EQUITIES REMAIN ATTRACTIVE

March 2012

Jack D. Brown, CFA
James R. Neel, CFA
Orville D. Ward, CTFA

Aviance Capital Partners
Focused Asset Management

In our latest commentary from early January, we stated "equities are positioned well in 2012" since "valuations are attractive, especially relative to bonds; economic growth is broad-based and poised to continue; and market risks are compelling, but exaggerated." In retrospect, we stated the obvious as investors flocked to the equity markets. Specifically, the broad U.S. equity markets gained an exceptional 12.5% over the 1st quarter of 2012.

From an economic standpoint, most indicators flashed green through the 1st quarter which proved to be the confidence-inducing elixir stimulating investors into stocks. Beyond encouraging economic statistics, a myriad of powerful incentives also pulled investors to stocks.

Consider that most investors who seek income and safety have historically held cash (i.e. money markets) or bonds. Today however, these instruments are not keeping up with inflation:

- Inflation is currently +2.9% (source: Dept. of Labor, CPI)
- Money market yields remain mostly below +0.2%
- 10-Year Treasury Bonds are yielding +2.1%
- U.S. corporate bonds are yielding +3.2% (source: Barclay's)

While bonds and cash are losing the battle with inflation, stocks remain attractive relative to these instruments. Many stocks, for example, provide dividend yields greater than bonds. Further, dividends grow over time whereas bonds typically provide a "fixed" level of income.

It is also worth noting that earnings yields for stocks remain historically appealing relative to bond yields (6.7% versus 2.1%). How so? The current price-to-earnings multiple for the S&P 500 (using trailing net earnings) is 15; meaning every $100 invested in stocks represents $6.67 in earnings (or 6.7%) to the companies. Compare this to bonds yielding 2-3% which produces only $2-3 in income for every $100 invested.

What, one might ask, is creating these incentives? With the Federal Reserve (the "Fed") continuing their short-term rate target of 0-0.25%, the stimulative throttle remains fully engaged. Further, the Fed remains a large Treasury bond buyer (U.S. Treasury issues debt and the Fed buys it). The combination of these factors results in our current low rate environment. Thus, investors have in part flocked to stocks to keep ahead of inflation.

How will this play out? We agree in large part with Harvard economist, Martin Feldstein who recently stated:

> *"When the economy begins to recover and companies have the ability to raise prices, the commercial banks will want to increase their lending. This will be welcome, as long as it is not too much or too fast. The Fed will appropriately want to limit the expansion of bank lending. This is what the Fed used to talk about as its exit strategy. Essentially, it would mean raising interest rates on the deposits at the Fed and allowing interest rates more generally to rise. If this is done in a timely way and on an adequate scale, the Fed will succeed in preventing the current vast liquidity from generating higher inflation."*

(continued on back)

His related concern is that political pressure resulting from high unemployment might lead to an inflationary bias at the Fed. We can't disagree here, either.

At some point, traditionally conservative instruments will indeed provide rates greater than inflation. However, until then we will likely remain biased towards stocks.

The risk to our outlook relates to the undulating nature of the stock market. It is unrealistic to consider that a +12.5% quarter will precede a string of similar results throughout the remainder of the year. In fact, any full year with a +12.5% return is welcome by most. Despite that the stock market ends the year higher than where it started two-thirds of the time, it also tends to range 20% between its low versus its high in any given year. As a result, we indeed expect 2012 to be a solid year for stocks given the incentives, however, we encourage investors to have patience as the inevitable peaks and troughs come to light.