

Investment Potpourri

The Stock Market

For the past three years, the stock market has been in a relatively narrow trading range. Earnings growth has been excellent and has helped erase some of the excessive valuations that built up in the late 1990's. In terms of yield, however, stocks are not on the bargain counter. The companies in the Standard & Poor's 500 Index now provide a dividend yield of 1.9%, well under the long-term median (1926-2005) of 4% and less than half the return provided by short-term U.S. Treasury obligations. The Index's price/earnings ratio has come down to median levels.

At the moment, the stock market seems at a stand-off between such favorable factors as 1) abundant liquidity, 2) lower oil prices, and 3) declining interest rates, and negatives like 1) a softening economy, 2) high debt levels, and 3) large trade deficits. The Wall Street crystal ball is always somewhat cloudy and today's imponderables include:

- Economy/Housing/Corporate Earnings—hard landing vs. soft landing?
- Federal Reserve Policy—further hikes/no action/cuts?
- Interest Rates (intermediate and long)—up or down?
- Inflation/Stagflation/Deflation?
- Consumer Spending (3/4 of Gross Domestic Product)—can they keep spending?
- Mid-Term Election—Republican or Democrat victory?
- War on Terrorism—will it be resolved?

People have related stock market decision making to the strategies employed by military generals. Sun Tzu is one of history's most famous military strategists and his advice was:

“Move not unless you see an advantage; use not your troops unless there is something to be gained; fight not unless the position is critical. If it is to your advantage, make a forward move; if not, stay where you are.”

This translates on Wall Street to the fact that avoiding losses and protecting your assets is just as important as making your money grow. To significantly overweight stocks, wait for periods when they are severely oversold and undervalued. At present, there seem to be enough questions and uncertainties in the environment to keep risk moderate, to ensure that portfolios are well diversified, and to emphasize quality in the selection of individual issues.

Demographics

In October 2006, the U.S. population is expected to reach 300 million. In 1967, it was 200 million, and in 1915, 100 million. Forty percent of the growth from 200 to 300 million has come from immigrants, half of them Hispanic. America's immigrant population was fifteen percent of the total population when we reached 100 million in 1915, five percent in 1967, and is twelve percent today.

Compared to other industrial countries, the U.S. is relatively young. Today, in the U.S. there are five people working for each retiree, but that ratio will fall to three-to-one when the last of the baby boom generation retires in 2029. In Japan, by mid-century, the ratio will be just over one worker aged 20-65 for each retiree. The same relationship is approximately true for European countries. California's population has gone from 1.5 million in 1900, to 6.9 million in 1940, and 40 million today. For Los Angeles County, over the same time periods the numbers are 170,000, 2.8 million, and 10 million. The orange groves and bean fields are gone and the Santa Monica freeway is a zoo.

What are the investment implications of these trends? Change is a part of life. We need to get better at urban planning. Huge amounts need to be spent on infrastructure. Washington struggles over how to temper population growth including the issue of a border fence. The environment, a safe food supply, and water are important issues. Politicians need to make sure their promises on Social Security, Medicare, and other social welfare programs are deliverable.

Housing

Housing is an important part of our economy. Economists believe one out of ten jobs in the U.S. are housing related. Two-thirds of American families own their homes and it is an important part of their balance sheets. When housing prices decline, consumers feel poorer and less willing to spend. Lower energy prices and interest rates may not be enough to offset this decline in confidence. David Rosenberg of Merrill Lynch has done some good work recently to put the housing outlook in perspective. He says residential real estate is currently valued at \$22 trillion, almost double the 1999 total. During that time period, home values have risen at an average annual rate of 11%. Increases in the cost of labor and raw materials cannot explain the rise, and rents have gone up only 3.2% a year. Rosenberg says the great housing price advance between 1999 and 2005 is a classic example of how a boom turns to mania and then a bubble. House prices, he says, are now the equivalent to eight years of wage income. It is Rosenberg's opinion that the unwinding of the excesses of the last six years will take time and will be painful. This housing outlook supports the probability of a hard economic landing.

November Elections

The Democrats are likely to pick up seats in both houses in November. Wall Street may not like it. Here are some implications if the Democrats are successful:

- Gridlock on Capital Hill
- Increased scrutiny of firms like Halliburton, Wal-Mart, and those in the drug and oil industries
- Emphasis on higher minimum wage, protectionism, and the environment
- Reversal of the Bush tax cuts and perhaps the 15% tax on long-term capital gains
- No permanent repeal of the estate tax
- Curbs on war expenditures and government spending in general

Inflation/Deflation

This is a tidbit, but it will be fascinating to see how it plays out. Despite the Federal Reserve's expressed concern about inflation, their worst fear is probably deflation. This happened last in the 1930's when the price of goods actually fell. This hurts the value of the dollar and increases the value of gold. At the moment deflation is isolated to particular products.

The problems of American automobile makers are well known. One further threat that hasn't hit the papers is the fact that China's simplest car (it probably does not meet U.S. safety and emission standards) is priced at \$4,000. Global oil companies would love to see these mass produced. Think of the demand for gasoline. A second deflation example is NBA-quality basketball shoes. New York Knicks player, Stephon Marbury, is endorsing sneakers priced at \$14.98 versus Nike Air Jordans that cost between \$100 and \$180. Two last examples, 1) does a \$4,000 Breitling watch tell time better than a \$50 Timex? 2) what will Wal-Mart's move into discount generic drugs (followed now by Target) do to drug pricing?

Over time, all will be revealed.

Effects of Recent Tax Legislation

President Bush signed a new tax relief bill on May 17, 2006, which extended the 15% tax rate on capital gains and qualified dividends to December 31, 2010. This low rate is valid under the regular tax system and the alternative minimum tax (AMT), which seems to apply to a growing number of taxpayers each year. So for the next four years, we can make investment decisions within the confines of our existing tax rate environment; and individual investors will continue to enjoy stock dividend yields without too much being paid out in federal taxes.

The new legislation allows all taxpayers to convert regular IRAs to Roth IRAs beginning in 2010. This results in an income tax bill for the value of the assets converted, to be paid over a two year period, but allows for tax-free withdrawals in the future.

Under the new legislation, the applicable age for the "Kiddie-tax" has been increased from children under age 14 to children under age 18. This means that the parents' top marginal tax rates will apply to the unearned income (in excess of \$1,700) of children under age 18.

The Pension Protection Act was signed by President Bush on August 17, 2006. One of its major benefits pertains to IRA holders who have reached age 70 1/2. During 2006 and 2007, these individuals can make charitable donations up to \$100,000 from an IRA. While these distributions will qualify as part or all of their Required Minimum Distribution (RMD), no income tax is paid on the distribution. While the taxpayer cannot take the contribution as an income tax deduction, he is usually better off foregoing the deduction and not reporting the income due to limits on total Schedule A deductions. The Pension Protection Act also gives permanent tax-exempt status to 529 college savings plans.

You should check with your CPA or business advisor before acting on the above legislation.

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