Buy Stocks, Not Economic Data

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Metrics such as GDP don't matter when top U.S. firms prosper even as Americans don't.

Global financial markets anxiously await President Obama's address outlining his new economic initiatives to a joint session of Congress during prime time next Thursday evening. Two weeks later, Federal Reserve policy makers will emerge from their two-day meeting with a monetary-policy roadmap.

The question for stock investors is, why should they care? Traders who assess minute-to-minute whether "risk" is "on" or "off" will want to know (in contrast to high-frequency trading computers ruled blindly by algorithms that tell them to buy or sell).

Clearly investors do care. Why else do they settle for returns of about 2% on U.S. government securities when world-beating U.S. corporations pay two to three times as much in dividend income?

Moreover, why do investors accept a return that is guaranteed to lose out to inflation for the safety of principal on U.S. government debt when they could garner payouts from blue-chip companies that ought to keep pace or exceed inflation and presumably provide capital growth?

The fact is that macroeconomic data and policies to influence the economy are having little impact on what's really important to equity investors, corporate performance. Yet rarely has there been more attention focused on macroeconomic data and policy decisions.

Clearly, the solution is to focus with blinders on what really matters to equity investors — earnings and dividends, and the price they pay to participate in those sums.

The reason for this, writes David P. Goldman, former head of credit research at Bank of America, is there are two U.S. economies. "One is dead in the water and the other is doing reasonably well," according to a special study he's published.

There is no single, aggregate economy. Las Vegas housing or Italy's economy are apt to remain in the toilet while large U.S. corporations that populate the Standard & Poor's 500 are doing quite well, he observes.

Unlike small businesses, S&P 500 companies don't have to worry about complying with new regulations such as providing health care. Start-ups face penalties if they fail to provide health care if they have more than 50 people on their payroll. Big companies generally provide health care and already deal with a myriad of other regulations, so they won't have anything more onerous placed on their shoulders.

Moreover, Goldman points out that foreign sales constitute 46% of the total for S&P 500 companies. Sales of the S&P 500 were up 10% in the second quarter from a year earlier, while real final sales to domestic producers (gross domestic product minus inventory changes and trade effects) were up only 3.8% without adjusting for inflation. And he adds that employment at the S&P companies rose 10.6% between 2009 and 2010 while total U.S. employment edged up just 0.7%.

"In short, we have a post-bubble economy whose recovery prospects are dim, and a core American capability that is recovering smartly," he writes. As with emerging markets, there are two tiers. China and India have booming, modern sectors and vast backward ones. We are not particularly interested in the latter, but "we want to know what Tata Industries or Reliant Industries are up to."

"Large-capitalization U.S. corporations with a stable domestic franchise (utilities) or strong global-market share remain the sweet spot on the investment spectrum," Goldman asserts. "For the moment, investors will not buy an 8% earnings yield [the inverse of the price-earnings ratio] while 10-year Treasury yields trade around 2%."

This also has been the point that's been pounded by Andrew Bary in the print edition of Barron's, most recently in "Bargain Days," on Aug. 15. For the S&P, the forward-earnings yield is a record nine percentage points above the near-zero real yield on 10-year Treasury Inflation Protected Securities, a level not seen since the early 1980s, the piece notes.

More particularly, Dan Ferris, editor of the Extreme Value newsletter, contends what he calls World Dominating Dividend Growers are better risks than the U.S. Treasuries. These blue chips have the best balance sheets in the world and are paragons of financial stability and soundness — in contrast to Uncle Sam.

Three such world-dominator blue chips that are in Ferris' buy range are Intel (INTC -News), Microsoft ((MSFT - News) and Abbott Laboratories (ABT - News). All have strong balance sheets, thick profit margins and "gush free cash flows" that are returned to shareholders through buybacks and annual dividend increases.

"Intel is a phenomenal bargain right now, yielding 4.1%. That's incredibly high yield for such an excellent business. It's less like a typical stock and more like a bond with a coupon growing more than 20% a year," he writes.

Intel also has been busy buying back shares, as has Microsoft, which appeared to boost the latter's shares 6% in June and 5% in July, Ferris continues. In addition, he looks for a 10% dividend hike from Mister Softee in the next few weeks.

Abbott's payout is up 9% from last year. "At a current yield of 3.7%, it's a much better deal than the majority of master limited partnerships (MLPs), real-estate investment trusts (REITs), business development companies (BDCs), and other risky securities trading at higher current yields," he adds. And though he doesn't mention it, dividends from corporations are taxed at a maximum of 15%, while REITs, MLPs and BDCs are taxed at ordinary income-tax rates.

There may be less contradiction between investors pursuing the paltry yields on Treasuries and shunning the lush ones on blue-chip stocks than it appears. Both reflect the pessimism shown in falling confidence surveys and evident in GDP data. But it's also clear that U.S. GDP, employment and the like are divorced from the performance of major American corporations. Investors should take advantage of that divergence.

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