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Assets less crummy

On Sept. 19, the day after the Fed didn't taper, a survey of investor sentiment by Market Semiotics, Castleton, Vt., uncovered a rare meeting of the minds: Everyone it canvassed was bullish on stocks. This arresting fact we take as our cue to update an old theme. Sell bonds, buy blue chips, this publication counseled at intervals in 2010-11. To the timely question, "What now?" we reply: Better stocks than bonds, still. But nothing's wrong with a little cash these days.

A Bloomberg story on Monday broke the news that the 2013 stock market is tracking with the break-out market of 1954, almost tick for tick. It was in October 1954, as you may very well not remember, when the Dow Jones Industrial Average finally heaved itself back to the 1929 highs. The bulls had been pacing the floor for 25 years.

People quoted in the Bloomberg dispatch compared the return of confidence in 2013 to the bucking up of sentiment in 1954. "What drove stock prices higher then was a revitalization of absolutely destroyed confidence," Jim Paulsen, chief investment strategist at Wells Capital Management, told Bloomberg. "What's driving things here is that same slow but steady revival in confidence."

But this confidence has been bought and paid for with fake interest rates. As a rule, it seems to us, government-issued optimism isn't the kind to lean on. Besides, for profitable investing, nothing beats fear (not one's own but other people's). Fortunately, given the central banking arrangements in place, promising stock-market entry points present themselves with some frequency.

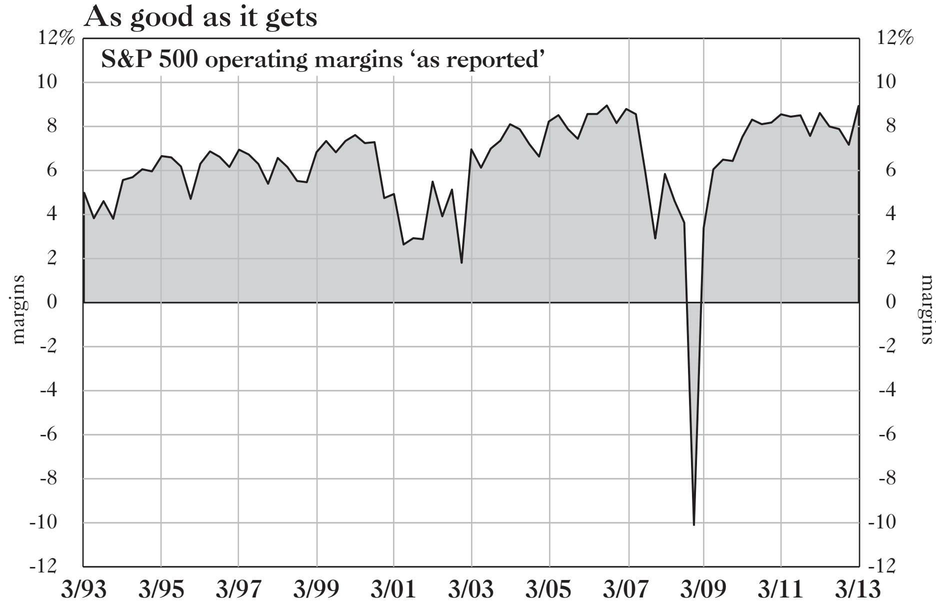
The first installment of what turned out to be a thematic series appeared in the May 28, 2010, issue of *Grant's*. The stock market was making heavy weather of it, and Treasurys were a port in the storm. In this context our clarion call rang out: "Buy beer, sell bonds." That is, buy the common stock of Molson Coors Brewing Co. (TAP on the New York Stock Exchange), sell the Treasury 3.5s of May 15, 2020.

"Bonds are inert contracts to pay dollars," we reasoned. "Unlike the CEO of Molson Coors, Timothy Geithner [the then-Treasury secretary] makes no attempt to get out in front of changing price levels and market conditions. And although he means no harm to the creditors of the United States, he's not on a mission to make them rich. To enrich the shareholders is, in fact, among the top agenda items of the executive corps of Molson Coors."

