

BROOKMONT CAPITAL MANAGEMENT

“A BUGG’S LIFE”

2100 McKinney Ave., Suite 900, Dallas, TX 75201
RBug@BrookmontCapital.com 214-932-6696

June 25, 2008

Along Came a Recession...

Back in September 2003, an issue of “A Bugg’s Life” listed the positive and negative factors that were driving the markets and how they would impact stock prices in the future. It should come as no surprise that the market drivers back in 2003 are very similar to those in 2008. The one addition to the list is the rate of inflation as prices for energy and food continue to rise.

Inflation/Energy Prices

This seems to be a good place to start the discussion since I paid \$90 over the weekend to fill up my SUV. When I wrote the newsletter in 2003, oil prices were trading around \$29/barrel (\$1.28/gallon for unleaded). Today, a barrel of crude runs around \$133 and there seems to be no resistance from it going even higher. Drivers in the U.S. are facing \$4/gallon this summer and many are trapped in large trucks and SUV’s that offer horrible gas mileage. For some consumers, paying an additional \$50/week at the pump is nothing more than a slight annoyance. For everyone else, it means fewer trips to Target, Red Lobster, and Six Flags (which cut ticket prices by \$10 at its St. Louis amusement park). While higher energy prices have not brought our economy to its knees, the ripple effect is now being felt by retailers, hotels, and auto manufacturers.

Energy prices are not the only pain being felt by U.S. consumers. Since September 2003, the price for ground chuck has risen by 28%, orange juice is up 35%, coffee is higher by 32%, and dairy prices have jumped 32%. I doubt anyone would consider the products listed above as “luxury items.”

Corporate Earnings

The latest round of earnings announcements marked the third consecutive quarter where growth in



corporate profits was negative. That has not happened since 2001 and is one of the few times it has occurred in U.S. history. During the first quarter of 2008, corporate earnings dropped more than 17% when compared to the prior year. Keep in mind that the bulk of the decline has come from the Finance sector where companies continue to write-down assets and add to their bad-loan contingencies. When the Finance sector is removed from the equation, corporate earnings actually rose 8% during the first quarter.

Corporate earnings will suffer through one more quarter of negative growth as finance companies continue to drag down the other nine sectors of the market. That changes during the second half of the year as easy year-over-year comparisons, tax refund checks, and low interest rates all work in favor for higher corporate earnings.

Looking into the second quarter of 2008, analysts expect earnings to fall 9% compared to the previous year and that number will probably get worse. Dating back several quarters, analysts have been way too optimistic in their forecasts and have been forced to cut them over and over. The Financial sector is expected to see a 53% decline in earnings growth during the second quarter. On the other side of the fence, the Energy and Technology sector are forecasted to produce 23% and 16% growth rates, respectively. This would be the third consecutive quarter of 20%+ earnings growth in the energy sector.

Politics

As this is a sensitive subject for many of us, our newsletter has always remained neutral when it comes to politics...or at least has tried to. Over the years it has been accused of being an “Apologist for the Democratic Party,” as well as a “Right-Wing Cheerleader.” That said, the November elections will play an important role for stock prices as the markets despise uncertainty. With the incumbent President serving his second-term in office, a new face will reside on Pennsylvania Avenue in about seven months.

The topic for us to consider is how each of the Presidential candidates would tackle the current tax laws that are set to expire at the end of 2010. These include lowered tax rates on long-term capital gains, dividend income, personal tax brackets, estate taxes, Alternative Minimum Tax exemptions, and the expanded 10% tax bracket.

Although the lowered tax rates on dividend income and long-term capital gains receive most of the criticism, their effects on Federal Tax Revenues are much lower than the other items listed above. For example, extending the 15% tax rate on long-term capital gains through 2018 would cost the IRS about \$101 billion in lost revenue. Extending the 15% tax rate on dividend income through 2018 would result in \$208 billion in lower tax revenue.

