The present climate in D.C. encourages spending to foster activity that will create jobs and economic growth. This expectation is integral to the favorable economic outlooks that most investors have entering 2010. Efforts to redirect TARP (Troubled Asset Relief Program) money to stimulate the economy are being discussed to avoid a dreary backdrop for the fall elections. Unfortunately many taxpayers see these kinds of spending initiatives as having little economic stimulus effect and only adding to the country's $12 trillion of debt.

Financial Assets inflate while Real Wages contract

Investors (households) benefit when the value of their stocks and houses increase. This started in 2009 for stocks, while house price boosts to household net worth are still a few years off even though home prices appear to have stabilized. Inflation is low but high levels of spending will encourage investors to own stocks and houses as inflation hedges during this decade. Workers on the other hand are faced with a high unemployment rate and competition from low wage countries. Thus the owners of assets will benefit while workers will continue to find it difficult to make real economic progress. As Congress looks for ways to generate revenues to cover their spending they have shown an interest in increasing taxes on capital assets in an attempt to close the gap between rich and poor. In many respects the US is in unchartered waters and the policy decisions of the next few years will be very determinative of how well or poorly stocks do this decade.

Next decade – Equities better, Bonds worse

In the table on page 3, we have forecast returns for the three major asset classes and inflation based on reasonable earnings growth rates (5%-9%), price-to-earnings multiple (16x +/- 2 points, beginning dividend yield (2.5%), bond yields (4.35% yield-to-maturity) and yields fluctuating +/- 2% points over the decade, and allowing for short-term disinflation giving way to rising inflation later in the decade. The 2010's single point estimates (column 4) are based on assigned probabilities and their near mid-point of the range indicates it was the 50% probability case. The key takeaway from the table is the deterioration in expected return from bonds and the improved return from equities over the next decade versus the decade just ended.

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	Decade (2010-2019) Range of Annual Returns[1]			——— Previous Decade Returns[1] ———				
	Low	est. High	10's	00's	90's	80's	70's	60's
Cash	0.5%	5.0%	2.5%	2.9%	4.9%	8.9%	6.3%	3.9%
Bonds[2]	1.5%	5.5%	3.8%	8.0%	8.8%	12.6%	5.5%	1.4%
Equity	7.0%	13.0%	10.0%	-0.9%	18.2%	17.6%	5.9%	7.8%
CPI[3]	1.0%	5.0%	3.0%	2.3%	2.9%	5.1%	7.4%	2.5%

Source: *data from 2009 Ibbotson Valuation Yearbook 1926-2008 and Woodstock estimates for 2009*

1 Compound Annual Return

2 Ibbotson 20 year maturity Treasury bond

3 Consumer Price Index

On Balance, a Positive Outlook

Favorable stock market statistics and near term business cycle momentum are on the side of investors as 2010 gets underway. Standard market signposts point to accelerating business conditions which will result in quarterly revenue and earnings comparisons moving into positive territory and easy year-over-year comparisons until 2011. Upward earnings revisions are likely during 1H 2010 (analysts have underestimated positive operating leverage). Some P/E multiple expansion could also occur. On $70 of normalized earnings per share in 2010 the S&P 500 is currently selling at about 16x (this was noted in the previous section). Only the conviction that 2010 is a cyclical peak in the economy and corporate earnings will decline could derail a continuation of the stock market's progress. Policy decisions and/or gridlock in 2010 will have a major say if that is to occur.

Higher interest rates are inevitable and higher taxes also seem likely. These are important pressures on prospective returns on capital. Asset class (cash, bonds, equities) returns over a decade are an important report card of the economic and financial vitality of a country. The next decade has the potential to be very good for equity investors provided the ground rules and policies are well thought out. A lot more convincing that this is the case must occur early in the decade to assure the potential returns shown above are achievable. ◆

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2010 Tax Update

Mary Ann Sardone

First, let's take a look at some of the key figures for 2009 taxes and then touch on some of the new provisions enacted during the past year.

