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SCARY COSTUME: A RECESSION IN A RECOVERY MASK

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Good news: The Great Recession actually ended in June 2009. So concludes the National Bureau of Economic Research, the official arbiter of business cycle turning points. However, by a host of measures, the worst downturn since the 1930s will likely continue to be followed by a plodding and uneven recovery.

That economic observer Harry S. Truman once noted that a recession is defined as your neighbor losing his job, but a depression is when you lose yours. For many individuals, the recession is not over, and it won't be for a while. And therein lies the challenge for the stock market.

Stock prices have been extremely choppy this year because market participants cannot quite make up their minds about the economic landscape. Has the economy begun a slow but self-reinforcing recovery? Or have we merely seen a prelude to another leg down — the so-called double-dip? Investors (traders would be the more appropriate term) have been literally reacting to the news of the day, propelling stocks sharply up or down depending on the tone of a given report.

Big boys are sitting on cash

The signals will be mixed for a while. Yet, while consumers and small businesses remain somewhat strained, larger businesses in general have weathered the storm quite nicely. In fact, total corporate cash flows have already rebounded to their pre-recession *peak*. This cash has been piling up on balance sheets and now stands at \$1.5 trillion. It is earning a near-zero return. Meanwhile, borrowing costs are absurdly low for investment-grade companies. At some point, this low cost of capital will be a powerful inducement for businesses to ramp up their investment spending to expand or acquire — and thus earn an attractive return on their capital. Such spending inevitably will lead to job growth.

Interestingly, a recurring theme in the media, blogosphere, and even among some of our own clients and acquaintances is the notion of an America in decline. With high unemployment, massive public and private debt loads, and collapsed asset values, it is hardly surprising that the mood is so anxious. Among individuals, there is a sense that the “system” is rigged against them, as personified by the massive bailouts of the banks as well as the Flash Crash in May. Overlay the increasingly strident discourse of our political elites — not to mention their inability to address the nation's challenges — and one begins to understand the American angst.

A new Misery Index

We have seen this movie before. One need only revisit the mid 1970s/early 1980s to find a parallel. That period also came on the heels of a severe bear market. The country was

extricating itself from a tremendously costly and unpopular war. After Watergate and Nixon's resignation, trust in government plunged and kept falling. Meanwhile, the economy was in shambles. An oil embargo led to gasoline lines and rationing based on odd/even license plate numbers. Remember the *Misery Index*? That sum of the unemployment and inflation rates reached almost 22% in 1980.

But then Paul Volcker broke inflation's back, the federal government began to get out of the way, and globalization took off. The economy and stock market began climbing again.

However, we Americans tend to have short memories. Perhaps it is just characteristic of our national ethos to look forward rather than backward. The previous two recessions proved fairly mild in depth and breadth, and they are coloring our perspective. It is understandable that the current environment seems so anomalous.

In the world, America is doing okay

Those who lament America's "decline" frequently confuse changes in our *relative* standing with our *absolute* position. Despite having only 4% of the world's population, the U.S.'s share of the global economy stands at about 26.5%. This share is indeed down a couple of points from the 1999 peak. The developing world, most notably the BRICs (Brazil, Russia, India, and China), simply has a steeper growth curve. Nevertheless, although our relative position has slipped (and will continue to naturally do so), the U.S. economy has still been growing in an absolute sense. Milton Friedman termed this misperception the *fixed pie fallacy* — the tendency to assume that there is a fixed "pie" with one party able to gain only at the expense of another. Globalization has clearly benefited developed as well as developing nations.

The two gauges commonly cited as evidence of the U.S. demise relate to jobs and dollars. It is undeniable that the number of U.S. factory jobs has dropped dramatically over the past 30 years. This comes from the confluence of two trends: an impressive increase in manufacturing productivity and our natural evolution from an industrial to a services and knowledge-based economy. The manufacturing sector's share of the U.S. *economy* has remained fairly stable despite the sharp drop in jobs. That is because manufacturing output has doubled in real terms over the last two decades. As we have previously pointed out, the United States remains the world's leading manufacturer in terms of the total value of goods produced, with 20% of global output.

The dollar store holds its own

A further weakening of the dollar supposedly represents the other signal of a waning United States. First, while our currency may well continue its long-term decline against a basket of other currencies, it is not going to implode. The dollar maintains its status as the world's primary reserve currency and is in no imminent danger of being supplanted. Currency prices are all relative. If the dollar is headed for collapse, the question is "against which currency or currencies?" The euro, yen, or pound? Their issuers essentially face the same macroeconomic challenges we do. The Chinese yuan? Many observers outside of the Middle Kingdom do believe the yuan is undervalued, but Chinese authorities have no desire to see the exchange rate shift dramatically.

