

WOODSTOCK

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Stocks - The Best Choice for Yield, Too

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From “Beat & Raise” to “Meet & Lower”

Over the thirteen months that the S&P 500 Index was in the process of rising 80% from the March 2009 low (677) to the April 2010 high (1217), corporate America was consistently reporting quarterly earnings that were well ahead of analyst expectations. This inevitably led to analysts raising their estimates for future quarters after managements gave encouraging forward guidance on business trends and earnings prospects. Although top line revenue growth in recent quarters has improved to high single or low double digits there has not been a real booming top line performance that has powered earnings ahead more than thirty percent in the last three quarters. The earnings surprises have come from a combination of strong overseas business trends, occasional (but not recent) foreign exchange translation benefits and eye popping margin improvement. The sluggish, often termed jobless, recovery is symptomatic of the tight cost control that has allowed incremental profitability to be impressive. A depressed Q4 2008 and the first half of 2009 did create “easy” future quarterly comparisons and that has helped magnify this cycle’s earnings gains thus far.

Monetary policy prevented the financial panic of late 2008 from getting completely out of control. It helped restore confidence in the system and liquidity gradually returned to markets that had seized up. Banks are hoarding excess reserves because of painful memories, deleveraging and sluggish loan demand. Fiscal policy has been large in dollar value (\$814 bns.) but disappointingly small in terms of sustainable impact on the economy. It’s hard to imagine that \$2,600 checks mailed to each and every American wouldn’t have had a more dramatic and lasting effect than what has been experienced. And as was predicted the “oomph” to the economy of the Administration’s fiscal stimulus plan would be over by mid-year 2010

according to the independent government agency, the Congressional Budget Office (CBO).

While there have been other worries along the way – the Euro mess, involving Greece in particular, and the May 6th “flash crash” on Wall Street – the lack of a sustainable economic recovery beyond mid-year 2010 has always been the high hurdle for investors when it came to evaluating the quality, longevity and capitalization rate of the excellent levels of earnings being reported. As often happens when there is little conviction, investors apply declining P/E ratios on advancing earnings because of concerns of sustainability. By the end of Q2 and certainly throughout Q3 2010 this lack of confidence has dominated market trading. As Q3 2010 comes to a close the pace of the economy feels about the same as Q2 but imports and inventory movements will determine if it stays under 2% growth. At present business and consumer confidence is shaky, higher tax headwinds loom for 2011 and investors are fearful that this pause turns into a full fledged slowdown or double-dip recession. In the next few quarters investors are girding for a vocabulary shift in corporate America from “beat and raise” earnings reports to “meet and lower.”

The S&P 500, currently at 1100, is priced at 12x-13x 2011 earnings estimates for an earnings yield of 7%-8% which is 4%-5% better than the 2.7% yield offered on the 10-year U.S. Treasury bond. While investors over the years are accustomed to stocks providing an earnings yield premium over bonds to compensate for the volatility of owning stocks, bond yields have sunk to a level that throws the appropriate equity risk premium (ERP)¹ into doubt.

