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March 26, 2009

Dear Client,

## The Trudge Will End

For even the thickest of skins, today's environment is proving to be most challenging. Phrases like depression, financial collapse and socialism are making the rounds and making folk concerned. A general sense of uncertainty with regard to the stock market, the economy, and the new Washington administration makes the scenario even worse.

From an investment strategy standpoint, I operate under the assumption that I can not predict future events. By example, coming off the dot-com bust in 2002, I did not anticipate the double digit returns of the following years. Vanguard Total Stock Market Index, a broad representation of the whole U.S. stock market, posted total returns of 31% in 2003 and 12% in 2004. Vanguard Total International Stock Index, a representation of European, Pacific, and emerging market regions, posted total returns of 40% in 2003 and 21% in 2004. Many sector funds representing energy and real estate looked even better.

Each morning, I trudge down my driveway to retrieve *The WSJ*. I say "trudge" because the walk has become a tiring journey. Most mornings greet me (and the rest of us) with bad news. Under Rupert Murdoch, the *Journal* has taken a more sensationalist format, with blaring headlines that make my morning routine somewhat less enjoyable.

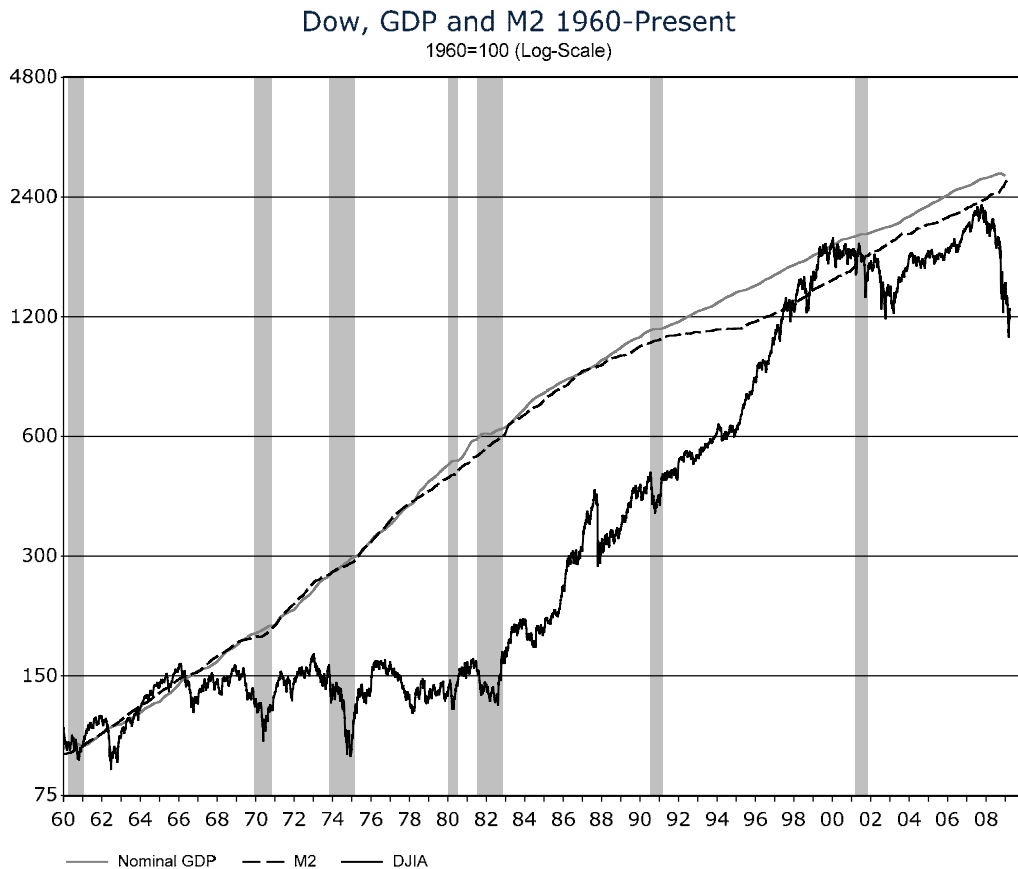
But not all the news is gloomy. Through the noise of nasty headlines and television's pessimistic talking heads, I have picked out trends, commentary and editorials with a more upbeat perspective. I want to acknowledge today's unpleasant environment, but also highlight items that give me optimism for the future.

