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Financial Markets Perspective

Stage Two of a Bull Market

April, 2012

The first quarter of 2012 recorded the best first quarter performance for stocks since 1998 or 14 years ago. The gain for the Dow Jones Industrial Average was 8.8%, the S&P 500 returned 12.6% and the technology-heavy NASDAQ rose 18.7%! These single quarter returns have eclipsed the returns for domestic equities over the past ten years. Conversely long-term government bonds fell more than 6% during the quarter. Typically, these results would cause an asset allocation out of stocks and into bonds. But with the economic data points skewing towards a recovery and the bull market in bonds looking tired, institutional investors put money to work in the stock market ushering in stage two of a bull market.

The first phase of the bull market as measured by the DJIA began at the low point of 6,469 on March 6, 2009 and, with a few moderate corrections along the way, reached a peak of 12,876 on May 6, 2011—a gain of 99%. Even with these two substantial increases, the DJIA is still below its all-time peak of 14,198 reached on October 12, 2007 -- almost five years ago. Similarly, the S&P 500, a broader measure of stock market performance, bottomed at 677 on March 9, 2009 and has rallied 108% through March 31st. The index is still 11% below its all-time closing high of 1,565 set on October, 9, 2007. Despite this impressive (and volatile) run, U.S. equities are still attractively priced for a number of reasons.

As we had pointed out in our last quarterly perspective, corporate profitability has been strong and has been an unusual contributor to the current economic expansion.

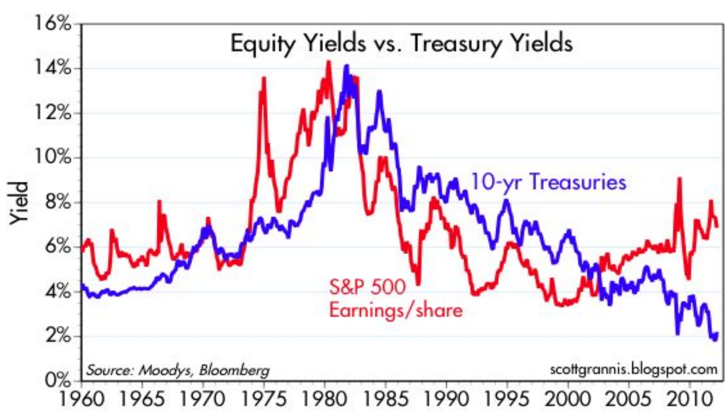
"For 2012, we are becoming less defensive in the face of continued strong gains in corporate profitability and a buildup in corporate wealth. Many corporations continue to increase dividends as last year's data shows an increase of more than $50 billion, up almost 90% from 2010 levels. Moreover, corporations still have record amounts of cash on their balance sheets ($2 trillion), which could lead to shareholder-friendly moves including share buybacks, dividend increases, and mergers and acquisitions. Lastly, violent swings in U.S. stocks last year kept many investors sidelined and underinvested in domestic equities. Continued favorable news will likely bring these investors back into the market." *Financial Market Perspective, January 2012*

In fact, current corporate profits as a percent of the economy (GDP) are approaching the record set in 2007. From the inflation-heavy 1970s, corporate profits have risen from a low 4% of GDP in 1974 to a recent 8% level as you can see from the chart on the following page. The question is: will corporations be able to continue to deliver at these above-average levels?

Excessively high profit margins that corporations are now experiencing are a result of dramatic cost cutting during the recent financial meltdown that included reducing employment and deploying more information technology solutions. As sales rebounded, much of this growth in revenues went straight to the bottom line. Add in the fact that corporations continued to issue bonds and refinance enormous chunks of their balance sheets and the above-average profit levels make sense. Bond issuance is running at $386 billion according to Dealogic. If the average corporation is refinancing debt at a 1% lower rate, these same companies are adding almost $3.9 billion in cash flow to their numbers. This cash flow can be used for investing in the business and to reward shareholders through higher earnings and dividends as we have witnessed. According to S&P Indices, net dividend increases reached $24.2 billion in the first quarter of this year which represents a 27.6% rise over 2011.