TAP went on to produce less than half the return of the S&P 500. But the theme was the thing, and we identified better foils for the 10-year Treasury note. Johnson & Johnson, Wal-Mart Stores and Kimberly-Clark were among those picks to click (see the issues of June 11, 2010, July 9, 2010, Dec. 10, 2010, and Oct. 7, 2011). Some clicked better and faster than others, but, in aggregate, blue chips excelled. Since mid-2010, the S&P 500 has returned 67% with dividends reinvested, the 10-year Treasury, 21%.

What seems so obvious today was

As good as it gets



source: S&P Dow Jones Indices

hotly contested two and three years ago. "[A]cross the financial markets, a sea change is taking place," *The Wall Street Journal* declaimed in September 2011. "Investors are abandoning the time-tested 'stocks for the long run' optimism that dominated since the late 1980s. Instead, there is a widening belief that the mess left behind by the housing bubble and financial crisis will be a morass to contend with for years." No surprise, then, that equity mutual funds were suffering "an exodus that more than reversed the total amount of money investors had put into those funds since stocks bottomed in 2009. The withdrawals matched the worst three-month period during the depths of the financial crisis." No talk then about the Great Rotation from bonds to stocks (the subject of three separate Bloomberg dispatches on Monday) or of the Eisenhower bull market redux.

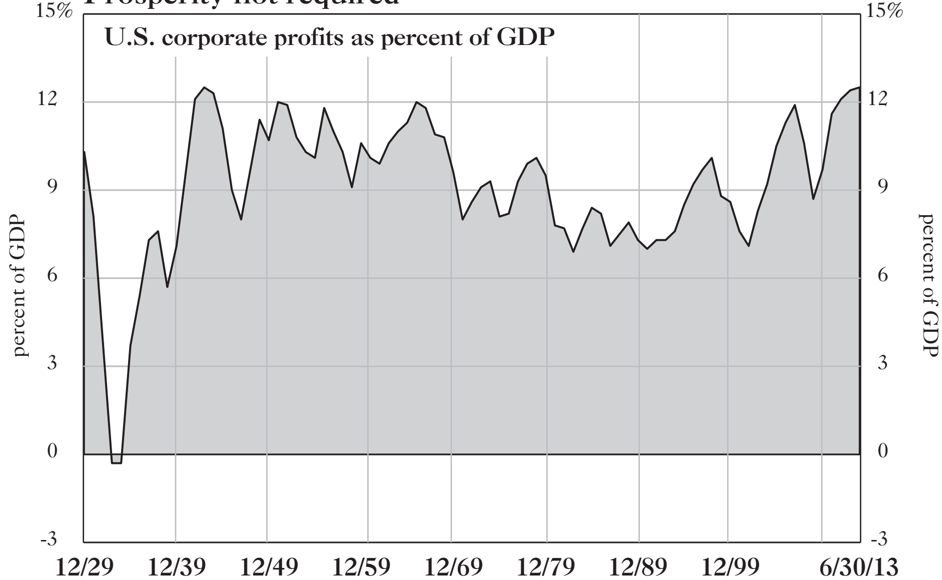
The fall of 2011 was a worrying time all right, but the worry had left its welcoming mark on valuations. Ten-year Treasurys were priced to yield 1.83%, 48 basis points less than the 2.3% dividend yield on the S&P 500. Not since the late 1950s had the blue chips outyielded the 10-year government note. Then, again, as the equity bears observed, not for many a moon had prospects for American growth seemed so lackluster.

But good managements made do even in the face of a meager recovery. Raytheon Co. (RTN on the Big Board), the $25 billion market-cap defense contractor that began operations 91 years ago, adapted and invented as well as any. Who among the founders, management mused in the 2012 annual report, could have dreamt that their creation would one day be producing missiles to shoot down other missiles or selling radar capable of tracking a batted ball on a flight path between Boston and San Francisco (an evident allusion to baseball's steroid era)?

And who, in June 2010, would have dreamt that RTN would deliver a total return of 70%, with dividends reinvested, over the next three years and three months? Or that, even after this price ascension, the stock would be quoted at just 13 times the 2014 estimate? The most optimistic dreamer would have been put off by a sneak preview of the next year's revenues. Here is the track of net sales: $25.2 billion in 2010, $24.8 billion in 2011, $24.4 billion in 2012 and $12 billion in the first half of 2013.

