
Todd's Perspective

Winter 2012

Economic Forecast 2012

Speech by Bosworth Todd before the Louisville Rotary Club
Louisville, Kentucky – January 19, 2012



Introduction:

I cannot remember a time when there was so much uncertainty about so many important issues. The persistent failure of our leaders to deal with underlying financial imbalances throughout the global economy lies at the root of current problems. Our policymakers are more focused on reflating demand than on dealing with excess of debt. However, the reluctance of consumers to take on more debt means that the process is now being driven by the government rather the private sector.

The prospect of a rising federal budget deficit is the next big threat to our financial stability and likely will be the source of the next big crisis, but probably not for several years. In that respect we are better off than Europe. They don't have the luxury of being the world's only reserve currency.

Undisciplined World:

Thirty five years ago in a letter to a friend, Dr. Albert Hettinger, age 85, a partner at Lazard, said: "We live in an undisciplined world that I believe stems from two factors—the excesses of a welfare state which has created expectations well beyond the ability of any economy to meet and, secondly, an endeavor to meet them

through printing more currency regardless of the fact that we can consume only the goods and services produced and can't eat \$20 bills." This letter could have easily been written today.

Today we have extreme government intervention and unsustainable stimulative policies. Remember last year we called this a "hostess twinkie' economy. It's like a 'sugar high', with massive deficit spending, and a Fed policy which interferes with the marketplace. It does this by driving down interest rates to practically nothing on short term notes and only 1.9% on 10- year Treasuries. The government is now spending \$1.60 for every \$1.00 in revenue. Don't expect Washington to let up on stimulus before Election Day.

The San Francisco Fed President said recently that uncertainty is having a depressing effect on the economy, as firms worry about the direction of policy and regulation, and households worry about income. Political gridlock in Washington and Europe add to this anxiety. Their research suggests uncertainty alone has potentially added a full percentage point to the unemployment rate.

My Economic Forecast:

How did my forecast of the economy and market work out last year? We had a bizarre market in 2011. With hindsight, the best approach would have been what seem to be contradictory bets on inflation [gold rose 31%] and on deflation [long term treasury bonds returned 30%!]

I got very close on four of nine statistics: I forecast 2.9% real GDP growth for 2011 and it came in about 2.8%. Thanks to Europe's problem's we may slow to 2% in 2012. I forecast West Texas crude oil would rise about 12% and it rose 13% to \$101. Because of tensions with Iran it may rise 10% this year to \$110. I expected earnings on the S & P would rise about 12% to \$94 and it appears they rose 14% to \$96. My estimate of \$101 this year is below the \$106 consensus from a recent survey. I thought the Euro would drop about 6 cents to \$1.27 and it dropped 3 cents to \$1.30. I look for a drop t \$1.24 this year

I got the direction right but was too timid on one variable. I expected gold to rise 6% to \$1,500 and it rose 10% to \$1,566 an ounce at year end, down about 15% from its August peak of \$1878. At that point it was up 50% from a year earlier and 600% from its lows ten years ago. It makes sense to maintain a modest position in gold as a hedge against continued currency debasement, even though current inflation is modest. I guess it might rise 10% this year to \$1725.

I was wrong on four. I expected the S&P 500 to rise 12% to 1410. It changed hardly at all, closing the year at 1257, having gyrated all over the place during the year. I'll guess 1325 this year, up a little more than earnings growth. I missed the inflation figure. I expected 1.5% and it

came in at 2.8%. I think Bernanke might achieve his 2% target this year.

I thought unemployment would stay about 9.5% and it fell to 8.6%, and most of that was in the last 3 months. I'll forecast it will drop to 8.3% by year end. The big shock was my forecast for the 10- year Treasury. I thought it would rise from 3.3% to 4%. Instead to my surprise it fell to 1.9%! That is a terrible shock to the conservative saver. I look for no change this year as the Federal Reserve has made clear its intention to keep short-term interest rates low through 2013.

What Have I Learned?

There are limits to what markets will tolerate in deficit spending. Possessing the world's only reserve currency is both a blessing and a curse. We have benefitted from dislocations in global financial markets. I thought our rising federal deficits would cause interest rates to rise, particularly after S&P downgraded the AAA rating on our Treasury bonds. Instead they fell. We became a safe haven for European investors. We are lucky that we have a political union as well as an economic union and thus our political process is forcing a change in our thought process, thereby giving us a chance to get our house in order before the markets do it for us. We have 2.0% interest rates vs. 6% or more in some European countries.

What is my Highest Conviction?

Of all the world's investment categories, high grade stocks, serving a global market possessing mountains of cash, willing to pay dividends, may be the single greatest source of real returns over the next decade. It certainly won't come from high grade bonds. Such stocks tend to be large, boring, and often out of favor, but they are

ideal in these uncertain times and where there are few liquid alternatives for income and stability. I'll list a few in a moment.

