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What Would Rip Van Winkle Say?

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If Rip Van Winkle fell asleep at the end of the first quarter of 2009 (after taking a supersized sleeping pill to assuage his shattered nerves) and awoke at the end of the first quarter of 2010, he would have been in for quite a shock. Major stock indexes rose about 4-7% over the first quarter of this year, which when combined with the surge of the last three quarters of 2009, compounds to an annual return of 40-60%!

Indeed, the remarkable retreat from the edge of what appeared to be the abyss of complete meltdown in the worldwide financial system has been quite spectacular. And, judging from the popular business press reports, the rapid pace of recovery has been largely unanticipated by most. The U.S. economy appears to have recovered more ground in the first quarter as inventory liquidation ended and consumer and business spending recovered from earlier lows, and we hold to our “square-root” recovery theme, with its V-shaped path at the front end of the economic cycle. While more subdued than the typical 4-6% pace of real GDP growth from past recession trough, a 4% recovery pace as we expect will continue to deliver positive surprises well into 2011.

Speaking of Rip’s other surprises; all of the following trends were unanticipated when he fell into his restless and troubled sleep a year ago:

1. Real GDP recovered sooner and faster than expected, particularly for the corporate sector.
2. Depressed corporate profits raced toward recovery with a string of positive surprises. Recovery in reported earnings to more than the \$80.00 level we believe roughly represents normal earning power for 2009 for the S&P 500 and is now a strong possibility for 2011.
3. Job losses in this jobless recovery appear to have come to an end, and one million net new jobs is our rough forecast for 2010.
4. The corporate bond market is open and active, even for low-quality “junk” credits.
5. Public corporations loaded up on over a trillion dollars of cash reserves and refinanced their debt loads, minimizing their need for bank credit to finance the recovery.
6. The Fed pegged short-term Treasury yields at 0%, ensuring that banks could repair their tattered balance sheets by earning huge net interest spreads to cover their past lending sins, which necessitated building massive loan loss reserves.

In response, we suspect that Mr. Van Winkle would say, “Wow! Wake up everybody and make hay while the sun shines!” Of course, given Rip’s known aversion to all kinds of profitable labor, he must mean others, not himself.

“Well, how long might that sun continue to shine?” you might ask the supposed sage Mr. Van Winkle. Being the astute investor that he is and knowing that there are long market cycles during which one ought to ignore the bad news (usually by snoozing in his case), Rip commented that the markets should rise FASTER and go FURTHER than generally expected. Of course, he cautioned that storm clouds are brewing on the horizon for 2012 and 2013, but that shouldn’t change one’s view of the clear skies today. **Of course, if you wish to learn more about the detail of Mr. Van Winkle’s perspectives, we trust you’ll read on as he answers your wary questions.**

Q: BUT, you reason, we've lost 8.5 million jobs since 2007 – won't this jobless recovery impede the economic recovery?

A: Boy when I look back at 08 and 09, I've never seen employers liquidate employees as fast as they liquidated inventories, exclaimed Rip. I'm glad I took a nap during the bloodbath. But now, companies must begin hiring again to support increased output of goods and services. Caterpillar's a perfect example of what's going on. As reported in the Wall Street Journal (and I've been catching up on back issues like this one from January of 2010), the company stated that in order to boost output 15%, some of their suppliers would have to *double* delivery rates to Cat! So now we've finally seen 162,000 net new jobs in March, and big companies like Intel and JP Morgan have even announced new hiring programs. Gee, now all we need is a bit more than 100,000 net new jobs a month for the rest of the year to hit a million new jobs for the entire year. **This pace of hiring could be the difference between growth at a 3% annual rate for GDP and getting up to the 4% annual rate for 2010.**

Q: BUT, you hypothesize, consumers are so overleveraged, they'll never spend again at the pace of the past decade.

