

Odds of 'Double Dip', Second Fed 'Quantitative Easing' and Higher Taxes Rise; Defensive Sector Positioning for a Slow Growth, Low Inflation Environment

The choppy U.S. economic recovery lost momentum in recent months as it continued a healing process from the worst recession in 75 years. The combination of the fiscal drag from higher deficits, softer consumer spending and a possible second leg down in housing worked to decelerate U.S. GDP growth to 1.7% in the second quarter, down from 2.7% in the first quarter and 5.6% in the fourth quarter of 2009. Moreover, the U.S. economy stands a 31% chance of double-dipping into recession in the next year, according to economists, CEOs, chief investment officers, portfolio managers and chief strategists recently surveyed by Pensions & Investments magazine.

Despite the rising possibility of a return to negative growth, the latest Blue Chip Indicators report forecasts U.S. GDP growth to be a slow but positive 2.7% for the year, but with a persistently high level of unemployment near 9.6% at year end, and with a Federal Reserve (Fed) that will keep its current fed funds target range of zero percent to 0.25% through mid-2011. The transition away from leveraged growth and deregulation to an environment with slower economic growth - which has been our base case forecast - and more regulation, is beginning to become more widely accepted.

Policy makers in Washington are increasing the already high level of economic uncertainty. If Congress does not act, tax cuts passed in 2003 under former President George W. Bush will expire in January, and qualified dividends would be taxed at the same rate as income, increasing from the current 15% to as high as 36.9%. The White House has supported capping the hike on the qualified dividend tax rate at 20%, creating at least a fighting chance that dividend-paying stocks could continue to maintain their tax advantage as compared to other forms of investment income. The expiration of any part of the Bush tax cuts would raise marginal rates, creating an additional economic headwind in the midst of an already uncertain environment.

Most economists, 31 of 51 (61%) recently surveyed by The Wall Street Journal, anticipate that the Fed will resume its large scale purchases of securities, known as quantitative easing, most likely after the November midterm elections, in light of the slowing economy. However, the Fed will likely have to lower its economic forecast to justify any new purchases and the potential effectiveness of such a program is uncertain as a new purchase program could potentially bring down long-term interest rates, many of which are already close to historically low levels. The Fed ended a program in which it acquired \$1.7 trillion in long-term Treasuries and mortgage-backed securities earlier this year. In August, the central bank said it would reinvest the proceeds from its maturing mortgage holdings into government securities, to keep the size of its balance sheet close to \$2 trillion.

The current conditions suggest that it will take years for household balance sheets to stabilize and that consumer deleveraging will likely be a headwind to economic growth for a significant period of time. With the overwhelming fears of a possible return to recession, and potentially a deflationary environment, investors fled to U.S. Treasury bonds in the third quarter, sending the yield on the 10-year U.S. Treasury note to 2.45%. In December 2008, 10-year Treasury yields sank to 2.03%, the lowest on record since 1953.

While the administration, Congress and the Fed continue the attempts at stimulating the economy, we will be monitoring the incoming data for any signs of a return of confidence that many of the economic policies are attempting to restore. Ultimately, the politics and any policy actions give way to the prospects of an economic cycle that will need to support the return of robust trends in corporate earnings. At the end of the day, in many areas the economy is sluggish for reasons that leave policy makers less effective, as consumers de-lever to rebuild their savings and pay down debt.

Preparing for Higher Taxes

2010 Income-Tax Rates			2010 Income-Tax Rates if All Bush Tax Cuts Expire		
Taxable Income		Marginal Tax Rate	Taxable Income		Marginal Tax Rate
Single	Married, Filing Jointly		Single	Married, Filing Jointly	
Over \$373,650	Over \$373,650	35.0%	Over \$382,650	Over \$382,650	39.6%
\$171,850 to 373,650	\$209,250 to \$373,650	33.0%	\$176,000 to \$382,650	\$214,250 to \$382,650	36.0%
\$82,400 to \$171,850	\$137,400 to \$209,250	28.0%	\$84,350 to \$176,000	\$140,600 to \$214,250	31.0%
\$34,000 to \$82,400	\$68,000 - \$137,300	25.0%	\$34,850 to \$84,350	\$58,200 to \$140,600	28.0%
\$8,375 - \$34,000	\$16,750 - \$68,500	15.0%	Not Over \$34,850	Not Over \$58,200	15.0%
Not Over \$8,375	Not Over \$16,750	10.0%	-	-	-
Top dividend rate		15.0%	Top dividend rate		39.6%
Top cap gains rate		15.0%	Top cap gains rate		20.0%

Source: U.S. Congress Joint Committee on Taxation

While we cannot invest in stocks and totally avoid the risks in the economy or the recent heightened level of financial market volatility, we continue to seek securities with more defensive qualities to counteract escalating uncertainty about the future. Increasingly, we expect to see a disparity between businesses that rely on a cyclical recovery in order to grow and those that have more stable, sustainable organic growth and profit cycles, and that demand for financial assets with relatively high yields and relatively low volatility could remain elevated for an extended period of time.

