

# Market Outlook

Midland Financial Strategies

4th Quarter 2010

*"The investor will do better if he forgets about the stock market and pays attention to his dividend returns and the operating results of his companies." - Benjamin Graham*

## Is the U.S. Economy Losing Momentum?

Our earlier view that US economic growth would slow in the second half of this year materialized. Our concern was that government spending alone would not fundamentally improve the housing market or add to job creation. Further, with the expiration of the housing tax credit, the residential real estate segment seems to have lost strength. Importantly, during the past 14 recoveries, the housing market was the first segment of the economy to improve. Thus, from a practical standpoint, it seems improbable that the economy can fully recover until the housing market stabilizes.

With boosts from corporate inventory rebuilding and Government spending dwindling, and with exports remaining subdued, growth as measured by GDP will likely further slow below the 2% for the second half of 2010. Longer-term, one thing is clear, U.S. consumption must

*...many baby-boomers are delaying retirement...*

slow, and exports must increase – the concurrence of these events is necessary to simply service the current amount of U.S. Government debt. Apparently, U.S. businesses, which are hoarding enormous amounts of cash, are not prepared to invest in expansion. Sweeping changes may be under way politically; however, this does not ensure that the U.S. will quickly adjust to the demands of a cost-sensitive global economy. To that end, it might take other fiscal measures to stimulate the economy, one of which we mention in the final segment of this piece.

From a positive perspective, housing has become more affordable. Nonetheless, consumers will need

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to have confidence that the economy will grow, and that the work environment is more secure, before they purchase homes. While we do not expect the economy to double recess, the slow 1.5% to 2.0% growth in GDP will do little to boost business confidence or expand payrolls – both of these attributes are necessary to support housing. As

a byproduct of economic malaise, many baby-boomers are delaying retirement until they have rebuilt savings levels or have improved retirement cash flows. At the beginning of 2010, some were of the opinion that the Federal Reserve would position itself to increase interest rates. We were puzzled by that view. With low inflation and weak economic growth, the markets have largely come around to our view that the Fed will not increase interest rates in 2010.

## All that Glitters is Not Gold

As we segue into capital markets, the combination of a slow recovery and a fervent political environment, made the capital markets conspicuously quiet for most of the third quarter. Then, suddenly, stocks recorded their largest September surge since the 1930's posting a 9% gain as measured by the S&P 500. Before the move, stocks had been range bound, somewhat reacting to economic news, but more squarely focused on changes in political dynamics. The political environment is as lively as ever, and there is much at stake as it relates to the scope of government spending, taxation, and the future for American business. All we can do, again, is focus on what we do know and firmly - this is comparative yields, valuations, and potential risks relative to reward prospects.

### Balanced Strategies Have Provided Stability



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Our greatest fear at present relates to two asset classes – long-term U.S. Treasury bonds, and gold, both which appear priced for perfection. What is the reason for surging prices? For Treasuries, a low inflation

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environment has been a key driver – for gold, massive Government debt and volatile currency rates. While both asset classes may help accomplish the avoidance of some perils, both are fraught with other risks, such as the possibility of a scenario which introduces a short period of deflation followed by a quick introduction of hyperinflation – leaving investors little time to change their investment strategies. This is not to say that Treasury notes and gold are not important asset classes. Nevertheless, we contend that both have entered the realm of speculation and may be oversubscribed.

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Our philosophy remains focused on long-term "investing" and "ownership." In sum, we believe in building solid and well rounded portfolios, capable of withstanding unforeseen economic shocks. Interestingly, even with the difficult economic times, our balanced portfolio allocations have produced positive returns for the last 3-year time frame as shown in the earlier graph which compares two of our strategies relative to the S&P 500, and our alternative (low correlation) strategy.

## Current Investment Strategy

The corrective and choppy phase of the prior two quarters seems to be giving way to a more sustainable advance in stock prices. There are down side risks that should be mentioned, however, such as the Currency Reform for Fair Trade act, which could have the same

dire impact as the Smoot-Hawley Tariff act did during the great depression. Situations like this can change conditions quickly, and need constant attention – thus, while we have forecasts, we know that they could change rapidly.

That withstanding, we think that the equity market is in a bullish trend. Again, we continue to favor dividend paying stocks, and, in particular, companies, large or small, with strong balance sheets.

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From an international standpoint, we continue to favor emerging market companies, over their developed market counterparts due to higher earnings growth, and more favorable valuation characteristics.

With fixed income, we remain constructive as it relates to alternative asset classes such as high yield bonds, which yield 4.5% more than the corresponding U.S. Treasuries. We also remain invested in international bonds funds, where appropriate, as this has helped mute currency fluctuations. As stated, longer-term, we may be approaching "bubble" characteristics with US fixed income. However, we do not sense that US yields will move higher in the near-term, as growth is relatively tepid, unemployment is high, and inflation does not appear to be a threat.

## Finding Yield in a Low Interest Rate Environment

With money yields at historic lows, where can yield needy investors turn? This is indeed a major question for numerous retirees. Problems in finding yields can do much to alter an investors wellbeing, both short- and long-term. These problems include:

- 1) **Playing it Too Safe** – investing in short-term guaranteed securities is a long-term safe bet, with one exception: will the small amount of interest earned be enough to support a specific lifestyle? Another question, what if rates stay low for a year, or two years, or even longer? Life is short, and living in the current time period is important, too.
- 2) **Stretching Too Much for Higher Yield** – with the two year Treasury note yielding less than .5%, many may invest in longer maturity securities to increase yield. This move, however, may not necessarily work out for the investor. If interest rates rise, principle values will fall. Even if CD's are used, penalties will apply if the CD's are prematurely liquidated for re-investment.