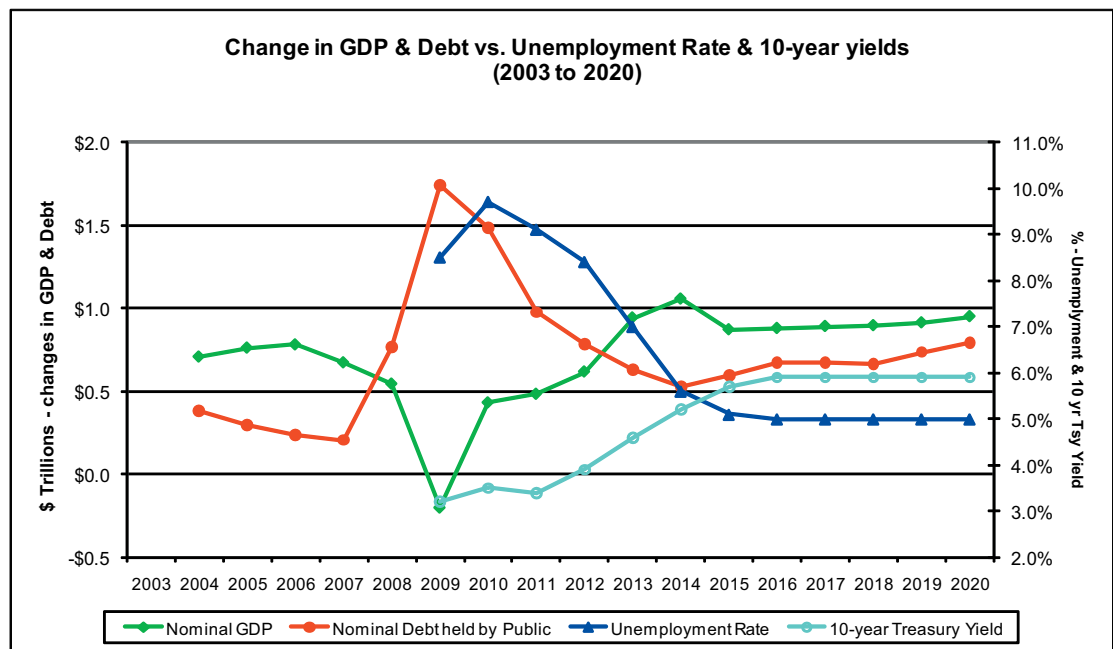
Some of our best current bond ideas are equities in defensive, less volatile sectors of the economy such as telecommunications, utilities, health care and energy.

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¹ Earnings yield (reciprocal of the P/E ratio) minus the 10Yr U.S. Treasury yield is the Equity Risk Premium (ERP)

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Source: Congressional Budget Office (CBO), *The Budget and Economic Outlook: Fiscal Years 2010 to 2020, An Update, August 2010*; data from CBO, analytics from Woodstock

Interest rates (yields) and valuation relationships have changed to such an extent that incremental equity exposure could be the best decision for adding income and reducing portfolio risk. After studying the CBO decade outlook on the Budget and the Economy we believe substituting income stocks for bonds will prove farsighted.

The CBO's decade outlook

Among the most striking insights of the CBO analysis was the need for nearly 6% annual nominal GDP growth in 2013 through 2015 to break a trend of debt growth greater than GDP growth. Annual GDP growth shortfalls anywhere near 1% would appear to wreak havoc - reducing GDP growth by \$200 billion a year and increasing the deficit a comparable amount. How bond investors would react to such a chronic set of conditions is impossible to predict. But the combination of credit worthiness and supply concerns couldn't be good for expected yields in our opinion.

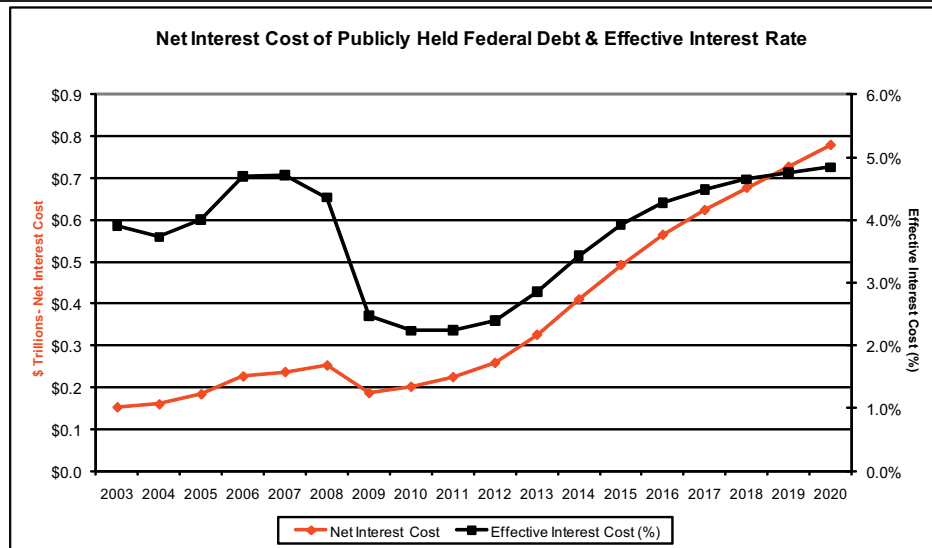
The above plot shows the CBO forecasting the unemployment rate declining from 9.8% in 2010 to 5.1% in 2015 while also expecting 10-year Treasury yields escalating to 5.7%, 3% points higher than today. The interplay between the growing outstanding debt levels and the expected rise in the cost of that debt can be seen in the following graph which shows the Net Interest Cost to the country rising from under \$200 bns. a year in 2009 to \$500 bns. by mid-decade and \$800 bns. by 2020.