Opportunity in Crisis

Every crisis provides an opportunity to find some new bargains. Stocks should outperform cash and government bonds over the coming year. Valuations are reasonable.

Five stocks for 2012:

I still like our "3-D" theme that is stocks that are: Diversified globally, a Dominant brand image, and a good Dividend. From last year's list, I am replacing AFLAC [AFL \$44] with Microsoft [MSFT \$28]. Aflac's 27% price collapse reflected investment losses in troubled European countries.

Microsoft [\$28, MSFT], a new addition, after producing a number of flops, has just introduced, with Nokia as partner, "Windows Phone", what critics say is the best smart phone on the market. There is also excitement about improvements in the X-box and the forthcoming updated operating system for the PC, called "Windows 8".

Microsoft's earnings have grown at a steady 11% rate for the last decade, yields 3%, and has a AAA balance sheet. Yet the stock remained flat. Thus the price-earnings ratio has dropped from 40X earnings to 10X. It earns \$23 billion on revenues of \$70 billion. This is huge profitability.

I have four carry-over stocks, McDonalds [MCD \$100] They have 33,000 stores throughout the world, grows earnings at a steady 13% clip, and yields 3%.

Philip Morris International [PM \$73]. While mounting regulation and health concerns continue to weigh on domestic tobacco stocks, this company which serves markets outside the U.S. has prospered after spinning off from Altria four years ago. It is now four times the size of the domestic company and has 54 plants around the world, serving 150 countries. It has substantial and steady cash flow. It has increased earnings at a 15% rate the past three years and yields 4%.

Coca Cola [KO \$67] is the world's largest beverage company, marketing over 500 brands throughout the world. It has increased earnings and dividends at a steady 10% rate for 50 years. It yields 3%.

Vodafone [VOD \$27], as you recall, is a British-based company with wireless operations in 26 countries, including 45% of Verizon Wireless in the U.S. While revenues are expected to slow to a 5% growth rate, the chief appeal is the 5.5% dividend yield.

This five-stock package yield 3.6%, sells at 14X 2012 estimated earnings, and has an average earnings growth rate of 10%.

Thinking Fast and Slow

In his new book, Thinking Fast and Slow, Nobel Laureate Daniel Kahneman says our brains are not well designed to exercise sound judgment. Investors are prone to overconfidence. They are constantly deluded by compelling stories. We also tend to disregard information that refutes our prior view. Extreme aversion to losses can lead investors to reject outstanding bargains at market troughs.

On Market Timing

Don't panic over transitory news. Stick to your plan. Too many investors with limited skills engage in too much portfolio turnover. Three fourths of all mutual funds failed to meet their benchmarks last year, a particularly volatile one. One should prevent emotion from overtaking reason. Market timing seldom works.

Benjamin Disraeli, a British Prime Minister, who died over 130 years ago, was noted for his business advice. He once said: "what we anticipate seldom occurs, and what we least expect generally happens."

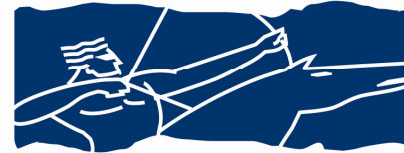
Conclusion:

Our economy ended 2011 on a strong note that is carrying over into the New Year. At the same time the European Central Bank's repo program may yet deliver a credible plan that will ease pressures on their fragile banks. The global environment will stay more deflationary than inflationary this year, despite large budget deficits in a number of countries. High unemployment has robbed labor of bargaining power over wages.

Government bonds are way overvalued, yielding less than 2% on a 10-year bond. Return prospects are better on corporate and municipal bonds. I love the 3% yield on good stocks. The tug-of-war between monetary stimulus on one side, and fiscal austerity on the other, points to continued market volatility but Coca Cola will still be the pause that refreshes.

Written by **Bosworth M. Todd, CFA,**
Chairman Emeritus

TODD-VEREDUS



ASSET MANAGEMENT LLC

101 SOUTH FIFTH STREET, SUITE 3100,
LOUISVILLE, KY 40202
(502) 585-3121 • (888) 544-8633 • FAX (502) 585-4203
www.toddveredus.com

This publication contains the current opinions of the author but not necessarily those of Todd-Veredus Asset Management, LLC. Such opinions are subject to change without notice. This publication has been distributed for informational purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy, or investment product. Information contained herein has been obtained from sources believed to be reliable but not guaranteed.

Specific stocks discussed are included solely as part of the review, and are not and were not recommendations for purchase or sale by investors. All or some of the specific stocks mentioned may have been purchased or sold by accounts under management in the past, and may be purchased or sold in the future. Investors should not construe the performance of any security as predictive of future results.