

Investments

THE VIEW FROM LOWRY HILL

THIRD QUARTER 2008



THIS ISSUE'S FEATURED TOPICS:

- ◆ Better-than-expected growth may result in greater rewards for stock investors during the second half of 2008. Skepticism remains high, providing the backdrop for positive surprises.
- ◆ Inflation is likely to rise at a pace that businesses and consumers can adapt to over time. With moderate levels of inflation, stock investments have historically been more attractive than bonds.
- ◆ Higher taxes are expected to coincide with the election of the new president, regardless of his party affiliation. In anticipation of a higher capital gains tax rate, we encourage clients to accelerate diversification plans for concentrated holdings. It also appears that the tax rate on dividends is likely to increase.

OVERALL OUTLOOK

We are optimistic about stock market prospects in the second half of 2008. Thanks to high overseas growth, demand for inexpensive U.S. goods, and the need for infrastructure building, earnings growth for many industries remains fairly good. Year-over-year earnings comparisons are likely to be more favorable in the fourth quarter, as the first financial write-downs were taken in September 2007. Corporate America is fairly healthy outside the financial sector, with high levels of cash and relatively low leverage. Worldwide liquidity is also very strong, as emerging-market countries continue to strengthen. Moreover, low U.S. interest rates should eventually help reinvigorate our economy.

If overall inflation ramps up to a much higher level, the price-to-earnings multiple (P/E) on stocks will likely fall. However, we believe that some offsetting factors will help keep overall inflation at more moderate levels. The P/E on estimated 2009 S&P earnings is currently at 14. History shows that when the P/E is at this level, the inflation rate is typically 4–6 percent (Morgan Stanley, “In the Flow,” 6/2/08). In other words, stock prices already reflect a higher inflation rate than stated government statistics.

Importantly, skepticism over stock prices remains high. It is challenging to feel encouraged with the proliferation of seemingly dire news, from escalating gasoline and food prices to the still-high housing foreclosures. However, when investors feel the worst, stock prices can begin to rally and often move quickly if news stabilizes or provides surprises to the upside.

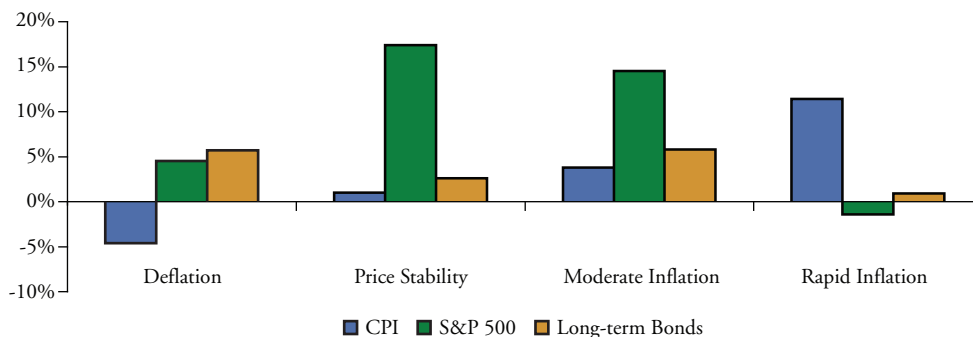
INFLATION AND PORTFOLIO STRATEGY

Inflationists typically believe too much money created in the world economy will eventually lead to an outbreak of inflation. Their adage: “Too much money chasing too few goods.” As the prices of commodities rise, this is actually occurring. There is significant demand, largely from developing countries (along with the U.S.) chasing scarce resources.

Contrary to popular belief, the inflation rate actually tumbled over the last 20 years—in spite of the broad money supply increasing worldwide. Improvements in productivity through enhanced technology and the impact of China’s low-wage workforce on the world market enabled the price level to stay low. At some point, those forces may slow or abate. With renewed upward momentum in commodity prices, in combination with a slowing growth environment, the potential for heightened inflation has increased.

When we weigh the drivers of inflation, we believe there is enough downward pressure on prices that overall inflation is likely to rise at a manageable pace. Historically, when the overall price level rises moderately, stock investments perform better than bonds. As you can see from the following chart, stocks have traditionally been a good hedge against moderate inflation.

ANNUALIZED RETURNS UNDER VARIOUS INFLATION ENVIRONMENTS 1920–2004



Source: Henry McVey, Morgan Stanley, 8/15/04.

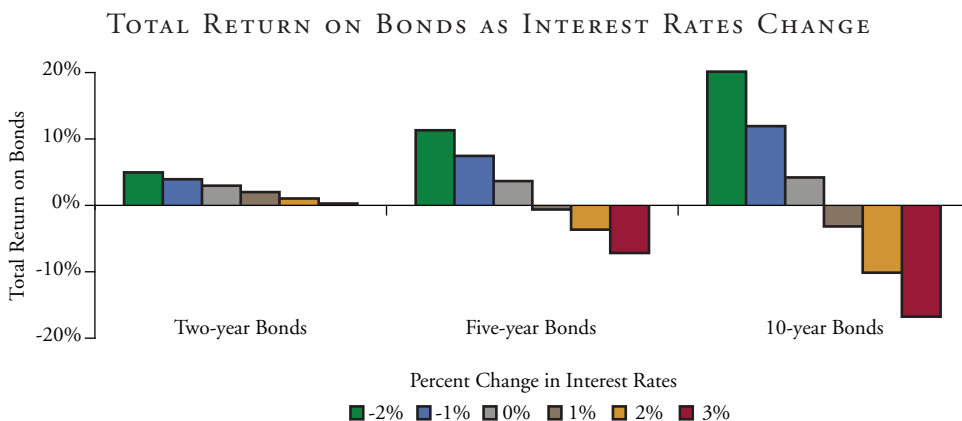
Inflation is caused by a general rise in demand for goods that outstrips supply. This demand is often due to faster growth (above-average GDP), a lower dollar, higher commodity prices, escalating healthcare costs, excessive liquidity or increasing wages. While higher commodity prices are concerning investors, we believe there are some possible offsets.