Bond buying has been understandable

Negative total returns from stocks over the last decade and the emotional damage of the 2008-2009 bear market have conditioned investors to shun stocks in favor of bonds or cash. Steady inflows into bond funds over the past thirty months have been accompanied by steady outflows from equity mutual funds. Sideline cash (money market funds) have retreated from their \$11-\$12 trillion peak, with the bulk of those funds likely shifting to bonds to take advantage of the yield pick-up. Our growing preference for 3% to 6% yielding stocks with modest growth is a more offensive decision than say a 2.7% yielding 10-year Treasury. And it may just turn out to be more defensive investment as well when yields eventually rise, as called for in the CBO report. We believe that bond fund purchasers are escaping from something (pain of capital loss) more than going toward something (an attractive recurring rate of return). Evidently, not many bond buyers are reading the CBO report "The Budget and Economic Outlook: Fiscal Years 2010 to 2020," for if they did they wouldn't be buying bonds aggressively. Based on the August updated CBO forecast of a 5.9% 10-year Treasury yield in 2020, today's 10-year will produce a -0.2% annual rate of return. (The CBO has 10-year yields flat at 5.9% from 2016-2020).

Although the CBO doesn't forecast the path of the dollar over the next decade this is hardly surprising.

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Congressional Budget Office (CBO), *The Budget and Economic Outlook: Fiscal Years 2010 to 2020, An Update, August 2010*; data from CBO, analytics from Woodstock

Managing the federal debt portfolio will be enough of a challenge for Treasury from a demand (buyers) standpoint without considering the additional challenges that would be presented if the dollar were weakening.

The weighted-average maturity of the publicly held federal debt was 4½ years in March 2010 (most recently available), ½ year longer than a year earlier. This would imply an annual rollover refinancing requirement of \$2 trillion. Adding annual budget deficits of \$1/2 trillion to \$1 trillion would result in an annual financing requirement of \$2½ to \$3 trillion per year for the next decade. It should be obvious why an above average equity dividend yield from a growing company has more appeal than a “risk free” U.S. Treasury bond.

Today’s 2.7% yield-to-maturity ten year U.S. Treasury bond has a duration (volatility) factor of 9 (8.9 actually). For every move of one percentage point in the bond market yield the bond’s price will change 9% in the opposite direction. Less than a one percentage point (82 basis points to be precise) increase in yield over the next three years would neutralize the income received and produce a zero total return for the three year holding period. Over ten years the CBO estimate of a 3.2 percentage point increase in yields to 5.9% would result in a below breakeven total annual return, for ten years.

Common stock dividends don’t have the baggage of deficit financing

Yields are going up eventually and that will produce capital losses for long term bonds. While some may argue that higher yields will compress P/E ratios, that need not be so. If the yield increase were the result of a return to healthier business

conditions P/E’s might not be negatively affected and could actually rise, given greater confidence in earnings being sustainable for a period of years. If yields were rising because of rising inflation expectations, or a “buyer’s strike” at buying U.S. debt, then P/E’s could compress because of the uncertainties that would engender throughout the financial system.

