November 19, 2010

The Capital ReCap

ReCap

Economic Activity

- Retail sales get boost from Autos; rises 1.2% for October. (+)
- Empire manufacturing plunges to 26.9; suggesting contraction. (-)
- Business inventories rise slightly. (+)
- PPI rises 0.4%, helped by gasoline prices. (+)
- CPI rises slightly, also helped by gasoline prices. (+)
- Housing starts drop 11.7%; the weakest level since April 2009. (-)
- Building permits rose slightly. (-)
- Initial claims rise 2,000; stay near lower bound. (-)

Equity Activity

- Ireland will be bailed out by EU; a three-year package of loans worth about $110B.
- CAT reached a $7.6B deal with mining equipment maker Bucyrus.
- LOW profits rise 17% on revenue jump of 1.9%; executives give bleak outlook.
- WMT saw profits rise 9.3%, revenues up 2.6% on strong international sales.
- HD profit soars 21%, revenues up 1.4%.
- GM raises $18.1B in IPO.
- TGT profit rises 22% on 2.2% rise in revenues.

Inside the Numbers

After turning to the negative over the past couple of weeks, markets took a breather and were relatively flat on the week. The S&P finished slightly below the 1200 mark and was up just 0.04% on the week.

A slew of economic data was released over this past week. Within the data, we got some idea of the health of the consumer and the state of inflation. Retail sales were up for the fourth straight month. The 1.2% rise in retail sales was mainly lifted by a 5% jump in auto sales.

Within the inflation indicators, we saw a small rise in the PPI. It was the fourth straight jump in the indicator. The 4.3% year-over-year growth is the fastest rise since May. The CPI barely moved and on a core basis (excluding food and energy), the index ticked down slightly (-0.007%). On a year-over-year basis,CPI is up 1.2%, well below the Fed's desired levels.

We tend to see PPI rise before we see it within the CPI index because producers bear the price hikes before consumers. Companies have been hesitant to pass these rising prices onto the consumer, but as has been seen in recent earnings reports, this could change soon. Companies are starting to see margins squeezed because of rising costs and these will likely be passed onto consumers in the near future.

On the housing front, we saw some mixed data as housing starts plummeted, but permits for new houses rose slightly. It still seems interesting that building permits continue to rise despite seeing a lack of demand within the housing sector.

The Capital Course

Over the past few weeks, the bond market has had the spotlight shined on them again. Ever since the Fed came out with their $600B bond purchase plan, we have seen bond yields go up and prices go down—just the opposite of what the Fed intended to accomplish.

The Fed's ultimate goal for the most recent quantitative easing was to lower yields on Treasuries far enough to force investors out of these safe haven investments and into riskier assets (such as stocks). With this philosophy, the Fed was looking to boost the stock market and ultimately boost individuals' asset values, thus increasing individual net worth and ultimately leading to higher consumer spending.

Other than continually monitoring the impact of the Fed's decisions on the overall economy, we continue to monitor the impact these decisions have on bonds and the total return they offer to income investors. Bond prices and yields move inversely, thus the recent rise in bond yields has had a negative effect on bond prices within portfolios. The question that needs to be answered is: how much do yields have to rise in order to make the percentage decline in value wipe out the investment's yield?

As an income investor, our main goal is to generate income, but we still have to be cognizant to negative impacts on values, as we don't want declining prices to wipe out our entire positive income stream. We tend to monitor this by watching the investment's duration and the change in yield for the Treasury investment that most closely reflects the investment's average maturity.

Looking at three investments we hold or have held, we can see how the recent yield increases have impacted the investments' values and ultimately their total return.

BSV is the short-term bond fund that we hold and we can compare this to the five-year Treasury. We can see that from August 20th (when yields were close to the lowest levels) to November 17th the five-year Treasury yield has not budged. The yield is still at 1.46% thus BSV, theoretically, should see minimal price fluctuations. And that has been the case as the security has seen a decline of only 0.29%, thus its total return is mainly the yield or approximately 2%.

BIV is the intermediate bond index and we decided to compare this investment to the 10-year Treasury. We can see that the value should be negatively impacted by about 1.5% (based on durations and changes in the 10-year yield) because over this time period, the 10-year yield has gone from 2.61% to 2.86%. In actuality, BIV has fallen in price 1% over the past four months. But with a dividend yield of close to 3.80%, we are still experiencing a total return of a positive 2.80%, while also receiving our desired income stream.

Lastly, BLV is the long-term index and we have been comparing it to the 30-year Treasury. We see that BLV should have a negative impact on its value of close to 8.2% as the 30-year Treasury has seen its yield go from 3.66% to 4.28%. The real price impact on BLV has been a decline of close to 7%; thus, with a yield of 4.80%, we have seen the total return on BLV be a negative 2.2%, approximately. With the concern of yields rising and the large impact it would have on the longer end of the yield curve, our Investment Committee decided to get out of BLV a few months ago because of the sole reason of seeing this negative total return.

As we can see, prices become more volatile as you move further out on the curve. Thus, it becomes more and more important to monitor the outside influences on the bond markets and bond yields. We are not saying that yields can't go lower, but we will continue to monitor them in order to continually accomplish our ***primary*** goal of the best possible income stream while trying to get the best total return we can in these markets.