**3) Over-Allocating to Higher Yielding [Risky] Security Types** – many investors are electing to invest more of their assets in high yield or lower investment grade securities. While a position in higher yielding securities may be appropriate, these types of securities are very vulnerable to shocks in the economy, and should be used in good measure.

*Problems in finding yields can do much to alter an investor's well being, both short- and long-term.*

Besides the challenge of low yields, and the problems associated with commonly used securities, investors face numerous

obstacles in addressing their concerns. One obstacle, obviously, is the multitude of investment vehicles that are available. Which of these options are suitable and warranted? Another obstacle, how does an investor find a trustworthy advisor to help select the securities and security types that will help achieve their goals? Moreover, are solutions that are being offered, suitable for each particular investor?

Investors must ask themselves four basic questions when addressing these circumstances:

- 1) What is the basic income amount needed to fulfill my living requirements?**
- 2) Given this amount, can this basic income be generated by my current investment portfolio? Or, as maturities continue to occur, will I be capable of funding my current living standards?**
- 3) Am I properly suited to follow capital market activity, to construct a portfolio that can help match today's demands, while keeping abreast of tomorrow's needs given a changing environment?**
- 4) If I need assistance, do I know an institution that can help provide guidance – does this firm have a documented process and proven history of providing this type of service?**

At Midland Financial Strategies, we are focused on answering these questions and tailoring solutions. For instance, many investors are currently overlooking asset classes and securities that can help fulfill their income needs, such as inflation protected bonds, dividend growing equities, bank loans, and international debt, which can help boost yields and buffer risks. Our



strategies, which pool the best of different asset classes, are often times appropriate for investors who are striving to improve yield, but at that same time, want reduced risk. For example, our High Income Balanced portfolio generates an attractive cash yield of roughly 3.8%. Portfolios like this can be very beneficial in a low interest rate environment.

### **Relieving the Burden of the Double Taxation of Dividends**

From time to time, it is worthy to think of abstract ideas as it relates to monetary and fiscal policy. With this in mind, we rethought the U.S. stance as it relates to the taxation of shareholder dividends.

While numerous attempts to stimulate the economy have been underway, there may be another that is worth considering – this is the removal of the double taxation of US dividends. To explain, profitable companies can do one of two things with excess cash. (1) They can take the money and reinvest it, or (2) take the excess funds and return some of them to shareholders in the form of a dividend. If a company pays dividends, the earnings are taxed twice by the government. The first taxation occurs at the company's year-end when it pays taxes on earnings. The second occurs when the shareholders receive the dividends, and must pay tax upon their receipt. Over time, this reduces the "velocity" of income (less to reinvest and distribute), and reduces economic opportunity. Putting this in perspective, taxing dividends is akin to one receiving a paycheck from work, in which tax is deducted, and after having given your children their allowance, having to deduct a portion for an additional tax.

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Given the current economic conditions, today might be an excellent time for the government to review dividend taxation policy. To that end, the reduction or removal of

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the double taxation of dividends could have 10 benefits to the economy and shareholders:

- 1) **Dividend Payouts Would Likely Increase** – with less taxation, there would be less reason and incentive to retain capital and dividends would likely increase.
- 2) **Economic Growth Would be Stimulated** – with an estimated \$1.86 trillion of corporate cash on the sidelines, some of these funds could be returned to shareholders. This cash would be spent, or saved, and increase the flow of capital throughout the economy prompting growth.
- 3) **Stock Ownership Would be Promoted** – as dividends increased, yield savvy investors would likely purchase and retain shares. This would also make shareholders more “long-term” in nature, as they would rely more heavily on dividends, and less on capital appreciation.
- 4) **Overall Debt Would Decline** – companies that use debt (corporate bonds) are allowed a deduction on the payment of debt, but not on the payment of dividends. If both were treated the same, equity would likely become a larger part of U.S. corporate balance sheets. This would lower the percentage of debt, and a byproduct would be to lower the cost of capital.
- 5) **Company Specific and Market Risk Would Decrease** – less leverage would lead to lower volatility in revenues, earnings, and ultimately, share prices.
- 6) **Questionable Accounting Techniques Would be Deterred** – as less incentive would be tied to the rise (or fall) of share price, the use of leverage and questionable accounting methods for artificially boosting share prices would be discouraged.
- 7) **Corporate Flexibility Would be Enhanced** – a company could raise or cut dividends based on outlook – this is much different than bonds, which have a “fixed-rate.” This would provide variability in overhead and more flexibility during difficult economic times.
- 8) **Transparency Would be Encouraged** – the payment and growth of dividend has historically

A higher focus on dividends would provide an earlier indicator of a company's health.

- 9) **Retirement Planning and Funding Would be Improved** – numerous pensions and retirement plans make estimates for “capital appreciation.” Having a dividend history would be a better tool for forecasting. Further, numerous “baby-boom” investors are seeking additional cash flow before they consider retirement. As dividends increase, this may lead to additional baby-boom retirements and would provide more room for those who wish to enter the work force.
- 10) **Foreign Capital Would be Attracted to US Markets** – countries like Finland, Australia, Switzerland, do not double tax dividend – the removal of double taxation could lead to more foreign countries investing with the U.S. With more foreign investment, this would, over time, lead to more economic opportunity.

Today, congressional leaders have considered raising the rate of taxation on dividends. Given the economic situation, this seems like a move in the wrong direction. And, given the current amount of cash being held with major corporations, dividend tax policy would be a beneficial area to re-address.

## Conclusion

To summarize, our recommendation is to structure long-term asset allocation strategies that allow our clients to maintain their income and liquidity needs, along with arming portfolios to withstand expected and unexpected short-term downturns. We also remain focused on our clients' individual tax circumstances when formulating investment strategies.

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