And if this underwhelming progres-

Prosperity not required



source: Bureau of Economic Analysis

sion of figures was not discouraging enough, the latest Raytheon 10-K report made a clean breast of the risk of which the world does not need to be reminded: "We depend on the U.S. Government for a substantial portion of our business and changes in government defense spending could have consequences on our financial position, results of operations and business."

"And yet," colleague David Peligal observes, "while Raytheon's top line has been stagnant, operating income has been on the rise. The figures are these: $2.62 billion in 2010, $2.83 billion in 2011, $2.99 billion in 2012 and $1.47 billion in the first half of 2013 (up marginally from the first half of 2012). Operating income as a percentage of sales—i.e., operating margin—shows this progression: 10.4% in 2010, 11.4% in 2011, 12.2% in 2012 and 12.3% in the first half of 2013. The stockholders have gained, all right, but they have harvested the fruits of expense control, not growth. Head count—total employees from continuing operations—fell to 67,800 in 2012 from 75,100 in 2009."

While applauding the Raytheon executive suite, one wonders: How much motive power can corporate management impart to a share price in the absence of what we used to call prosperity? Furthermore, with S&P operating margins near a record high, and with corporate profits as a share of American output at a new record, how much brighter can the earnings picture become? Profit warnings for the third quarter are coming in thick and fast, Reuters reports, while Unilever, the world's second-largest consumer goods company, warned late Monday about plunging sales in emerging markets.

Like Raytheon, 3M has struggled to generate top-line growth from continuing operations. But what its management has signally achieved—besides consistent operating margins in the low 20s—is bottom-line growth. Fully diluted earnings per share have vaulted to $6.32 in 2012 from $5.63 in 2010 and to $3.32 in the first half of 2013 (up from $3.25 in the corresponding half of 2012).

At 3M, as at many another blue chip, enlightened capital allocation has filled the breach that an underachieving economy has left. Thus, on July 25, the former Minnesota Mining & Manufacturing Co. boosted its full-year gross share-repurchase program to between $3.5 billion and $4.5 billion from between $2 billion and $3 billion. For the five years through 2017, the company has earmarked $7.5 billion to $15 billion for share buybacks, compared to $7 billion so allocated between 2008 and 2012. The projected outlays would add one to two percentage points to annual growth in EPS, no small thing in the light of the 6% EPS growth achieved in 2012.

Contemplating 3M, one naturally thinks of other deep-rooted American institutions. The split-rated U.S. Treasury, for instance, is clothed with a mighty taxing power. Yet the federal government's free cash flow is negative and the Treasury may actually default on its debts one fine October day. Different risks attach to 3M, which generates substantial free cash flow, has net debt of only $152 million and has boosted its dividend for 55 years running. The stock, which trades at 16.2 times the 2014 estimate, yields 2.1%.

Wal-Mart, whose shares we cheered three years ago, is the poster company for the proposition that super-abundant cash flow is the next best thing to economic growth. At year-end 2010, Wal-Mart was quoted at $55.09 a share, 12.3 times the 2011 estimate, the lowest P/E in 20 years. The stock price had hardly budged since 1999, when a besotted Mr. Market assigned it an earnings multiple of 58. Still, over the next 11 years, sales, earnings and dividends logged compound annual rates of growth of 8%, 11% and 17%, respectively. Book value per share grew at a compound annual rate of 13%. Though the share price had run ahead of business value, the business carried on. Over those 11 years, the stock price did penance, flatlining even as gold and the 30-year Treasury bond produced returns of 392% and 63%, respectively.

"All investing is a cycle," grandly observed the Dec. 10, 2010, issue of *Grant's*. "Is it so farfetched to imagine that, over the next 10 or 11 years, the returns to a living business directed by adaptive management will trump the returns on a government security or to a beguiling precious metal?" In the subsequent not quite three years, WMT has returned 46%, the 30-year Treasury 21% and gold minus 7%.

How this corporate achievement came to be is a credit to Wal-Mart's management as much as it is a discredit to the world's macroeconomic management. In the six months to July 31, the retailer's year-over-year revenue growth came in at just 1.7%, compared to year-over-year growth of 6% and 5%, respectively, in the full fiscal years ended Jan. 31, 2012 and 2013. In an Aug. 15 press release, Wal-Mart's CFO, Charles Holley, called the retailing environment "challenging" (do ranking corporate executives know any other adjective?) and reduced the in-house forecast for growth in net sales this fiscal year to between 2% and 3% from between 5% and 6%. On Sept. 25 came word that Wal-Mart was cutting back its suppliers to pare unwanted inventory.