On the other hand, if the estate tax is allowed to completely phase out after 2010, the IRS would see Tax Revenue decline by \$670 billion by 2018. The lowered personal tax rates would cost \$571 billion over the same time period, and increased exemptions for AMT would result in more than \$612 billion in lost revenue.

When the tax rate on dividends was reduced in 2003 to 15%, higher-yielding stocks enjoyed one month of outperformance. This quickly turned around as a price arbitrage opportunities existed for institutional and non-taxable investors, who sold high-yield stocks until they reached price equilibrium. Since that time, high-yield stocks have only outperformed the general market based upon normal business cycles. This has been the case since the 15% tax rate has a sunset provision in 2010 and investors have viewed the lower rate as only a temporary relief.

If the 15% dividend tax rate is allowed to expire at the end of 2010, some taxable investors would witness as much as a 160% tax increase. While this sounds onerous for high-yield stocks, we would expect a short-term price decline to be met with a price arbitrage similar to 2003 where institutional and non-taxable investors step in and buy these names.

The chances for making the lower tax rates on capital gains and dividend income permanent is becoming very remote. In 2003, there were 51 Republican Senators and the vote to lower the dividend tax rate was along party lines. Today, Republicans count 49 members of Congress and The Rasmussen Report sees a possible slaughter for Republicans in November’s Congressional elections with Democrats picking up at least 5, and potentially 12, seats in the Senate. They are forecasting a similar blood bath in the House as well.

The chart below shows how each candidate has voted on tax issues during their term in the Senate. Although a candidate’s prior votes cannot guarantee how they will vote in the future, it is probably a much better barometer than a campaign platform.

	<u>McCain</u>	<u>Obama</u>
Repeal the Alternative Minimum Tax	Yes	No
Raise Estate Tax Exemption to \$5 million	Yes	No
Permanently repeal the Estate Tax	Yes	No
Retaining 15% tax rate on dividends and capital gains	Yes	No
Increasing tax deductions for college tuition	No	N/A

Economy

The debate continues whether the U.S. economy has fallen into a recession. Semantics aside, there is no argument on the fact that growth has slowed to a trickle. Unemployment is up, retail sales are lower, and consumer confidence has fallen to a 30-year low. On the bright side, the stock market has remained fairly stable and corporate earnings growth (Financial Sector aside) is still positive.

However, economists are not expecting growth to resume to its “full potential” for at least 18 months. For the second quarter of 2008, the economy is projected to grow at an anemic 0.2% and 1.2% for the full year. If that is the case, 2008 will shape up as the 7th slowest year of growth since 1970.

International economic growth will also play a major role this year as many Asian countries soften the fallout from the U.S. recession. The U.S. economy remains by far the largest in the world and represents 29% of the global economy, the exact number it represented in 1990. On the other hand, the ranking of foreign economies has changed over the years as represented by the chart below.

	Cumulative Growth Since	% of World Economy	% of World Economy
	<u>1990</u>	<u>1990</u>	<u>2007</u>
USA	62%	29.0%	29.0%
Japan	25%	17.2%	13.0%
China	422%	1.8%	5.9%
Germany	31%	6.4%	5.3%
U.K.	51%	4.7%	4.4%
France	37%	4.4%	3.8%
Italy	26%	3.8%	2.9%
Brazil	59%	2.0%	2.0%

The fact that the rest of the world continues to grow at a faster rate than the U.S. is a double-edged sword, however. Foreign economies are not as dependent upon the health of the U.S. however it will keep price inflation at a high rate while our economy suffers. Demand for food, commodities, and energy is strong around the globe and continues to push prices higher for Americans as well. In prior U.S. recessions, we could count on prices to fall as American demand for products dominated the world.