The six tax brackets for 2009 remain at 10%, 15%, 25%, 28%, 33% and 35%, but the income levels for each bracket have increased. The 2009 brackets are as follows:

Tax Rate	Single Filers	Married Filing Jointly and Surviving Spouse	Head of Household	Married Filing Separately
10%	Not over $8,350	Not over $16,700	Not over $11,950	Not over $8,350
15%	$8,350 - $33,950	$16,700 - $67,900	$11,950 - $45,500	$8,350 - $33,950
25%	$33,950 - $82,250	$67,900 - $137,050	$45,500 - $117,450	$33,950 -$68,525
28%	$82,250 - $171,150	$137,050 - $208,850	$117,450 - $190,200	$68,525 - $104,425
33%	$171,150 - $372,950	$208,850 - $372,950	$190,200 - $372,950	$104,425 - $186,475
35%	Over $372,950	Over $372,950	Over $372,950	Over $186,475

Additionally, the deductions for personal and dependency exemptions have increased, up from $3,500 in 2008 to $3,650 in 2009. The standard deduction for each filing status has also increased; singles and and married filing separately increased to $5,700 up from $5,450 in 2008, joint filers increased to $11,400 up from $10,900 in 2008, and head of household filers is up to $8,350 an increase of $350 over 2008.

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For 2009, the threshold limits for these exemptions are subject to phase-out when adjusted gross income exceeds $250,200 for joint filers or surviving spouse, $208,500 for head of household, $166,800 for single taxpayers and $125,100 for married persons filing separately.

High income taxpayers will benefit as the income threshold phase-out has been increased for itemized deductions. In 2009, itemized deductions are subject to phase out when adjusted gross income exceeds the threshold of $166,800 for single, head of household and married filing jointly taxpayers, and $83,400 for married filing separately. In addition, medical expenses, investment interest deductions, deductible gambling losses and casualty and theft losses are not subject to phase-out.

For those taxpayers who do not itemize their deductions there are several additional deductions that increase the standard deduction. As in 2008, there is an additional standard deduction for state and local real estate tax paid equal to the lesser of the tax paid or $500 ($1,000 in the case of joint filers).

For taxpayers who purchased a new automobile, truck, motorcycle or motor home between February 17, 2009 and December 31, 2009 the amount of sales tax and excise tax attributable to the first $49,500 of the purchase price may be added to the standard deduction or taken as a deduction on Schedule A. This deduction is phased-out for taxpayers whose modified AGI is between $125,000-$135,000 for single filers and between $250,000-$260,000 for joint filers.

An additional standard deduction is also available to non-itemizers for casualty losses incurred during 2009, which occurred in federally declared disaster areas. The casualty loss is added to their standard deduction amount and is not subject to the usual reduction equal to 10% of adjusted gross income.

On November 6, 2009, The Worker, Homeownership, and Business Assistance Act of 2009 was signed into law. As part of this legislation, the first-time homebuyer credit was extended and expanded. The deadline for qualified home purchases has been extended to April 30, 2010. If a buyer enters into a binding contract by April 30, 2010, the buyer has until June 30, 2010, to close on the purchase. The maximum credit for first-time buyers remains at $8,000. The eligibility requirements for purchases have been expanded to allow a "long-time resident" credit of up to $6,500 to others who do not qualify as "first-time homebuyers."

To qualify, a buyer must have owned and used the same home as a principal residence for at least five consecutive years of the eight-year period ending on the purchase date of a new primary residence. For all qualified purchases in 2010, the taxpayer has the option of claiming the credit on either their 2009 or 2010 tax returns.

The American Recovery and Reinvestment Act of 2009 reinstated and increased a couple of popular energy credits available to homeowners as described below.

The nonbusiness energy property credit is available to individuals for the installation of nonbusiness energy property, such as residential exterior doors and windows, insulation, furnaces, heat and water pumps and central air conditioning systems. The credit applies to qualified energy improvements and property installed between January 1, 2009 and December 31, 2009. The property must be installed in or on a dwelling in the United States that is owned and used by the taxpayer as his/her personal residence. The credit is equal to 30 percent of the taxpayer's residential energy property expenditures plus the cost of qualified energy efficiency improvements for the year. The amount of credit a taxpayer may claim is limited to a maximum of $1,500 for both 2009 and 2010.

The residential energy efficient property credit of 30 percent of the cost of residential alternative energy equipment, such as solar heaters and equipment, fuel cell plants, qualified small wind energy property and geothermal heat pump property is also available to taxpayers for property placed in service before January 1, 2017.

The American Recovery and Reinvestment Act of 2009 also increased the alternative minimum tax exemption amounts and extended the ability to fully utilize nonrefundable credits against alternative minimum tax through December 31, 2009. The 2009 exemption amounts are $70,950 for married couples filing jointly and surviving spouses, $46,700 for single taxpayers and head of household and $35,475 for married couples filing separately.

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