

# MILES *Capital* UPDATE

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## Low Interest Rates - Short-Term Blessing, Long-Term Curse?

In response to the recent recession and global financial crisis, the Federal Open Market Committee reduced its interest rate target to near zero in December 2008, where it still stands today. The Federal Reserve has also engaged in two rounds of quantitative easing (i.e., injecting liquidity into the system by buying bonds in the open market) with a goal of keeping interest rates low.

The near-term benefits of low interest rate policies include stimulating the economy by lowering the real cost of borrowing, helping to recapitalize the banking system by raising net interest margins (and thus earnings), and raising asset prices (though as we have seen before, asset price bubbles are a real danger).

The Fed's highly accommodative interest rate policy is approaching its 28th month, with little sign that the "extended period" of low rates referenced in Fed statements is coming to an end any time soon.

As we note in the articles which follow, the U.S. economy is showing signs of improvement (though significant headwinds in the form of continued high unemployment and distressed values in the home market still exist). It seems inescapable that the Fed's low interest rate policy has been effective at stimulating the economy short term. But what of the effects of such a policy long term?

While the stimulative effect of temporary interest rate reductions cannot be argued, there are costs to low interest rates. Those costs are visited differentially on different types of investors. And, in our view, those costs rise as the period of Fed-induced low rates extends.

Our income-oriented clients are particularly hard hit by ongoing low rates. Consider, for example, insurance companies. Low interest rates pose three significant challenges for insurance companies. First, lower rates mean lower interest income, reducing earnings available to pay claims. Second, by reducing discount rates, they increase the assumed cost of future liabilities, putting pressure on capital. Finally, an insurer's investment decisions in response to low rates can sow the seeds for future challenges as the insurance company moves

further out the yield curve or into lower quality credits.

Low short-term interest rates significantly reduce operating income for local governments – many of whom are limited by statute to investing in high quality, short-term income instruments – putting added pressure on budgets already strained by falling tax receipts. At this writing the yield on overnight repurchase agreements or "repos" had fallen below 5 basis points, and the average net yield to investors on money market funds nationally was 1 basis point.

Retirees have also seen their incomes cut dramatically. According to the Federal Reserve Bank of St. Louis, personal interest income has declined 9.6 percent or \$128 billion since its peak in the third quarter of 2008.

As we consider the long-term impact of low interest rates, we are reminded of a famous section in Warren Buffet's 1997 letter to shareholders of Berkshire Hathaway where he asked:

*"If you expect to be a net saver during the next five years, should you hope for a higher or lower stock market during that period? Many investors get this one wrong. Even though they are going to be net buyers of stocks for many years to come, they are elated when stock prices rise and depressed when they fall. In effect, they rejoice because prices have risen for the "hamburgers" they will soon be buying. This reaction makes no sense. Only those who will be sellers of equities in the near future should be happy at seeing stocks rise. Prospective purchasers should much prefer sinking prices."*

What is implicit in the above comment is the concept that buying the same earnings for a lower multiple leads to a greater return over time.



David Miles  
Chief Executive Officer

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## Low Interest Rates (continued)

Applying the same logic to the U.S. bond market, while a decline in interest rates sounds appealing because it increases returns in the immediate term, if those interest rates are pushed down artificially, future prospects are dimmed meaning low yields today and declining bond values when higher rates return.

Artificially low interest rates offer a good short-term “jolt”. They are not a prescription for long-term success. In our view the Federal Reserve should fulfill its commitment to end

quantitative easing in June and begin to normalize short-term rates when the recovery appears sustainable, likely early next year.



David W. Miles  
Chief Executive Officer

## Economy: Growth Continues, but the Water is Choppy

Global growth is becoming more entrenched in the market psyche despite ugly headlines in the first quarter. The spark of social unrest in Tunisia lit fires across the Middle East and North Africa, sending oil prices higher on fear of supply disruptions. Unfortunately, these social upheavals drifted to the background when in mid-March an earthquake and tsunami ripped through the northern part of Japan causing a nuclear crisis and unimaginable pain for the Japanese people. These events gave stock prices pause, but they have since shrugged off the fear and moved higher.

While it's important to recognize the challenges that remain, we are encouraged by the slowly improving domestic economy. Falling initial jobless claims have translated into a steady decline in the unemployment rate to 8.9 percent. Personal consumption accounted for a larger part of GDP growth in the fourth quarter than previous quarters, suggesting consumer optimism about the future. And rising demand for commercial and industrial loans is being met

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by somewhat looser lending standards. While these data points are not yet a robust trend, they point to better growth ahead.

Another step in moving toward sustained growth is a graceful exit from very accommodative monetary policy. The Federal Reserve is extensively involved in the markets, keeping short rates historically low and encouraging risk-taking by companies and investors. Should domestic growth continue, we will see the Federal Reserve take steps to reduce this support sometime later this year. This transition is fraught with difficulties and will undoubtedly generate additional market volatility.

The water is choppy and that provides opportunities. While risk-management remains central to our investment strategies, we will be nimble to take advantage of this volatility for client portfolios. An uneven recovery is challenging developed and emerging markets alike, but a long-term perspective keeps our head above water.