Index Returns as of June 25			
<u>Index</u>	<u>June</u>	<u>Year-to-Date</u>	<u>One Year</u>
S&P 500	-6.05%	-10.55%	-12.12%
S&P Mid-Cap	-4.39%	-1.70%	-5.13%
S&P Small-Cap	-5.14%	-5.02%	-12.33%
Dow Jones	-7.61%	-11.01%	11.51%
NASDAQ	-5.84%	-10.74%	-8.53%
EAFE (Intern’l)	-7.52%	-12.41%	-11.90%

Live and Die by the Gas Guzzler

Detroit thrived (and survived) during the past two decades on large trucks and SUV’s. Soccer Moms across America climbed into Suburbans and Expeditions every day of the week, and their husbands purchased Ford F-150’s for the occasional trip to a Home Depot. These vehicles were considered to be “practical” since they could haul more passengers and plywood than ever needed. The fact that gas prices were around \$1.50/gallon meant that efficiency and practicality were mutually exclusive.

As proof that Detroit was earning fat margins on these gigantic vehicles, it was not long until Toyota and Nissan brought out their own large trucks and SUV’s. Even the names of their new vehicles screamed “large” (Tundra, Titan, Sequoyah, and the notorious Land Cruiser). However, the Asian manufacturers never forgot that small and mid-sized cars are the true backbone of their existence.

As gas prices have reached \$4/gallon, their commitment to the car segment is paying huge dividends. During the month of May, car sales in the U.S. outperformed the truck segment for the first time in twenty years and Detroit suffered as a result. General Motors saw a 27% decline in sales compared to the previous year, with Chrysler (-25%) and Ford (-15%) not faring much better. This allowed Toyota to come within 9,000 units of surpassing General Motors for U.S. sales leadership during the month.

This does not mean that the foreign manufacturers now own the U.S. market. They have also been hurt by the implosion in large trucks and SUV's. As well, the Lexus division has been a significant drag on Toyota's sales for more than a year and analysts speculate that there is more to this story than just a slower U.S. economy. This fact may be a surprise to many of you as the media holds this brand name on a very high pedestal. While Lexus saw its monthly sales figures slide 22% from the prior year, its competitors BMW (+10%) and Mercedes (+0%) fared much better.

Live and Die by the Sub-Prime Loan

It is no secret that bank stocks have been under tremendous pressure during the past twelve months as sub-prime loans have come back to bite creditors around the world. The carnage has gotten much worse as bank stocks have fallen as much as 41% this month alone. The chart below is a sample of some of the largest and most well-known money center and regional banks. For complete disclosure, the Brookmont Dividend Equity Strategy currently owns JP Morgan, PNC, and U.S. Bank.

	<u>June</u>	<u>2008</u>	<u>1-Year</u>
Bank of America	-20%	-33%	-40%
Citigroup	-14%	-34%	-60%
Comerica	-22%	-30%	-48%
Colonial Bank	-24%	-64%	-79%
Fifth Third	-45%	-58%	-71%
Huntington	-34%	-59%	-70%
JP Morgan	-12%	-12%	-17%
Keycorp	-42%	-48%	-63%
PNC	-8%	-7%	-14%
Regions	-34%	-48%	-61%
SunTrust	-28%	-37%	-53%
US Bank	-9%	-4%	-5%
Wachovia	-25%	-51%	-61%

Robert Bugg – Principal and Chief Investment Officer
214-932-6696

Bill Leonard – Director of Client Relations
214-932-6855

Neal Scott – Principal and Fixed Income Manager
214-932-6647

Suzie Begando – Portfolio Manager
214-932-6712

DISCLOSURE

The articles and opinions in this publication are for general information only, are subject to change, and are not intended to provide specific investment, legal, tax or other advice or recommendations for any individual. We suggest that you consult your attorney, accountant or tax or financial advisor with regard to your individual situation. Although information has been obtained from sources Brookmont believes to be reliable, we do not guarantee its accuracy and it may be incomplete or condensed. Brookmont is not liable for any typographical errors or incorrect data obtained from reliable sources of factual information.

This is a service notification for your benefit. This is not a marketing or advertising communication. Please be assured that we respect the privacy of our subscribers. To remove your name from future mailings, please reply to this message with UNSUBSCRIBE in the subject line.
