

INVESTMENT OUTLOOK

1st Quarter 2009

Since September 5, 2008 we have experienced a radical change in our capital markets. Perhaps I should spell it with a capital K for *Kapital*. Beginning with the conservatorship of Fannie Mae and Freddie Mac, government ownership of AIG, the engineered death of Lehman Brothers, the slippery slope of Citibank, Bank of America, TARP, TALF, PPIP, and the government firing General Motors' CEO...we investors have been kicked and volleyed about. We don't know where or when the next curve ball is coming from. Our government has made the challenge of investing stimulating if nothing else.

This recent form of Socialistic Kapitalism is a new paradigm shift for us. Rising unemployment, plunging corporate profits, unreal government commitments to prop up the economy all spell budget deficits as far as the eye can see. I don't like it. But I know how to survive it and prosper.

Wall Street's role

Part of the global financial systems belly flop was brought to us by Wall Street and their bankers. Yes, the same bankers are now angrily leaving their jobs because the government caps on their egregious bonuses cut a few million from their income. Perhaps this creative destruction is just what the economy needs: Turning college grads into engineers, nurses and manufacturers rather than over compensated Wall Street paper pushers. What a concept—workers who actually produce something useful and tangible rather than made-up, toxic securities no one can understand.

Perhaps this creative destruction will force voters to elect officials who can live within their city, county and state budgets. And maybe, just maybe, people will once again live within their means and continue to pay down the debt now flooding their personal balance sheets.

Deleveraging is salvation

The outcome of this *deleveraging* by business and households is slower growth. Good news for corporate bonds. By paying down debt, limiting these worthless share repurchases and cleaning up their balance sheets, corporate America will emerge from this recession much stronger. Less debt makes corporate bonds safer.

The public finance sector is not as fast a learner as corporations. Although many states are cutting back on social and health related expenditures, it's not fast enough. The rate of economic decline is faster than the deceleration of their spending.

Taxable equivalent yield

Two things for certain are increasing: State and federal taxes. The new California top tax rate is 10.55%. New York city-dwellers get scalped even worse: 12.62%. The new administration's "shared sacrifice" isn't shared at all. There is a cacophony of higher sales taxes, fines, fees, property tax, and sin tax. You name it. So it is obvious that the safest of safe, tax free municipal bonds will be "The Investment of Choice" for those of us weary of sharing any more of these sacrifices.

Californians in the highest combined state and federal tax bracket of 45.55% can easily earn 4% tax free in a safe municipal bond. The 4% is a taxable equivalent yield of 7.35%. New York City residents earning the same 4% in a locally issued municipal bond will have to find a comparable taxable investment yielding 7.64% to come out the same. Good luck—especially if you throw in the safety munis provide.

Worried about inflation? I think as our federal tax rates increase (which the current administration has been up front about) this will keep a floor under municipal bond prices and a lid on their yields.

If you believe US economic growth will slow for the next several years and that the choking regulations coming down from Washington may strangle future securities markets performance, then an additional dose of tax free municipal bond income will be the perfect supplement to your taxable retirement income.

Fixed income will outperform equities

Most analysts and portfolio managers are forecasting equity markets to generate much lower returns than those of the 1980's and 1990's. High quality investment grade corporate bond yields are equivalent to what's usually associated with equities. Remember, a very large percentage of equity returns was due to dividend payments. Now, with the average dividend yield of all S&P 500 stocks at a low of 2.38%, bonds offer superior risk-adjusted returns. Over \$77 billion of dividend cuts were announced in the first quarter, additional dividend cuts are likely. This is bad for equity holders but great for bond holders. The same effect for a bond would be that it stopped paying its coupons—in other words, default. Unlikely in most cases.

As the baby boomers pick themselves up from their 401k and IRA equity annihilation they will become more risk averse. There's no time left to make up stock market losses. All these ingredients bode well for the bond market. For the foreseeable future, the time has come for we fixed income investors. We'll make the most of it!

Enjoy the ride,