### The economy and money growth

As the following chart demonstrates, since 1960, nominal GDP (the economy) has grown at an annual compounded 7.2% through the end of 2007. Money growth (M2) has been the same, at 7.1%. For stocks, the compounded rate of growth has been a close 6.8%. Doesn't it seem logical, then, to look at long-term economic and money growth as growth-track magnets for

*"Diversification and patience built on a foundation of value and compound interest."*

stock prices? The chart below lays out nearly five decades of history. My assumption here is that stock prices will eventually fall in line with the other two.



### Potential for explosive rebound

When a rebound comes, it could be explosive. In the recessions of the early 1970s and 1980s, the prime rate was 20% and 12%, and CPI inflation was 14% and 16%. Average unemployment at the cycle trough was 17 weeks and 21 weeks. In the current cycle, we are already at 19.8 weeks, but the prime rate is a scant 3.25% and the CPI is negative. Much of the unemployment discussion may be overblown. Last June, over 75 million Americans started to retire, leaving their jobs in droves. Even in a normal year, corporate turnover can be much higher than you might expect. Don't forget, many companies had overstaffed in the prosperous years of the recent past.

With streamlined head counts, cheap cost of capital, and plummeting raw material costs, profit margins coming out of today's current recession could explode. To date, the BRIC countries—Brazil, Russia, India, and China—are still on track to record positive GDP growth in 2009 (we'll see). This enormous buying power group was not in place following the early 1970s and 1980s recessions.

## Myths about banks

In a March 9 *WSJ* editorial, Kenneth Lewis, chairman, chief executive officer, and president of Bank of America provided some clarity on a few key claims that he believes have been repeated so often they are now taken to be fact.

Claim #1. The banks aren't lending. "This claim is simply not true. Yes, banks have tightened lending standards after a period in which standards were too lax. But, according to Federal Reserve data, bank credit has actually increased over the course of this recession, and business lending is trending up modestly so far in 2009. Also, mortgage finance volume is booming as a result of low interest rates. What's gone from the system is the easy credit that got us into this mess, as unregulated non-bank lenders have disappeared, and the market for many asset-backed securities has all but dried up. Most banks are making as many loans as we responsibly can, given the recessionary environment."

Claim #2. The Troubled Asset Relief Program (TARP) hasn't worked. "Not true. Last October, when the TARP was enacted, systemic risk threatened our entire financial system and economy. The point of the program was to stabilize surviving banks, prevent a total meltdown, and enable banks to lend more. TARP and other government programs have worked, and banks are making more loans as a result."

## Recovery indicators being ignored

In his March 3, 2009, blog, Larry Kudlow had the following to say about recovery indicators.

As Team Obama readies its nearly \$300-billion mortgage bailout—a plan that at best will have only *minor* positive impact, and at worst will welfare-ize the housing sector even more—there are recovery indicators out there that are being ignored by the pessimistic administration and its media allies. Consumer incomes, after tax and adjusted for inflation, have increased for five straight months, which is largely from the tax-cut effect of plunging energy prices. Housing affordability is at a record high. Purchasing-manager surveys are now bottoming out. Fear-based credit spreads continue to decline. The money supply is expanding rapidly. And commodity prices are bottoming.

And then there's one indicator that never gets enough credit—the shape of the Treasury yield curve.

When short-term rates moved above long-term rates back in 2006, [U.S. Federal Reserve Chair] Ben Bernanke rushed to tell us that it would not signal a recession, since interest rates were too low and historical precedence would not apply. By the middle of 2006, this curve had turned decisively negative, and roughly a year and a half later the economy headed into recession.

