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2011 – A Mixed Bag

A year ago investors were looking forward hopefully to 2011 – anticipating a decent recovery in the economy, higher corporate profits, further healing of the badly wounded financial system, and a long-overdue push to start narrowing the huge and growing federal budget gap. Well, unfortunately only one of those happy expectations was realized in full: higher corporate profits. The other three were mostly disappointments – making for a blah stock market last year, ending up about where it started after wild fluctuations along the way. The Dow-Jones Average, concentrated in 30 large, Blue Chip companies, rose 5.5%, while the broader S&P 500 Index ended up exactly flat versus a year ago.

The U.S. economy has been more sluggish than most analysts anticipated a year ago. Here are the figures on real Gross Domestic Product growth since the Great Recession hit bottom in mid-2009:

Quarterly Year-Over-Year Growth – Real GDP

Year	Quarter	Growth	Year	Quarter	Growth
2009	3rd Quarter	1.8%	2011	1st Quarter	0.5%
	4th	3.9		2nd	1.3
2010	1st	4.0		3rd	2.0
	2nd	3.8		4th	3.5 est.
	3rd	2.7			
	4th	2.3			

Note the slowdown in early 2011 as the continuing slump in the housing market, the ongoing burden of excessive consumer debt, and the painfully slow recovery in the job market combined to depress consumer spending. Somewhat surprisingly there was a small pickup in the final quarter, when businesses rebuilt their depleted inventories and consumers who had any money available decided to cut their savings rate for a while from more than 5% of income to 3.5% and indulge in a little more spending. Most analysts believe, though, that these were temporary phenomena, so the average forecast of economists for the first quarter of 2012 is a relapse in GDP growth to just 2%.

The numbers show that this economic recovery has been slower and smaller than rebounds from past recessions. The reason for this is simple: What we experienced in the crash of 2008-09 was not a typical business slowdown caused by temporary over-production of goods (cars, appliances, TV sets, etc.). Rather it was the bursting of a major *financial bubble* (much of it occurring in housing) that, in turn, depressed the economy. Leading up to 2008, we experienced a huge excess of spending, way above growth in consumers' incomes; a gigantic excess of borrowing, far beyond many people's ability to repay their loans; and at the same time an unprecedented binge of spending and borrowing by the federal government, plus many state and local governments.

Now, putting it simply, having fallen into a deep financial hole, it will take many years to climb back out – by spending less and saving lots of money to pay off the excessive debt. And to the extent that many borrowers will be unable to do that, and will therefore default on their loans, the lenders will lose lots of capital that could have financed future loans. So they, too, will have to save billions more to rebuild their own capital. We see this happening now, as banks have cut their dividends by anywhere from 50% to 80-90-100% to use most of whatever current earnings they have to start rebuilding their capital. Thus, the essential, extended process of restoring the financial system will be a restraint on economic growth for at least five years and perhaps longer.

Two other depressants confront the American economy. First is the seemingly intractable political process of developing a sensible plan to overcome the totally intolerable federal budget gap. A year ago the Bowles-Simpson deficit commission produced such a plan, but political pressures immediately derailed its very logical recommendations. It's pointless for me to say any more about this discouraging situation here. I think our only recourse now literally is to pray for a dawning of sense and responsibility in Washington, however that miracle might happen. The federal fiscal crisis is hurting our economy and any steps to resolve it may also be a drag for a while.

Speaking of intractability, the second depressant for the U.S. is looming in Europe as the torturous process of planning for financial recovery in the various highly stressed countries there lurches on contentiously through political minefields, with no practical solutions appearing as yet. So Europe is slumping into a renewed recession, after hardly any recovery in 2009-11. This is extremely important because Europe as a whole, including both the European Union members and countries outside that organization, is the economic giant of the world. Europe accounted for 32% of global GDP in 2010, vs. 24% for the U.S. and 6% for China. So reduced economic activity in Europe will hold down the entire world economy, including America's.

None of this sounds very promising for greater economic improvement in the U.S. during the new year. Realistically, the best we can hope for now is further slow gains in business activity. And there's a chance even that may not occur.

Aided by generally helpful government actions and a return to common sense in our financial institutions, the strengthening of the U.S. financial system is proceeding reasonably well. But it has a long way to go, and the big detriment remains the major problem that caused the crash in the first place: extreme weakness in the housing market. So many stupid, shaky mortgages were issued in 2001-2007at crazily high home values that today *well over half of all mortgages now outstanding are under water;* that is, the principal amounts of the mortgages are higher than the current market values of the homes. In many cases, people owe their banks 40-50% more than the present value of their houses! How long will they continue to make their mortgage payments?

This means that there are still many more loans that will go into default. Although the banks have set aside reserves for these losses, we on the outside have no way of knowing if the reserves are adequate, and maybe the lenders don't either. But as the housing market continues in the dumps, with prices still declining in some areas, it seems likely that more loss reserves will have to be booked. That outlook and the smaller losses still ahead in other types of loans, plus the continuing federal debt crisis, mean that a full restoration of financial health remains quite a ways off for the U.S.

