Boenning Morning Comment

This report is prepared for us by Tower Bridge Advisors July 2, 2010

Stocks lost ground again yesterday although they recovered significantly from the morning lows. Once again signs of slowing economic growth weighed on equities. Slower manufacturing growth in June, higher weekly unemployment claims and very weak pending home sales, none of which were very surprising, were the primary downside catalysts. The market is desperately looking for any piece of positive news but expecting the worse.

As problems get larger, the urgency to respond increases. In the last couple of months stocks have declined by over 10%, growth appears to have slowed and job growth appears to have decreased dramatically. We will know more details about jobs later this morning. Somewhat slower growth and a modest decline in stock prices so far hasn't generated much in the way of urgency in Washington but that is starting to change. As stock prices fall day by day, as more and more economic data indicates economic weakening, and as talk begins to rise about the possibility of a double-dip recession, the President has begun to speak. Initially his instincts are to deflect the blame. The problems were created by the Bush Administration. Past policies failed. Big business is responsible. Banks won't lend even after the big TARP bailout. You know the rhetoric. But as time passes, these excuses hold less and less water. After all, Americans don't really want to know whom to blame, they want more jobs, more income and more security. It is the President's job to provide them.

November is a big election and it is barely over 120 days away. It is obvious that the worse shape the economy is in, the worse incumbents are going to do. Since it is the Democrats who are in the majority and who have controlled policy initiatives 100% for the past year and a half, they are going to be held accountable. They may try and blame someone else but voters aren't going to buy that.

It is virtually impossible for policy actions initiated today to actually create millions of new jobs by November. Congress and the American public aren't going to buy a repeat of the $800 billion stimulus package passed last year given that it fell way short of goals. But as problems get more severe, at some point the President is going to have to put issues like immigration and cap and trade/tax aside and address the one issue American voters have declared is number one every election since the Great Depression. Jobs. The right policy initiatives, even if not fully implemented by the time of election, will be cheered by both Wall Street and Main Street. The wrong initiatives will be quickly booed. Reflect back to the fall of 2008 when Bernanke and Paulson were flailing away almost daily trying anything that would work. Even when they finally came up with TARP, they had to alter the original purpose from buying toxic assets to direct bank investments. Stocks didn't go straight up immediately. But they stopped going down and a new bull market started a few months later.

There is no guarantee the Obama administration will get it right but, if the data continues to move in the wrong direction, there is virtual certainty that it will try and Wall Street will quickly issue its report card. They will know quickly whether they are on the right path. If they fail, it will be Republicans in Congress next year that will likely lead the way. Remember 1994? President Clinton had eroded public confidence pursuing health care reform and voters swept Republicans into power with their Contract for America. Of course right now, Republicans don't have an equivalent contract but expect something from them by Labor Day. Hopefully, our economic course 6 months from now will look a light brighter than it does today.

But six months is a long time. Meanwhile investors are suffering. Out of fear they are piling into government bonds driving the yield on 10-year Treasuries down below 3%. If fear worsens, even 2% is possible. The 2008 low was 2.11% so it isn't that far fetched although that certainly isn't a forecast at the present time. Against that backdrop, dividends look rather appealing. Many blue chips with decades long records now yield over 3%. In March 2009, when the 10-year yielded 2.11%, the yield on the Dow approached 4%.

Today, however, the picture is better. Corporations are flush with nearly $900 billion in cash. With so much excess capacity they don't have to spend that money on expensive expansion. A good chunk of that cash is available for shareholders. As growth slows for many companies cash flow increases. Companies like McDonald's have increased dividends sharply in recent years and investors have bid up share prices. But for some companies the egotistical decision to admit they can no longer grow at historic rates is a chasm too big to cross. So they sit on the cash. Some pay small dividends to appease those who complain. Think Microsoft. Others, like Cisco, pay nothing at all. They create a dilemma for shareholders. On one hand, they are generating huge cash flow which should be reflected in higher valuations. But without communicating a coherent plan for building cash balances, shareholders are reticent to bid up stock prices. Companies respond that they actively buy back stock but they have horrible records of buying at low prices. In fact, they usually buy at high prices. Both Microsoft and Cisco own Treasury stock portfolios purchases at much higher prices than current valuations. No one is going to reward managements for building a portfolio of stock now down 20%, 30%, 50% or more.

Let me use Microsoft as an example. It pays $0.52 per share and trades at a little over $23 per share. Yield of 2%+ is nice but not overwhelmingly appealing. But here is a company with tens of billions of dollars in excess cash on the balance sheet that will earn well over $2 per share this year and next. Historically, maturing blue chip growth companies can and do pay out 50% of earnings. Given that Microsoft has virtually no capital expenditures and absurdly high profit margins, it probably can pay out more. The government almost certainly would ban any attempts by Microsoft to make a huge acquisition in the computer industry and investors certainly don't want it to buy into another business. If the company increased its dividend to $1.00, it could still maintain its stock buyback program. Such a dividend would generate a yield of over 4%. Undoubtedly the stock would sell up sharply bringing the yield down into the mid or low 3% range. Can you think of any decision Microsoft could make that would be more rewarding to investors?

Microsoft isn't alone. Many companies are destined to grow a lot more slowly in the world we live in and will generate increasing amounts of free cash flow. Indeed, over the next several years, as the world deleverages, slower growth and higher dividends may become the norm. Higher dividends are the only attribute of common stock that bonds can't match.

Today Lindsay Lohan is 24. Acts 12. Larry David is 62.

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