However, the Treasury curve has right-sized since February 2008, roughly a year ago. Today, 10-year govies are roughly 3%, while the 3-month Treasury bill is about 0.25%. This, of course, is a sign of monetary ease—usually with about a one-year lag the economy responds to this therapy. Well, it's about a year right now.

Noteworthy is the factoid that nearly every post-WWII recession has been preceded by an inverted Treasury curve and an oil shock. Sound familiar? Then the economy heals as oil prices come down and the Treasury curve normalizes. Also sound familiar?

### Pent-up demand could quickly pull economy out of its hole

The *WSJ*'s Justin Lahart wrote on February 9 that “companies have cut back on new equipment spending to the point that they may no longer be keeping up with the rate of depreciation on their old equipment. In the fourth quarter, spending on new equipment and software fell at a 27.8% annual, inflation-adjusted rate—the steepest decline in 40 years. Once consumers and companies start thinking the worst is behind them, they will have some spending to catch up on, as they replace holed socks, keyboards with sticky keys and the like.”

### A perma-bear is buying

Jeremy Grantham, who oversees \$85 billion as chief investment strategist of Grantham, Mayo, Van Otterloo & Co., urged investors to start moving money from cash to stocks before “rigor mortis” sets in, reported Bloomberg on March 10. “Typically, those with a lot of cash will miss a very large chunk of the market recovery,” Grantham wrote in commentary posted on the company’s website on March 4.

Grantham estimates fair value on the S&P 500 at more than 30% above today’s level. He is also predicting inflation-adjusted returns of 10%-13% over the next seven years. At an assumed 2% inflation rate, investors would earn more than 160% over the next seven years under Grantham’s scenario.

Grantham, 70, earned the nickname “perma-bear” by colleagues for his grim view on stocks for more than a decade.

### Missing market gains

Over the years, I have cited work done by Ibbotson Associates to illustrate the dangers of market timing. Ibbotson makes the case that investors who attempt to time the market run the risk of missing periods of exceptional returns. “A hypothetical \$1 investment in stocks at year-end 1925 grew to \$2,279 by year-end 2001. However, that same \$1 investment would have only grown to \$15.97 had it missed the 38 best months of stock returns.” Similar results were found when observing the 20-year period ending in 2001.

Ibbotson concludes: “Although successful market timing may improve portfolio performance, it is very difficult to time the market consistently. In addition, unsuccessful market timing can lead to a significant opportunity loss.”

On March 5 the Dow rose 2.2%, to be followed by another advance of 5.8% on March 10. On March 5, Caterpillar and Alcoa led the Dow with 13% single-day gains. Citigroup and GE led stocks on March 10 with gains of 38% and 20%, respectively. For the week ending March 13, the stock market recorded its best week since November, with the Dow Jones Industrial Average advancing 597 points, or 9%. Ibbotson cautions investors against missing too many of these days.

Whether or not the recent market gains are the start of a recovery is impossible to say. What does seem probable is an environment offering sharp, unexpected gains in a short period of time. Long-term investors will not want to miss these gains.

One of our goals at Richard C. Young & Co., Ltd. is to identify themes and trends that can benefit our clients on a long-term basis. As tough as today’s environment has been, we continue to believe investors are best served with a percentage of their portfolio invested in the stock market. We continue to favor dividend- and interest-paying securities, currency diversification from countries including Canada and Switzerland, gold, natural resources and consumer staples.

As always, I encourage you to call us at 800-843-7273 with questions regarding our long-term investment strategy, or to update us with changes to your financial situation.