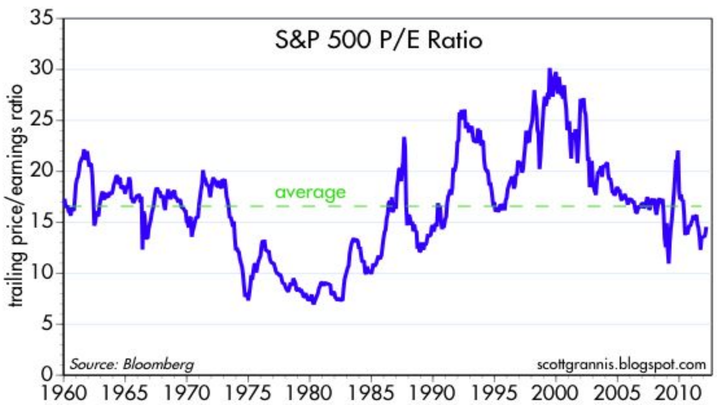
Going forward, profit margins could fall back towards the average due to a rebound in hiring and reduced government spending, but this decline will likely be offset by improving growth as economies around the world embrace capitalism and become part of the global economy.

Another way of looking at corporate profitability is to compare the earnings yield on stocks with the yield on 10-year Treasury bonds. In general, when Treasury yields are higher than equity yields, the market doesn't have conviction in stocks. As you can see from the chart,

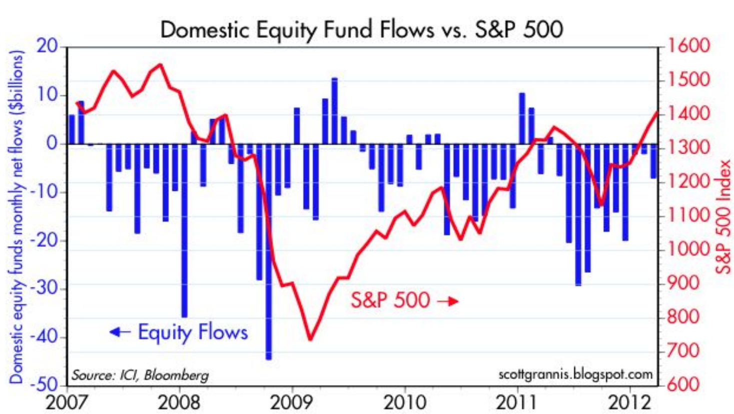


earnings yields are still substantially higher than bond yields -- a condition that has been relatively rare over the past 52 years. When the market is very confident in the ability of earnings to rise over time, as it was from the early 1980s through the early 2000s, earnings yields were consistently below the yield on Treasury's because investors were willing to forego a portion of the relative safety of bonds in order to capture the expected price appreciation from equities. Today, investors would most likely prefer to earn a yield of 6.9% from equities versus a yield of 2.2% from Treasury bonds.

When stock prices are brought into the picture it is evident that stocks, as measured by the price to earnings ratio (P/E), are as cheap as they were in the early 1980s. In those days corporate profits were not as rich as they are today. Moreover, interest rates were in the double-digits making borrowing very expensive. In 1980 when an investor was faced with buying a cheap stock or a government bond yielding more than 12%, the decision was a no-brainer. Today, with the government bond yield around 2.2%, buying stocks with a trailing 12-month P/E ratio of 14.6 is not a difficult decision to make either.

