

JANUARY 2012 – THE BEST AND WORST OF TIMES

“It was the best of times. It was the worst of times.” So goes the opening line in Charles Dickens’ classic novel, *A Tale of Two Cities*. It has become a cliché due to its irony and usefulness. It probably fits the opening of 2012 in the economic and investment worlds.

Interest Rates

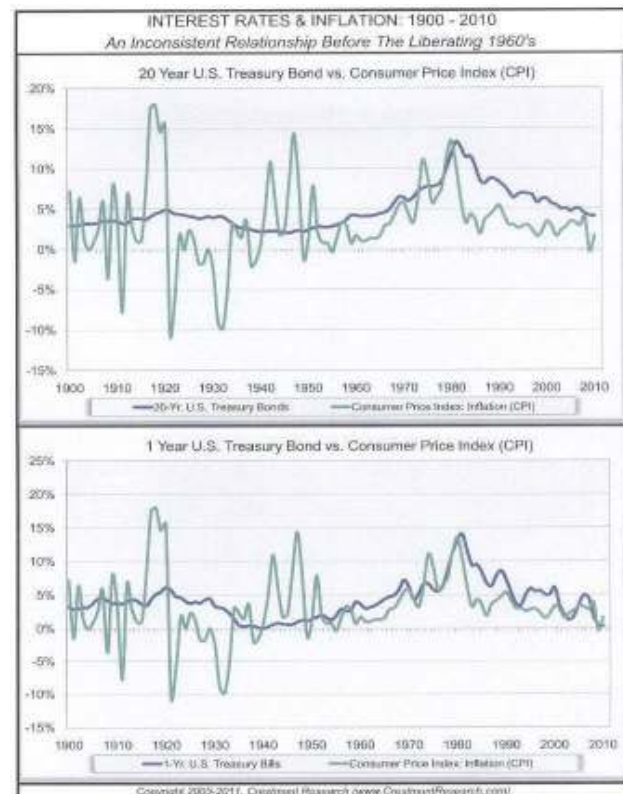
On the one hand, Americans and their government currently enjoy the lowest cost of debt ever in their history. That should ease the interest payments of businesses and consumers and free up money for spending and investment.

The rate on the 1-year T-bill has ranged from nearly 0% during the Great Depression to 14% in 1982 at the height of inflation. The average is probably around 3.50%. Rates are now 0.12%.

At current debt levels (102% of GDP) and current interest rates (0.12% on 1 year Treasury bills and 2.67% on the 20 year Treasury bond) about 1/6 of the federal budget goes to interest. Imagine what that fraction would be with normal interest rates.

On the other, personal debt has not come down a lot from the highest level America has ever seen. Government debt as a percentage of the economy has never been higher and is climbing rapidly.

As you can see by the blue line, from 1900-2010 the rate on the 20-year Treasury bond has, aside from the 1970-2007, ranged between 2.4% - 5%. It is now 2.67%.



At some point interest rates will begin to rise again but probably not soon. The Fed will do all in its power to keep that from happening, not just to stimulate the housing market and spending in general but to keep Washington from insolvency. Most likely they will rise because absent a Republican victory in 2012 the debt level of the US will keep rising and its credit rating will keep falling.

Deficit Spending

Pleasing voters at all costs is the spirit of Washington that has us in so much trouble. It might be our future but consider this: our nation is currently borrowing 40% of every dollar we spend. The simple math in the table below ([Source: CBO](#)) and on the next page shows the state of our country’s finances.

U.S. FEDERAL BUDGET FOR 2011 SIMPLIFIED

Actual Federal Receipts and Disbursements (rounded)

Federal budget	\$3,834,000,000,000
US tax revenue	\$2,567,000,000,000
New debt (deficit)	\$1,267,000,000,000
National debt	\$14,122,000,000,000 (grew 8.9% in 2011)

Below I have removed some zeroes to make it similar in size to a family budget, in 2011 our country earned \$25,670 spent \$38,340 and adding \$12,670 in debt to the credit card last year. It not yet the worst of times but we are headed that way on a speeding train that has accelerated. Our total debt equals 100% of the size of our economy (GDP) now. In 1988 it was 51%.