Warm regards,



Matthew A. Young  
President & Chief Executive Officer

P.S. Check out this article called “Simple Way of Boosting the Economy,” by David A. Hammer:

Forget about all the increases in government spending and taxes! President Obama’s rescue package is nothing more than using the economic downturn as an excuse to promote a socialist spending agenda and has little in the way of economic stimulus. All the government has to do is cut the corporate tax rate to the same rate levied by most of our foreign competitors. By cutting the corporate tax rate from 35% to 25% or less, our products could become more competitively priced in the global market, fewer jobs would be shipped overseas, jobs would be created in the U.S., personal income would increase, inflation would remain at low levels, our balance of payments would improve, the dollar would increase

in value, thereby increasing the purchasing power of Americans, interest rates would remain low (helping home values), and capital spending on plant and equipment would increase, thereby creating even more jobs.

Another benefit from reducing the corporate tax-rate would be an increase in the value of investments that would help our citizens' retirement plans. Government workers, including politicians, have a defined-benefit plan for their retirements, where the employer (i.e., the taxpayer) guarantees the amount of their pensions. So, unlike most Americans, their retirements are not subject to the fluctuations of the investment markets. No wonder the administration makes light of the "normal gyrations of the stock market." But, 93% of non-government workers have retirement plans where their benefits are a function of the level of securities prices. The politicians talk about the questionable future of Social Security; meanwhile they have neglected the value of individuals' primary assets, the value of their real estate and market investments.

*David A. Hammer, a chartered financial analyst with a BA in economics and a former adjunct professor at Boston University, has been employed in the investment business for 42 years.*

P.P.S. The March 4 *WSJ* reported: "The average six-month yield on small denominated 'savings' CDs was 1.14%, down from 1.15% the week earlier." Most money-market yields are no better and three-month T-bill yields look even worse. Today, we have the unusual situation where the S&P 500 yield exceeds the yield on the three-month T-bill. Not only unusual, but this marks the worst relative-yield position for T-bills and best for stocks in five decades. Currently, investors can receive a higher cash flow from many dividend-paying stocks than money markets and T-bills. Our Retirement Compounders program, which invests in 32 dividend-paying securities, has a current yield in the 5% range. Aside from paying a nice dividend, the group of names in the portfolio, which includes Illinois Tool Works, Hormel, United Technologies, Coca-Cola, Proctor & Gamble and Kimberly Clark, are companies most likely not to go out of business—a comforting thought in these troubled times.

The information contained in this letter is for informational and educational purposes only. It is not intended nor should it be considered investment advice or a recommendation of securities. Please contact our office directly with any questions regarding items appearing in the letter.

Looking past the current morass the global economy is in, you can make a strong case for inflation and much higher interest rates. In our view, the proper portfolio positioning for rising inflation and higher interest rates is to own gold, sound foreign currencies, and stocks. Investors often forget that, over the long term, stocks are an inflation hedge. But there are pitfalls that should be avoided when you purchase stocks in an inflationary environment. First, you should focus on high-dividend-paying stocks. Second, you should invest in companies with pricing power. In an inflationary environment, companies without pricing power suffer. To find industries with pricing power, we look to the Federal Reserve's monthly report on capacity utilization. The report provides utilization statistics at the industry level. Those industries operating close to full capacity generally have the ability to pass on higher raw materials costs in an inflationary environment.

Where is the pricing power today? Chart 1 shows the capacity utilization rate of the automobile industry. Automobile plants are operating at only 40% capacity. There is little chance new car prices will rise until there is a big turnaround in these numbers. Chart 2 shows the capacity utilization rate of the electronic products and computer industry. Utilization here is also at an all-time low. Chart 3 shows the capacity utilization of the food industry. Utilization, while down somewhat from its high, is still close to 83%. Even at its record low, the food industry's utilization rate only dropped to 77.5%. In an inflationary environment, food companies will have no problem passing along rising input costs. Our highly favored Vanguard Consumer Staples ETF is loaded with food companies. Chart 4 shows a similar picture for the utilities industry. Since records began utilization has never plumbed to the depths common in the automobile industry. Utilities shouldn't have a problem passing on rising input costs if inflation picks up. We are buying the Utilities Select Sector SPDR Fund to help position our clients portfolios for the prospect of higher inflation.

Jeremy Jones, CFA  
Chief Investment Officer

