

## CINDERELLA IS BACK

January 4, 2012

It's that time of the year when we venture forth with our list of possible surprises for the coming year. In thinking through the possibilities, it occurs to me that many appear to be lined up and interdependent, leading us to envision a "surprise scenario" for the first six to nine months of 2012. All this stems from a potential domino effect of these possibilities. The prospects are quite exciting, but at this early date seemingly a bit farfetched. Nevertheless, I will attempt to lay out the pieces in a way that will explain the possibility of a "Cinderella Market" for the better part of 2012.

The recent strength of the dollar, triggered by comparative weakness in other global economies, will have a deflating effect here at home. Commodity prices, all denominated in dollars, will likely weaken as a result of a strengthening dollar. These lower prices will translate to lower raw material costs for U.S. manufacturers giving them higher profits than their foreign competitors.

A strong dollar also has the additional effect of lowering prices of foreign products in the U.S., effectively increasing the disposable income of Americans. The overall effect will be similar to a tax cut for individuals and manufacturers.

The deflationary effect also helps the Federal Reserve Board in its fight against inflation, enabling the continuance of low interest rates, in spite of our diminished credit rating. Low rates, in turn, keep the cost of business credit cheap, and allow more would-be home buyers to qualify for mortgages, helping to firm housing prices. An actual increase in home prices is distinctly possible for a short while, as inventories have been depleted in many parts of the country.

When comparing the values of asset classes around the world, one can quickly conclude that the United States Equity Market is the most attractive alternative for investors. The dividend yields for many well-financed companies far exceed the prevailing interest rates for bonds. Additionally, the current tax code allows for a healthy "tax discount" for dividend recipients over bond holders.

These unusually low relative valuations have evolved through the "din" of volatility, credit risk, and budget deficits. Nevertheless, most "fixed income" investors still find themselves committed to bonds for their income needs. A shift in allocation to stocks for some fixed income investors could unleash enough buying power to spark a significant stock market rally. After all, there are still trillions of dollars invested in bonds at these low interest rates.

American equity investors, after being counseled to make foreign investments for years, now find that troubled markets in Europe and the Far East are creating losses in foreign portfolios. The strong dollar is creating currency losses on top of these market losses. If this trend continues, we envision a flood of repatriated dollars coming home to purchase American equities in order to escape the "double whammy" involved with foreign investing.

Our "Cinderella Market" thesis up to this point has been based on the effects of a strong dollar emanating from weakened foreign economies, and foreign financial stress. But there is more.

An internal look at the "business of America" reveals some emerging economic strength. Unemployment claims are down while consumer confidence numbers are up. Credit card delinquencies are down while purchasing manager's indexes and railcar loadings are up.

Preliminary readings indicate the Christmas retailing season closed on a strong note. All-in-all, these are signs of strengthening in the American economy, and while not robust, any strength is like a breath of fresh air. These positive fundamentals can easily provide the catalyst for the rest of our Cinderella Scenario to come together.

The dismal American mood and its overall “funk” are ready for a change. The anti-Wall Street political rhetoric has helped create a very negative outlook within the much maligned Wall Street community. As the primary season begins to identify the Republican Candidate, we can expect an uptick in the polls for the new challenger, bringing some uplift in spirit to Wall Street. Frankly, this attitude change will probably be temporary, but its very timing could go a long way toward helping the market. The nearing of the Supreme Court decision on ObamaCare, scheduled for June, could trigger speculation that the legislation will be overturned. We give it a 50/50 chance, but it is cause for hope by many who fear the legislation for its higher costs and tax increases.

These reasons could easily support a surprising Cinderella Market in 2012. However, they are not likely to last for long, as they do not address our long term financial and economic structural problems.

The realization that we are in a “longer term high unemployment and lower growth trend” environment suggests that recessions will be more frequent and recoveries shorter in duration and somewhat intermittent. Accordingly, investors’ holding periods must be reduced in an effort to maximize returns in this increasingly volatile environment. Long term growth will be difficult to achieve unless we can grow revenues at a faster rate than expenditures. To that end our belief is that we must cut spending growth; but, we will leave this subject for now as you will have ample time to hear this argument repeated often during this election year.

In the meantime, I’ll take a surprise Cinderella Market worth a couple of thousand points or so on the Dow...before the clock strikes twelve.

Happy New Year!

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