Remove 8 zeroes to see it similar in size to your budget

Annual family income	\$25,670
Spending	\$38,340
New \$ on credit card	\$12,670
Credit card balance	\$142,122

Federal Debt

PUBLICLY HELD DEBT/GDP OF SELECTED COUNTRIES IN 2010

France	82%
Germany	83%
Greece	142%
Italy	119%
Ireland	96%
Portugal	93%
Spain	60%
U.K.	80%

U.S. 63% & adding 9%/yr (100% in total debt)

Source: www.cia.gov/library/publications/the-world-factbook/rankorder/2186rank.html

So, why is Spain in so much trouble with similar debt to the US? Compared to Spain, the US market has:

- Much greater size, easy for large companies and countries to put \$\$ into
- Stronger reputation
- Higher credit rating
- Our own currency, giving us more flexibility
- US Federal Reserve is extremely accommodating
- Faster growth (2% vs. -1%)
- Lower unemployment (9% vs. 20%)

But, with our federal debt growing nearly 9% last year due to the big deficit, in 4 years we are on target to have publically held debt of 100%. In 6 six years, we will catch up to Italy, second worst in Europe.

But, another thing will happen. As I mentioned above, our credit rating is worsening, so far just one notch from AAA. But, if debt continues to climb, our rating will drop more and the interest rates will increase.

If interest rates on treasury bills went up from 0.12% to the long term average of 3.5%, 1/3 of the entire federal debt would be refinanced in the following year at interest rates 28 times higher than today. That's because the Treasury Dept. currently has 36% of the debt in maturities of one year or less and needs to refinance them when they mature. The rest of the federal debt is financed with maturities of 2-30 years weighted toward the shorter end.

If rates went back to normal on all maturities, the percentage of the federal budget going to interest would jump from 7% (www.nationalaffairs.com/publications/detail/managing-the-federal-debt) to somewhere between 15%-20%. That is somewhere between almost \$300 billion and \$400 billion in extra spending on interest. The only reason I can think of for financing so much debt at such low interest rates is because shorter maturities usually have lower rates than longer maturities. Thus, the Treasury Dept. saves \$300-400 billion this year, but foregoes the once in 50 years chance to lock in extremely low rates.

Europe

Europe holds the key to whether stock markets in 2012 are best or worst. Expectations couldn't be much lower and spirits have been lifted lately by the European Central Bank loaning a lot of money to banks at a very low rate in exchange for banks buying more government bonds, especially of the trouble countries like Italy and Spain. Northern European banks are not participating but French, Spanish and Italian banks are very active in buying bonds of their own countries.



On the other hand, these banks need to recapitalize and get rid of problem debt and this program does not help that at all and may exacerbate the problem. Meanwhile Europe is entering recession that many think will be mild.

If you tell me how Europe will do this year I will tell you how world stock markets do. It really is almost that simple.

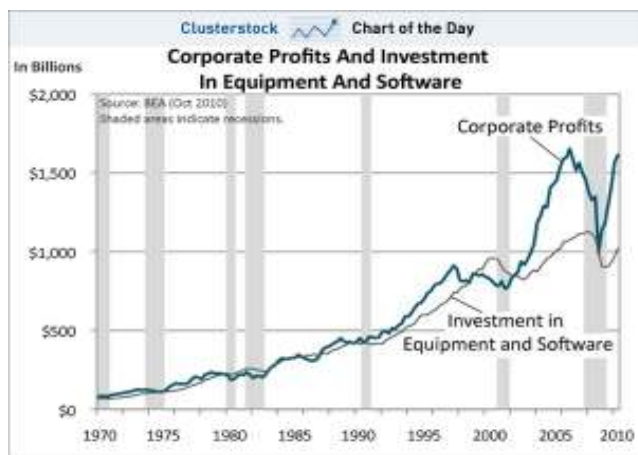
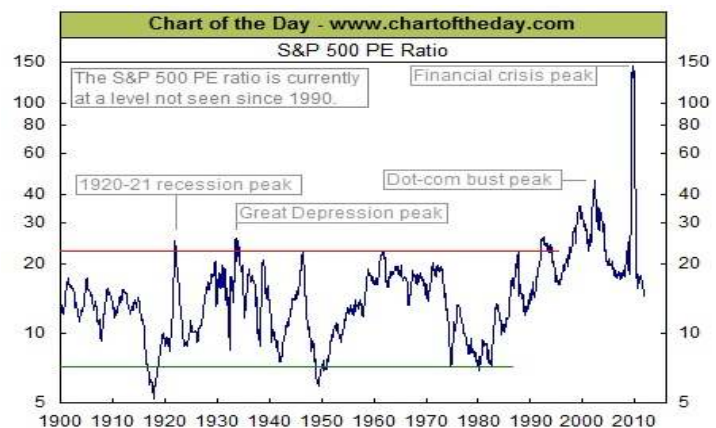
Outlook for Stocks