## Equity: Surprising Strength

Despite a host of extraordinary events in the first quarter, the equity market performed well, with the Standard & Poor's 500 Index rising more than 5 percent. For the third quarter in a row, no sector of the Index registered a negative return. With a 16 percent return, Energy was

the strongest performing sector as oil peaked above \$106 per barrel. Similarly, the Industrials sector posted a gain of more than 8 percent as growth in emerging markets continued to fuel global industrial production.

## Equity (continued)

Given the variety of challenges in the first quarter, the strength of the equity market was a pleasant surprise. In mid-March, the earthquake in Japan led to a sharp pullback in the market and the ongoing conflict in the Middle East drove oil prices above \$100 per barrel for the first time in two years. In addition, financial pressures continued to build in Europe as policy makers were unable to overcome the political hurdles to implementing a long-term sovereign debt solution. In China, the government continued to slowly raise interest rates in an effort to keep inflation under control. And, economic conditions in the U.S. remained mixed, with modest improvement in unemployment amid continuing housing market weakness.

In spite of these challenges, equity investors have been patiently waiting for solutions to unfold. We believe this patience will be rewarded. Specifically, we believe that Japan will eventually recover from the recent economic disruption and that the situation in the Middle East will not lead to a

decline in the equity market unless the conflict spreads to a much larger oil producing nation such as Saudi Arabia. Also, we believe the European Union will gradually move toward a solution to the sovereign debt problems given that it is in the best interest of the largest member countries to do so. And, it appears likely that China will be able to keep its economic growth in check. As for the U.S., economic improvement remains slow, but signs of sustainability, such as improvement in unemployment, continue to emerge.

With improvement in the global economic environment, we expect equities to appreciate over the long term as many companies have healthy balance sheets and reasonable stock valuations relative to earnings growth prospects. Nevertheless, the equity market will likely remain volatile in the short term in response to positive and negative economic surprises. Thereby, the best course of action remains to filter out short-term economic noise and focus on long-term investment objectives.

## Fixed Income: A Tug of War

A tug of war game could best describe the fixed income markets during the first quarter of 2011. On one side you have the bulls touting robust business profits, improving employment trends, and solid global growth representing better days ahead. On the other side you have the bears who point to commodity and oil price increases, the sovereign debt risks in Europe, and the tragic events in Japan indicating slowing growth ahead. At the end of the quarter you could say the bulls are winning the war, but not by a large margin.

During the quarter, interest rates, as measured by the 10 year U.S. Treasury bond, were modestly higher ending the quarter at 3.5 percent. Rates varied considerably during the quarter as the market interpreted mixed signals from economic, political, and global events. The difference between long-term interest rates and short-term interest rates remains at historically high levels. We expect this trend to continue over the next couple of quarters as the

Federal Reserve retains its low interest rate policy to stimulate economic growth.

The fixed income markets continued to show solid performance for the quarter. Spread sectors including corporate bonds, agency bonds, and mortgage backed securities outperformed similar duration U.S. Treasuries. In addition, the market continued to reward risk in general as lower quality assets outperformed higher quality over the quarter.

Our outlook continues to favor many of these spread sectors albeit with slightly less conviction given the strong performance they have experienced year to date. Corporate bonds, and especially financials, offer attractive relative value given their strong fundamentals and positive earnings trends. The recent increase in dividend payments, as well as mergers and acquisitions across this sector, bear watching, as these events tend to be negatives from a corporate bond perspective.

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# Diversified Equity Income

As discussed in our recent white paper, “Dividend Stocks: Income and Appreciation Opportunity”, there are many potential benefits to including a dividend-focused strategy in your asset allocation. Dividend paying stocks have delivered attractive returns, with a lower level of volatility, compared to the broader equity market over several decades.

Historical data demonstrates that, over the long term, dividend paying stocks deliver superior returns with lower volatility. Companies that pay dividends are typically able to generate stable cash flows supported by the maturity of their businesses, diversified revenue sources, and the longer term focus of management. As volatility in the equity market continues, we believe the greater income certainty and stability of dividend paying stocks will have growing appeal to both institutional and individual investors.

Analysis of the S&P 500 from 1930 to 2010 indicates that dividends contribute nearly 50 percent to the stock market’s total return. Stocks with increasing dividends have widely outperformed non-dividend paying stocks and the

S&P500 since 1972. In addition, our analysis suggests that equity valuations remain attractive relative to earnings growth expectations.

Dividend paying stocks are also an attractive complement to bond investing. Bond yields have been near historical lows for an extended period of time, and dividend paying stocks should be attractive for income seeking investors, despite the difference in risk between stocks and bonds.

These factors, along with several others, have contributed to the favorable environment for dividend stocks and made them worthy of consideration for most investors.

As always, please contact us at 800-343-7084 if you would like to visit with any of our team members about this or other investment opportunities.

Past performance does not guarantee future results. The analysis above is subject to changes in economic and market conditions. Future results may vary. This is not a recommendation.