Happily for the stockholders, Wal-Mart is also paring the share count. At 3.25 billion, there are 10% fewer WMT shares in the world than there were in August 2010. You get a sense of how important buybacks are by comparing the growth in net income, on the one hand, with the growth in net income per share, on the other. Between the start of fiscal year 2012 and the midpoint of fiscal 2014 (i.e., between Feb. 1, 2011, and July 31, 2013), net income has grown at an annual compound rate of 1.7%, while net income per share has grown at the compound annual rate of 9.8%. Nor did the retailer trade a stockholder-friendly share reduction for a creditor-unfriendly financial disfigurement.

"Wal-Mart," observes Carol Levenson, co-founder and director of research at *Gimme Credit*, "posts enough EBITDA growth to offset the additional borrowings for buybacks, thus keeping leverage essentially unchanged. These companies [i.e., the best and the biggest blue chips] also have a quaint corporate culture that values high bond ratings for safety, ease and cost of capital access, reassurance for long-term customers and competitive advantage. This goes against the mainstream trend lately of aspiring to nothing better than 'investment-grade' ratings."

That Bloomberg story on the echoes of 1954 omitted the interesting fact that, from September 1954 through August 1955, the Consumer Price Index registered 12 small consecutive monthly year-over-year declines. We leave it to the reader to try to imagine the uproar that such a slouch of falling prices would produce in 2013. Yet, an electronic search of *The New York Times* and *The Wall Street Journal* archives for the word "deflation" over the course of those 12 months turns up not one obvious relevant match. The Greatest Generation, only a quarter-century removed from the Great Depression, seemingly was unconcerned.

As for the present generation, *Grant's* wishes to revise its thesis of 2010-11. We are not bearish on stocks, but they are no longer absolutely attractive. They are, however, still relatively attractive. As between the two manipulated asset classes, bonds and stocks, we judge the latter to be the less crummy.

Through its manipulation of interest rates, the yield curve and—perhaps most of all—expectations about the future path of interest rates and asset prices, the Bank of Bernanke has kept its thumb on the financial scales. The investor can't be sure of what he or she is buying. Is it a pound of value, or perhaps just 13 ounces? Pending a recalibration of the monetary unit of account, or a reshuffling of posted prices, caution is in order.

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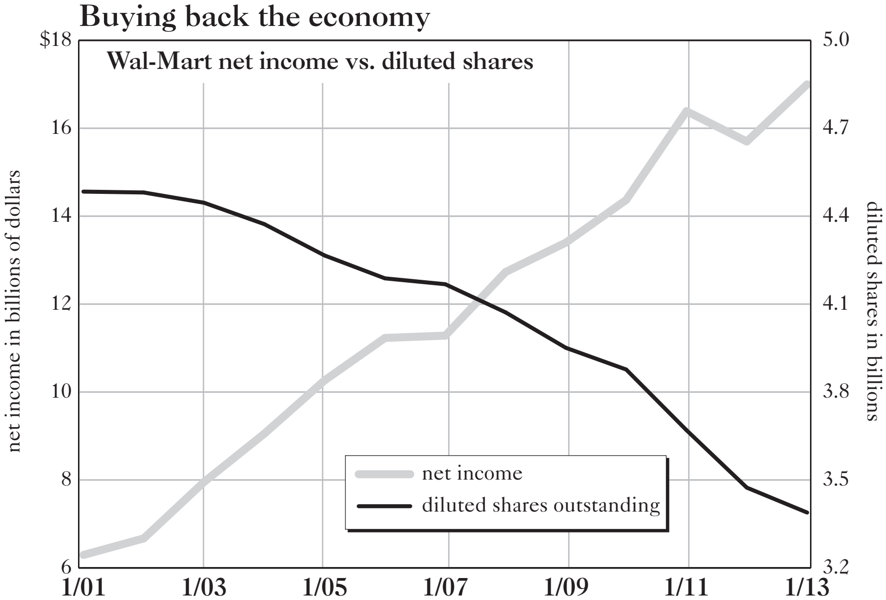
Buying back the economy



source: The Bloomberg