Stocks prices are a little cheap now, but not by a lot, given the present uncertainty.

At right is a long term chart of the price/earnings ratio (P/E) i.e., the price one pays for stocks as a multiple of their earnings. Extremes should be bought or sold depending on the reason for the condition.

We are currently at a P/E of 13.8, slightly below normal. That gives room for P/Es to expand with higher stock prices. That's good. Stocks are also cheap on price to book value and price to sales.

Companies have never been more profitable or had more cash on hand to finance expansion. Consider the chart below showing corporate profits and corporate investment.



Notice the lag of 1-3 years between higher profits and higher corporate spending. Then note the huge spike in corporate profits from 2000 on that was briefly interrupted by the 2007-09 recession.

Many large, global companies are flush with profits but reluctant to commit to investing in equipment and software. This is mainly due to uncertainty over prospects for world economic growth. Because world growth mainly depends on corporate expansion we have a Catch-22 scenario.

The other source of uncertainty is the highly unpredictable rush of regulation and other higher costs from our friends in Washington.

Investment Strategy



This is likely to be either a very good or bad year for stocks and is unlikely to be flat, as it was in 2011. The answer depends mainly on how Europe does. Until we know which will take a few weeks or months, we need to set sail, keeping an eye out for storms. As CT Shedd wrote, *"A ship is safe in the harbor but a boat is not made for that."*

There is no reason for keeping a ship idle with a zero return on investment unless a dangerous storm is imminent. That is not certain at this point.

How does one intelligently invest in such a time? In general, I think the answer is:

- Follow the most rewarding trends as long as they are not extreme
- Emphasize high dividends and income
- Have risk controls in place
- Diversify

Stocks

We are going into the New Year with slightly lower than normal allocations to stocks and will keep that until the trend turns decidedly up or down. To *control risk we are mainly sticking with lower volatility funds* such as *Sterling Capital Equity Income* and *iShares Equity High Dividend Fund*.

Foreign Stocks

International stocks had a horrible year in 2011. For example, China lost -22%, Japan -16%, Brazil -23%, France -15%, Germany -15%, Italy -20%, Israel -31%. The US, the UK and Indonesia were the only countries not deeply in the red. I will starting to build positions overseas soon, particularly in emerging markets due to (1) their higher growth and (2) because they are out of favor, they have low prices.

Bonds

Low growth worldwide and falling inflation in emerging markets argue for exposure to US corporate bonds and mortgages and foreign bonds, especially in emerging markets. Let the pros pick the countries and we will pick the pros. Muni bonds continue to pay well and perform well.

Alternative Income

Steelpath Select 40 Fund investing in fairly low volatility master limited partnerships paying 6.7% on average is the only alternative investment I am using right now.

Gold

We sold our gold at a higher price than today, having made a nice profit in 2011. I will be buying gold shortly because the risk to the downside is probably 10% and gold will benefit from either higher world problems (the fear trade) or lesser world problems in which case riskier assets will become popular and that favors gold and other commodities. Gold stocks are very out of favor and we may invest some there.

Cash

At 0% interest the only reason to hold cash is to use it as a temporary reprieve from falling stocks should that happen at some point during the year.

Real Estate

2012 will again be a good year for picking up distressed residential properties, including rental houses. Housing stocks have jumped 40%-80% in the last ten weeks and are already back to pre-bubble prices. REITs have been on a terrific 10-year run but are pricey now and have higher than average volatility.

Dave Hoshour

Cornerstone Investment Services

www.CornerstoneInvestment.com 704-698-1040 DaveH@CornerstoneInvestment.com