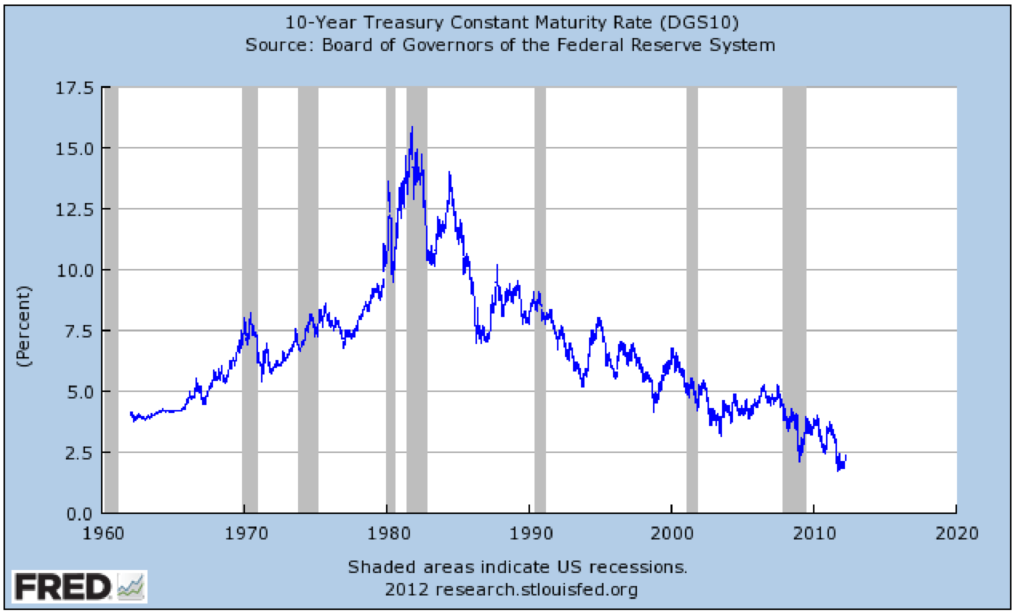


Another gauge of the second stage of a bull market is general investor confidence. After bear markets many individual investors tend to move away from stock investing and into "safer" investments such as bonds and money market funds. This shift was especially true during the Seventies when returns on bonds were better than returns on stocks. Even money market fund yields were unusually high at between 5 and 7%. The chart shows flows into equity funds.



These domestic equity funds continued to experience outflows during the first quarter. According to the Investment Company Institute (ICI), U.S. stock funds had $14.9 billion in net redemptions through March 28th. And these outflows are occurring even though money market funds yield less than 1%. This lack of investor confidence represents potential money to be invested in U.S. equities.

The last benchmark of the second stage in an equity bull market is the bond market. The peak in interest rates during our lifetimes occurred in the early 1980s when the 10 year Treasury bond yields approached 16% as you can see in the following exhibit.



Since that peak some thirty years ago, interest rates have been in a general downtrend. As a result, long-term bonds have experienced a dramatic increase in price. Over the course of this period, as bonds reached their maturity, investors were forced to purchase new bonds with lower interest rates. So, while market participants (borrowers) hailed these times as being a great bull market for bonds, bondholders (investors) were penalized by lower income.

For the last thirty years, investors have come to accept bonds as a conservative way to protect portfolios from volatility. Income remained relatively constant (up until recently) and bond prices generally trended upward as interest rates trended downward. Now that the Federal Reserve has taken interest rates as low as they can go, there is only one way for them to go. When interest rates begin to rise, current outstanding bond prices will begin to fall. The further out to maturity a bond is the bigger will be the price decline. Investors who hold bonds to maturity will get all of their money back but they will sacrifice the ability to purchase higher yielding securities as rates rise. As a result, we will likely see assets moving out of government bonds and into securities with less interest rate risk and higher growth opportunities.

Conclusion

Remembering to take a longer-term perspective is a challenge in today's 24/7 information technology world but highlights the importance of investing in stocks. The long-term rate of return on a diversified portfolio of domestic equities has been about 10% per year. However, the most recent ten years has produced just about a zero return even though corporate profitability has been constantly improving. Investors who focus on the long-term will see that domestic equities offer further upside opportunities.

Conversely, the party in bonds is nearly over. The best forecaster of future interest rates is the current interest rate. The Federal Reserve Board's commitment to maintaining low rates reinforces the expectation that interest rates will stay low making new bond investments relative losers. Over the past thirty years, both bonds and stocks have risen in tandem providing investors with favorable positive returns. We have probably reached a critical turning point in that relationship as a de-coupling is underway.

Fun Factoid

Canada is withdrawing the penny from circulation this year, saving taxpayers about C$11 million ($11 million) annually and forcing retailers to round prices to the nearest nickel. The Royal Canadian Mint, which has produced 35 billion pennies since it began production in 1908, will cease distribution this fall due to the coin's low purchasing power. Production and handling cost for the one-cent coin are a C$150- million drag on the economy, according to a 2006 study by Desjardins, a Levis, Quebec-based financial institution. Business groups welcomed the move, which follows other countries such as Australia, Brazil and Sweden. Maybe the United States should consider doing the same thing.

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