The dollar was up earlier this year on euro-zone fears. As the threat of a sovereign debt crisis receded, the greenback moved back down. More recently, the dollar has been under pressure on the possibility that the Fed may again purchase bonds to “grow” the money supply. Technically, an increase in the money supply reduces the value of money, thus devaluing the dollar. But a weaker dollar per se is not a negative for the U.S. economy. Indeed, a lower dollar has actually been a tailwind by making our exported goods cheaper to foreign purchasers. It was the export sector that helped propel the country out of recession. A lower dollar also leads U.S. consumers to favor domestic goods over imports.

If you ease it, will they borrow?

The Federal Reserve faces a conundrum. Despite keeping its benchmark rate near zero for almost two years, the central bank has not yet seen the unleashing of a cycle of borrowing and spending. The first round of so-called quantitative easing — the Fed’s \$1.7 trillion purchase of Treasury and mortgage bonds — ended in March. Borrowing rates did fall, but that too failed to stimulate significant activity. Hence the call for QE2 — no, not the venerable ocean liner. The fundamental problem remains the fact that the huge pile of money conjured up by the Fed largely remains idle on bank balance sheets. It is not being lent, circulated, or multiplied through the economy. There is simply still too much uncertainty among lenders and borrowers. That will take time to recede.

For better or worse, the Fed is at least trying to be constructive. The same cannot be said for many of our elected officials. The common view is that the stock market does not mind inertia in Washington. In short, gridlock is good. We’d argue, however, that given pressing fiscal challenges, the nation can afford to defer hard decisions for only so long; decisions, by the way, that have been deferred by members of *both* parties over the years. And the longer we delay, the more painful the ultimate medicine. Perhaps the electorate finally gets this, as evidenced by the anti-incumbent backlash prevailing today in many Congressional races.

Dividends make the difference

With investor sentiment still fragile, bond funds continue to attract the bulk of mutual fund inflows. It will take a more sustained rally by stocks to reverse this trend. From a valuation standpoint, stocks appear very attractive compared to the alternatives of bonds or cash, unless one foresees a deflationary spiral. An examination of a specific company’s securities illuminates their relative appeal.

To pick one of many candidates, consider Johnson & Johnson, the broad-based healthcare company. Its seven-year bonds were recently selling at a yield of 2.3%. Put another way, an investor who purchased the bonds today and held them until maturity would earn an annualized return of 2.3% over the period. Meanwhile, the company’s common stock can be purchased at a price that results in an annual dividend yield of 3.5%. This is a striking disparity. Not only will the stock initially produce more income (assuming no dividend cuts, which seems reasonable), but JNJ has historically increased its dividend at a double-digit annual rate. Unlike the bonds, there is no obligation for the stock to be exchanged for a given value, but certainly odds are that a seven-year investment in JNJ’s stock will produce a return that exceeds the 2.3% on its bonds.

Indeed, in a slower growth environment, we believe dividends may well account for a higher proportion of investors' gains from stocks than they have in recent decades. Ned Davis Research recently pointed out that over the 1959-2009 period, the S&P 500 stock index produced an annualized return of 9.2% per year, with 5.9% coming from appreciation and the other 3.3% from dividends. However, from 1927 to 1958, when the S&P 500 returned 10.2% annually, 4.5% came from appreciation and 5.7% from dividends.

Long-term, slow but steady

Third-quarter earnings reports have begun to trickle out. Analysts expect total S&P 500 operating earnings to be up 30% from the corresponding period in 2009. With the economy having slowed this summer, there is obviously some risk that the earnings outlook could become a bit cloudier. A new wall of worry for investors? Actually, in many respects, the current environment offers a mirror image of the late 1990s. Back then, investor sentiment was extremely positive, valuations were sky high, and the earnings outlook was robust. Stocks were the obvious asset to own and at any price. A bond was good for getting out of jail and that was about it. The biggest worry related to having enough broadband capacity. In hindsight, a secular bear market was about to commence.

Today, sentiment has improved somewhat with the September rebound, but it has generally been weak. The rally off the March 2009 lows has never been fully embraced. Meanwhile, stock valuations are quite reasonable. Yet the majority of dollars are flowing into bonds — today's expensive asset class. While acknowledging that the existing backdrop remains fragile, from current prices, the odds favor decent performance by stocks over the next five to ten years.

— Christopher J. Singleton, CFA, Managing Director

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