Healthcare (Overweight) - Despite the overhaul legislation passed early this year, we continue to believe that the long-term growth prospects, financial strength and attractive valuations continue to favor selected names in the Healthcare sector. We have favorable views on several companies with operations in healthcare services, medical devices, and pharmaceuticals (including generics), while we have avoided other areas, including managed care, healthcare facilities and healthcare distributors. Although nominal consumer spending in this area has suffered as a result of the downturn, we believe the demographic trends such as aging, increasing obesity, and the benefits of many recently completed mergers and acquisitions will benefit the companies in the sector.

Information Technology (Overweight) - Growth across product cycles due to pent up demand from corporations, along with exposure to the rapidly expanding emerging economies remain positives for the Technology sector. Our exposure continues to focus on the software, information technology services, computers and communication equipment subsectors, with less exposure to the more cyclical semiconductor equipment and internet services areas. Many companies in this space have an annuity like aspect to a portion of their revenue streams due to license renewals and/or maintenance agreements. Additional characteristics that look appealing to us in the Technology sector include experienced management teams, large cash balances, and growing dividends.

Consumer Staples (Overweight) - We maintain that this sector is one of the least vulnerable to negative earnings revisions in a sluggish economic environment and favor supercenters, as well as other food and staples retailers, beverages, household and personal products and food products, with no exposure to the tobacco subsector. By selling many of the goods that impact our lives on a daily basis, many companies in this space are defensive, with less economic sensitivity. Price competition, especially from generic brands, ticked up in the downturn, but exposure to the rapid growth of the emerging economies has been one positive offsetting factor. Overall cost control in the sector has led to growth in cash flow, and many companies in the sector offer attractive and growing levels of cash flow, and above-market dividend yields.

Utilities (Overweight) - Although the recovery in demand for electricity has been choppy, the regulated utility industry sector remains defensive in our analysis, while offering dividend yields that are well-above the overall market. Our exposure is focused across multiple regulated electric and gas utilities with investment grade credit ratings, and manageable dividend payout ratios, with no exposure to the more volatile independent power producers.

Telecomm Services (Equalweight) - We maintain at least an equalweight allocation to the leading integrated/wireless carriers in the telecom sector due to the attractively-high dividend yields.

Materials (Equalweight) - Our equalweight allocation in the Materials sector consists exclusively of our exposure to one of the world's largest gold producers as a currency, and volatility hedge. We maintain a zero weight to the more cyclical, industrial materials subsectors such as chemicals, paper and packaging, and construction materials.

Energy (Underweight) - The global growth slowdown, which has reduced energy consumption and lowered capacity utilization, is a key factor driving our underweight to this traditionally cyclical area. The oil spill and drilling moratorium in the Gulf of Mexico and the new regulatory environment are further pressuring the sector's outlook. Our exposure consists of firms in the integrated oil and gas, and equipment and services subsectors, with a zero weight in pure play refining, storage and transportation, and coal companies.

Industrials (Underweight) - Given the peaking phase of the economic recovery, we currently believe there are more attractive opportunities in less economically cyclical industry sectors. Our underweight exposure remains in the aerospace and defense, electronic equipment and wholesale distribution subsectors, with little to no exposure to the building products, construction and engineering, or transportation sub-industries.

Consumer Discretionary (Underweight) - We maintain an underweight in this sector due to weak consumer confidence, a soft labor market and ongoing risks in housing. Our underweight exposure is allocated in the discount retail, and restaurant subsectors, and we maintain no holdings in the apparel, automobile, homebuilding, media, or travel and leisure areas.

Financials (Underweight) - We believe that an earnings recovery in the financial sector will be modest due to the impacts from U.S. regulatory reform and pending, stringent global capital requirements. Moreover, a downturn in housing, along with ongoing consumer deleveraging, are also potential headwinds in this sector. Our underweight exposure is comprised of high-quality companies in asset management, custody banking and insurance, and we maintain no exposure to money-center banks, capital markets participants or real estate investment trusts.

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