After this discouraging litany it's pleasant to switch to the good news: the absolutely remarkable strength in U.S. companies' profits last year. As I wrote in October, this phenomenon has been driven primarily by the big, strong companies, the "Blue Chips." They have benefitted from being in good businesses, with favorable growth trends, both in terms of pace and consistency. Their planning is good, their new product development is successful, and their cost controls are very effective. Other, smaller companies share some of these attributes, especially stringent cost controls (to the detriment, admittedly, of new job creation). So the overall U.S. profit performance in 2011 was excellent. Here are the figures for the Standard & Poor's 500 companies – a group that is heavily weighted toward large firms.

S&P 500 Earnings

	Reported Earnings	Write-Offs	Operating Earnings
2011 Est.	$89.00	$ 8.40	$97.40
2010	77.35	6.42	83.77
2009	50.97	5.89	56.86
2008	14.88	34.63	49.51
2007	66.18	16.36	82.54
2006	81.51	6.21	87.72
2005	69.93	6.35	76.28
2004	58.55	8.55	67.10
2003	48.78	6.57	55.35
2002	27.59	20.36	47.95
2001	24.70	21.12	45.82
2000	50.00	8.86	55.86

The table shows that companies continued to write off failing products and under-achieving businesses in 2011 at a normal rate. The two earlier bulges in write-offs, of course, represent all the excesses in the wild *technology* boom that came to a head in the early 2000's and the devastating *financial* losses in 2008-09. The most significant

numbers in the table are the new peaks in both reported and operating earnings last year. That was a great achievement by corporate managements, and it's the primary reason why the stock market held up so well in 2011, in the face of widespread bad news from the economic and financial spheres.

Looking ahead, the obvious question is: Can this good earnings trend continue? Common sense tells us maybe not. Surely if economic conditions in the U.S. remain sluggish, while getting worse in Europe (which seems likely) and in Asia (where growth is slowing markedly now), the conservative outlook has to be for decelerating American-based companies' earnings growth in 2012.

Furthermore, there's another uncertain earnings factor. U.S. companies' profit margins today are sky-high, far above any level in history; and in competitive markets, extremes always return to some sort of normal level eventually ("regressing to the mean" in the language of statisticians). This is the old "trees don't grow to the sky" syndrome. To see how fabulous profit margins are today, and how far they'd have to fall to get back to the old normal, look at these numbers. (They show total U.S. corporate profits as percentages of GDP, which essentially represents "sales" for the American economy.)

Corporate Profit Margins

Total U.S. Corporate Profits As % of GDP

2011 Est.	10.3%	2003	6.6%
2010	8.6	2002	6.4
2009	5.3	2001	5.2
2008	7.8	2000	6.4
2007	8.6	Earlier Peaks	
2006	8.3	1997	7.7
2005	8.2	1965	7.9
2004	7.8	65-Year Median	5.8

There are a few basic changes that are most likely permanent, which explain part of the big jump in profitability – notably the increased use of technology to replace labor and a greater proportion of high-margin service activities in overall business operations. So these could sustain some, but certainly not all, of today's very high margins.

I have no idea what would trigger a decline in these margins. All we know is that like any excess, they are vulnerable to being deflated to some degree – not necessarily this coming year, but some day, somehow. The key message of this table for investors is: Don't pay high prices for these supercharged earnings because today's very high margins probably won't last in full forever. (But it *is* nice at least to enjoy them now!)

Turning to the bottom-bottom line for shareowners, the news on dividends is not nearly as good.

S&P 500 Dividends

		Amount	Payout Ratio	Year-End Yield
	2011	$25.75	26%	2.1%
	2010	22.74	27	1.8
	2009	22.41	39	2.0
	2008	28.38	57	3.2
	2007	27.73	34	1.9
	2006	24.88	28	1.8
	2005	21.75	29	1.7
Avg.	1994-99		37	1.9
	1984-93		48	3.8

Note: Almost all of the 2009 dividend reduction represents cuts and eliminations by banks and other financial companies.

Last year saw a continuation of the long pattern of low dividend payout ratios (the proportion of earnings per share paid out in cash dividends). This started twenty years ago when managements began to use an increasing proportion of net profits to buy in, and retire, shares outstanding. The idea was to increase earnings per share (same profit ÷ fewer shares = higher earnings per share) and thus boost stock prices to benefit shareowners (including the corporate executives who had huge stock options). In execution, this has worked well at times and poorly in many cases – mainly because large share repurchases have often been made when businesses were doing well and their stock prices were way up – only to fall later when business results became less favorable. This wasted lots of shareowners' money.

Anyway, it is what it is, and for too long investors have had to live with low dividend yields as they experienced much less growth in their dividend receipts than in the earnings of their companies. This has caused unhappiness about the skimpy "bird in the hand" that dividends represent, as opposed to the elusive "bird in the bush" of potential stock appreciation.

S&P 500
Annual Growth – Earnings & Dividends

	Earnings	Dividends
2002 – 2011	7.9%	5.0%
1992 – 2001	8.9	2.7
1982 – 1991	8.6	6.3

So 2011 was not a great year for investors, but considering everything that transpired, it wasn't too bad. How 2012 will turn out is anyone's guess. The self-assured gurus of Wall Street are telling us with their usual precision exactly what will occur next year. But those prognostications often miss the mark, and I don't try to play that uncertain game. All I can foresee is another mixed bag, with both pluses and minuses, and at least a few surprises as always.

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