Give Me Equities (Large Cap) or Give Me Debt (Emerging Market)

Today the investment risks between buying quality, higher yielding stocks versus intermediate and long term maturity bonds cause one to question the suitability of high bond allocations in portfolios. It would seem to be a guaranteed no or negative return proposition as noted above if the CBO is anywhere near right on interest rates. If they are too conservative in their rate outlook the return outlook is even worse. 3% to 6% equity yields growing at 3% to 6% (the lower yielders grow at the higher rates and vice-versa) look to offer a more attractive return outlook and solidly in the positive column even in the higher interest rate scenario, particularly if that signals a stronger economy.

In addition, relative to U.S. denominated debt, emerging market debt issuers (both sovereign & corporate) have better (2x-3x) forecasted economic growth, high savings rates, low external debt levels, strong currencies, generate excess cash allowing them to buy our debt, and no deficit financing issues themselves. And many would be advantaged if commodity price inflation continued for most of the decade, as many predict.

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Stocks have always been important sources of income as dividends have, over time, accounted for one-third to one-half of total investment return. There is more focus on stocks today for a source of income because money market returns are pathetic at 0.25% or less. The 10-year Treasury bond has a 2.7% yield-to-maturity. Because of 2008-2009 bear market and the flash crash in May of this year investors are reluctant to opt for the attractive yields available from many large cap companies. What is a suitable equity allocation in a portfolio after all this volatility is also blinding investors to the use of income stocks for a significant portion of their bond allocations?

An equal priority for a portfolio manager seeking maximum portfolio return is to control portfolio risk. After studying the CBO outlook and thinking about a near \$3 trillion annual U.S. financing appetite we are more convinced that income stocks will out earn bonds with less volatility and will not have any of the supply concerns that could plague the U.S. Treasury market this decade.

** for simplicity municipal bonds were ignored.*

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Woodstock Tax Update

The tax cuts established during the George W. Bush Administration, the Economic Growth and Tax Relief Reconciliation Act of 2001, and the Jobs and Growth Tax Relief Reconciliation Act of 2003, will expire on December 31, 2010. This legislation cut taxes on earned income, long-term capital gains and dividends and made numerous changes and adjustments to the tax code, including personal exemptions and itemized deductions.

Tax Rates

The six tax brackets currently in effect - 10%, 15%, 25%, 28%, 33% and 35%, were implemented in 2001 and will expire at the end of 2010.

President Obama has proposed to keep the 10% through 28% tax rates and to replace the top two rates with 36% and 39.6% rates. The 36% bracket would begin at \$200,000 for single filers and at \$250,000 for married filers. He has not specified where the 39.6% bracket would begin.

Capital Gains and Dividends Taxes

Currently, the maximum federal rate on qualified dividends and long-term capital gains is taxed at 15% (zero tax rate applies to individuals in the 10% and 15% tax brackets). These rates will expire at the end of 2010. The President proposes to tax qualified dividends and long term capital gains at 20% for taxpayers in the top two tax brackets of 36% and 39.6%. The zero percent and 15% rates for individuals in the lower tax brackets would not change.

Phase-Out Rule for Personal Exemptions

The Economic Growth and Tax Relief Reconciliation Act of 2001 repealed the personal exemption phase-out for individuals in the higher tax brackets for tax years beginning after 2009. This provision is scheduled to expire on December 31, 2010.

The Obama administration proposes to reinstate this personal exemption phase-out effective for individuals with incomes over \$200,000 and for married couples filing jointly whose incomes exceed \$250,000.

Phase-Out Rule for Itemized Deductions

For tax years beginning after 2009 the limitations on itemized deductions was phased-out for higher-income individuals. This provision is scheduled to expire on December 31, 2010.

The Obama administration proposes to reinstate the limitations on itemized deductions for individuals with incomes over \$200,000 and for married couples filing jointly with incomes over \$250,000.

As it stands now, no decision has been made on these proposed changes and passage is uncertain as most politicians are reluctant to raise taxes due to the politics of Washington in general, and particularly during an election year. It's possible that the lawmakers could extend the Bush tax cuts for all taxpayers through 2011, allowing them additional time to reach agreement on a more permanent fix to the tax system.

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