THE IMPACT OF VARIOUS INFLATION DRIVERS

Inflation Drivers	Current Status	Impact on Inflation
Economic Health	Problems in the financial sector and in the housing market create downward pressure on the price level by dampening general demand.	Current weakness is creating downward pressure.
U.S. Dollar	A falling dollar usually leads to higher prices for imported goods. The dollar shows signs of bottoming after a long decline. Even Fed Chairman Bernanke has commented on the importance of dollar strength.	A falling dollar has been contributing to inflation, while a rise in the dollar would reduce inflationary pressures.
Commodity Prices	Food, energy and raw material prices have been rising since 2001. Some adjustments have already been made to adapt to higher price levels. Commodity prices are largely a function of supply and demand but can include a speculative element.	Higher commodity prices contribute to rising inflation. Reversal of the dollar decline, as commodities are priced in dollars, could provide some relief.
Healthcare Costs	Increases have slowed.	Healthcare costs are having a lower inflationary impact than recent years.
Liquidity, Money Supply, Fiscal Stimulus	The Fed has been trying to lift liquidity by lowering short-term interest rates. However, the impact of those lower rates generally takes time to take effect. In the interim, the government stimulus checks may help.	Longer term, the increase in monetary and fiscal stimulus may lead to an increase in inflation. However, changes in interest rates take time to make a difference.
Unit Labor Costs (wages plus productivity)	Significant productivity improvements have offset wage increases.	The current neutral impact could change as other dynamics evolve.

In a growing economy, it is natural to experience some inflation. Businesses can adapt to rising prices over time. The concern lies with prices spiking quickly—and in the resulting dislocations. This rapid spike occurred in the 1970s, creating much angst. The situation today is quite different. Interest rates are much lower. Oil is not nearly as important to our economy as it was then. In the 1970s, real compensation per hour was increasing at 2–4 percent annually. Labor had more power and productivity improvements were not high enough to provide an offset. In contrast, we’ve experienced a slight decline in today’s hourly real compensation (Merrill Lynch, Economic Commentary, 5/8/08).

From a client portfolio standpoint, bond investments would not perform well in a higher-inflation environment. This performance would represent a marked departure from the last 20 years (when interest rates declined, and bond prices rose). For those clients who own bonds, we recommend keeping bond ladders short, particularly for taxable bonds. The following chart illustrates the impact of rising interest rates (as a result of higher inflation) on bonds. The longer the bond, the greater the impact.



Source: Bloomberg. At 0%, Treasury note yields as of 6/12/08. Assumes interest rates change X percent by 6/1/09.

Importantly, if allocations shift toward a higher weighting in equities, portfolio volatility would increase. This should be taken into consideration as the asset allocation is established. There is a tale of a six-foot-tall man who drowned crossing a stream that was, on average, only five feet deep. In other words, investors have to be positioned to withstand some short-term volatility to take advantage of these longer-term trends.

LIKELY RISE IN CAPITAL GAINS AND DIVIDEND TAXES

Whether a Democratic or Republican president is elected later this year, future tax rates are likely to be higher. For those investors who have concentrations of stock or other very low-basis holdings, we think this is a good time to accelerate sales. The benefits of diversification are well known but make even more sense at lower tax rates.

What might be less appreciated is the impact of higher taxes on dividends. There was a time when dividends really mattered. From 1871 to 1950, the dividend yield on stocks was 4–6

percent—a major contributor to the long-term return on equities of approximately 10 percent. Wall Street was dominated early on by wealthy individuals, many of whom used the income for living expenses. After the depression, dividends provided a dependable stream of earnings. They were also used as a way of assessing corporate health. However, by the 1960s, the veterans of the crash had died or retired. Pension funds became large buyers of equities, and they were interested in longer-term growth. Above-average stock returns seemed easy, and the importance of dividends began to wane (Peter Bernstein, “Dividends and the Frozen Orange Juice Syndrome,” 5/15/04).

Today, the dividend yield on the S&P 500 averages only two percent. When the tax rate on dividends finally declined to its current level of 15 percent in 2003, there was very little appreciation of the benefit. However, with demographics shifting, more people are relying on their investment income for living expenses (Ibid.).

We do not know how high the dividend tax rate will go. Today, dividends and capital gains are both taxed at 15 percent—low by historical standards. The dividend tax is somewhat higher than the capital gains tax because it is paid every year, while the capital gains tax can be deferred until the time of sale. If the capital gains tax rate is increased, we believe that the dividend tax rate will increase by at least as much and possibly more if dividends are treated as ordinary income (which was the norm until 2003). If the dividend tax rises from 15 percent to 40 percent, a high-income investor stands to pay another \$25,000 of income tax for every \$100,000 of dividend income.

IMPACT OF POSSIBLE RISE IN FEDERAL DIVIDEND TAX RATES

	Current 15% Tax	28% Tax	40% Tax
Dividend Income	\$100,000	\$100,000	\$100,000
Tax	\$15,000	\$28,000	\$40,000
After-tax income	\$85,000	\$72,000	\$60,000

A rise in the dividend tax has other implications. Companies may be encouraged to reduce payouts, and instead, return earnings to shareholders via stock buybacks. Alternatively, if firms retain more earnings, investors will be more dependent on management to use the cash wisely. Municipal bonds may benefit, as there is less competition from the lower after-tax returns of dividend-paying stocks. To some extent, we believe a dividend tax-rate hike is already priced into stock valuations. However, investors may need to make some adjustments for lower after-tax dividend income.

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