December 17th, 2010

The Capital ReCap

ReCap

Economic Activity

- Federal deficit widened by $30.1B, the 26th straight shortfall. (-)
- Retail sales rose more than expected; rising 0.8% in November. (+)
- PPI was up 0.8%, the 5th consecutive monthly rise. (+)
- CPI was up for its 5th consecutive month, albeit lower than expected. (-)
- Capacity utilization rose slightly to 75.2%, below average of 80.6%. (+)
- Housing starts rose 3.9%, while building permits fell 4%. (+,-)
- Initial claims continue to fall; dropping 3K. (+)

Equity Activity

- ORCL saw its profit jump 28% on a 47% rise in revenues.
- RIM saw record phone shipments for 6th consecutive quarter; earnings up 45%.
- BBY saw revenues come under pressure as top line dropped 5% and EPS estimates downgraded.
- MCD plans to boost spending in China by 40% next year.
- After failing to win 3Par deal, Dell acquires Compellant at near 20% discount.

Inside the Numbers

As we closed out the final full trading week for 2010, we saw markets close relatively flat. The S&P 500 was up less than half a percent.

Despite many investors' desires to have mindsets shift from contagion and yield curve worries to Santa and the New Year, we still had a good amount of economic data to digest.

We received some data pertaining to the well-known fiscal problems facing our country. We saw the budget deficit widen for the 26th consecutive reading. As NDR reports, the deficit now represents 8.9% of nominal GDP. We also saw the current account deficit, our dependence on foreign capital, widen by $4 billion.

On the consumer front, we continue to see strong retail numbers. Not only did we see a better-than-expected reading this month, we also received upward revisions for October and September. NDR points out that retail sales growth has historically been correlated with nonfarm payrolls growth. If this continues, we could see a strengthening economy into 2011.

Another point of interest was the CEO economic outlook index, which rose to its highest level since Q1 2006. The survey, which was completed prior to the tax legislation being introduced, showed that CEOs expect increases in employment, capex, and sales over the next two quarters.

Lastly, we received some inflation data. PPI continued to rise and is now up 3.5% year-over-year. Also, CPI is up 1.1% on a year-over-year basis. With the recent move by General Mills to raise product prices, we are beginning to see the rise in commodity/input prices passed onto the consumers. This is due to the fact that companies cannot continue to see margins contract due to increased costs and will likely be a trend into 2011.

The Capital Course

(All data used within The Capital Course was provided by Ned Davis Research)

With this being the last Capital ReCap of the year, we thought it would be good to revisit the ReCaps most talked about topic from the year: dividends. With the extension of the 15% dividend rate, along with the rest of the tax rates, investors have been relieved of a major uncertainty surrounding taxes.

Now that the rates have been extended, it seems more likely that companies will use their cash to boost dividends because of the low rate shareholders have to pay, rather than boosting stock repurchases. Also, we will likely see a jump in capex spending, as the new tax legislation will treat capex spending very kindly for the upcoming year.

With the tax question answered regarding dividends, the million dollar question now becomes where should investors put their money in order to reap quality dividends or increased dividends for the upcoming year.

NDR recently released a report on the comeback of dividends. They showed that currently the average dividend payout for companies, or the percentage of earnings that are paid out as dividends, is close to 35%. This is well below the long term average of 59%. Also, companies are holding a record amount of their net worth in the form of cash… this being close to 14.6%.

Looking at those two data points would suggest that spending will likely increase and that will probably include dividends moving higher.

One industry which should be looked at when wanting to find dividend growers over 2011 will be the financial industry. Throughout history, financials have been known to pay healthy dividends and that was one of the main reasons for investors to hold these companies. As we begin to see the major financial firms pay back TARP and get out from underneath the government's reins, we may begin to see these firms boost dividends. Financials continue to be flush with cash and their balance sheets are getting healthier every quarter. As management becomes more comfortable with the economic environment, investors may reap benefits in the form of increased dividends.

Internally, we performed a very basic screen of the S&P 500 looking at three fundamental factors: dividend payout, cash position and free cash flow yield. We screened for the companies that had dividend payouts less than the average, but cash positions and free cash flow yields greater than the average. The basic assumption was that these companies are in a position to raise dividends in the future. Interestingly enough, nearly 25% of the companies that made it through the screen were financials.

Microsoft is one company that investors don't tend to use in the same sentence as dividends but actually made it through this screen. Microsoft recently increased its dividend by more than 20% and seems committed to continue paying their shareholders with their large, over 40% of its total assets, cash position. As the company continues to mature and see fewer positive ROI projects, it will continue to return cash to shareholders in the form of dividends.

Going into 2011, dividends will continue to be a hot topic and play an integral part in equity total returns. As NDRs research has pointed out, dividend growers and initiators have historically outperformed others, returning greater than 9% per annum.

Thanks for perusing.
CIA