A: True, admits a sober Van Winkle (after years himself of paying attention to everyone else's business but his own), the days of using one's home equity to become a spendthrift are over. Yet, we already seem to be witnessing the evidence that when the fear of being fired subsides, pent up consumer spending ensues. With the huge recovery in stock market wealth and such a depressed base of spending on homes, autos, and durables, even a modest recovery off the bottom will lead to big consumer spending advances. **Surprisingly, personal consumption could contribute 2% or more to the advance in overall GDP growth over the next 18 months.**

Q: BUT, you observe, the banks are reporting declines in net lending due to an absence in loan demand. Doesn't this portend a weak economic recovery?

A: I've seen this story before, remarked Mr. Van Winkle, when commercial real estate lending dried up in the 1990-92 recession and IPO financing all but disappeared after the bursting of the tech bubble in 2000. But, just look at corporate balance sheets today and count up the cash reserves of the current members of the S&P 500. There was \$1.13 Trillion in cash & equivalents on the books of non-financial companies in the index at the end of 2009, even while they modestly reduced total debt since the end of 2008. Corporate America slashed working capital to build cash reserves, and once the financial markets opened back up for business in the 2nd quarter of 2009, companies were able to refinance debt, issue equity, and further strength balance sheets to the point that many don't need new bank lending to support their investment plans. **No wonder the banks are seeing little loan demand even while corporate investment has turned sharply higher.**

Q: BUT, you plead, small businesses, the engine of our job growth over the last couple of decades, can't get the lending they need to finance their growth. Won't this hold back growth?

A: Why it's hard, bemoaned Rip (contrary to his normally happy, well-oiled disposition), to keep up with all the new regulations and taxes the government plans to levy on small businesses in the next few years. But that's why businesses are hiring so many temps - even highly trained, expensive ones for manufacturing jobs. That's also why it'll take years to regain all of those lost employees. As loan charge offs decline for many banks this year, lending standards will ease for small businesses, but everyone's likely to be surprised by how big businesses become the early engine of job growth this cycle rather than small ones.

Q: BUT, you whine, what about the expiration of the Bush tax cuts, won't this kill the recovery?

A: Well that's why you better be making hay right now, exclaimed the agitated Van Winkle. But there's an interesting twist underway now, however. The worst case appears to be getting less bad in the near term and even worse in 2012 and 2013 (e.g. the Medicare tax on dividends and interest). It's foolish to think that employers and investors don't know how to accelerate economic activity into years of lower tax rates and less burdensome regulations. You know, when the farmer like me sees storm clouds (higher tax rates) on the horizon, he'll naturally work his combine more hours today to bring in the harvest sooner than he previously planned. So 2011 is progressively looking like a better year for the economy at the expense of 2012-13. So with upside surprises yet to

come in real GDP growth, a moderate pace of job recovery, robust advances in corporate profits, even now moderate market valuations, the upside surprises in the stock market are likely to take it up FASTER and go FURTHER than expected. **If real GDP growth continues at a 3-4% pace and inflation stays moderate at less than 2.5%, stocks still represent a superb investment even from here. This is the most likely outcome for the next two years.** At around \$1,400 on the S&P 500 (and the timing at which this might occur), we'd recommend taking another look at these underlying fundamental trends.

Yet in our conversation, Rip offered this final admonition that rising tax rates and regulatory burdens ultimately will depress economic growth rates and raise inflation rates, particularly after the cumulative effect of the government debt and monetary expansion of the last two years. **Beyond the next couple of years, Stagflation remains the real risk. That's the "flat" part of the square root sign.** Rip yawned (given his natural propensity toward idleness anyway), "I pretty much slept through the 1970's as those high tax rates and high inflation rate took away from my (and everyone else's for that matter) incentives to work, save and invest."

Stagflation is never good for the stock market, he opined, but in Stagflation, investors want more of this return up front in the form of dividends. So 2010 and 2011 are likely to be huge years of dividend initiation, restoration, and ultimately growth. Thanks for taking time out of your napping to offer this sage analysis and advice, Mr. Van Winkle.

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