4Q10

# THE FSAG ADVISOR

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## Market & Economic Update

The third quarter has been volatile from both a financial market and economic perspective. The S&P 500 has gone from its worst August performance in 9 years (-4.5%) to its best September since 1939 (+8.7%). The economy has gone from increasing fears of a double dip recession to increasing signs of at least a stabilization of moderate growth prospects.

Investors are questioning whether the improved tone of equity markets over the past month is merely a reflection of stocks moving to the upper end of their trading range or if this trend is a reflection of real underlying changes. Certainly, the macro backdrop does seem improved when compared to one month ago.

Economic data has moved from "bad" to "less bad", and the rhetoric from Washington has recently focused on some pro-business and tax policies. Optimism is growing that with the upcoming midterm elections, investors may be seeing some more equity-friendly policies in the works. From our perspective, we are leaning more toward the positive side of the market debate and remain optimistic that the economy will avoid a double-dip recession, meaning that stocks should be able to continue to grind higher.

In perhaps the most notable headline, the National Bureau of Economic Research told us that the recession ended in June of 2009. The "Great Recession" marked the longest recession since the Great Depression, and over the 18 months of its existence, it resulted in an annualized decline in gross domestic product of 2.8% and a loss of 7 million jobs.

In other economic news, the Federal Reserve commented last week that it remains committed to doing what it can in terms of using its balance sheet to reflate the economy. Mirroring recent statements from the Bank of England and the Bank of Japan, the Fed made it clear that low growth levels are not acceptable, nor are deflation risks, and that the central bank stands ready to begin the next phase of quantitative easing.

In its statement, the Fed admitted that it believes inflation levels are too low, limiting its ability to promote stable prices. This was a significant statement, as until now the Fed was more focused on the slow pace of growth and high unemployment. These concerns obviously still remain, but by explicitly adding deflation risks to the list of problems, the Fed has made it clear that additional policy action is needed.

Although the downside risks to the economy seem to have eased over the past month, there is little reason to expect high growth rates to resume soon, suggesting that the Fed's work is not finished.

The world's developed economies seem to have settled into a period of positive but weak growth marked by high unemployment and high deficits. In this environment, the Fed is under pressure to help the economy break out of this phase. The prospects for additional quantitative easing measures have already prompted a decline in the value of the dollar and the lowering of private-sector borrowing costs.

It appears the Fed is also trying to restore confidence among consumers and corporations. Much of the slow growth that is plaguing the economy is due not only to the structural problems of ongoing deleveraging, but is also a result of the fact that companies and households are unwilling to spend in the current environment.

### 2010 Returns

| | |
|---|---|
| *DOW* | *5.58%* |
| *S&P 500* | *3.89%* |
| *NASDAQ* | *5.08%* |
| *Russell Small Cap* | *9.12%* |
| *Russell Mid Cap* | *10.97%* |
| *MSCI EAFE* | *1.07%* |
| *Barclay US Agg* | *8.49%* |
| *Barclay Muni.* | *7.76%* |

The Fed is hopeful that by using its balance sheet to reflate the economy, confidence levels will improve and spending will resume.

The global economy seems to have decoupled to some extent, with the developing world still doing well and the developed world stuck in a soft patch. We do not expect this soft patch to result in a renewed recession, however. The U.S. appears to have stabilized into a low-growth environment and Japan has become more aggressive in terms of promoting growth. The European debt crisis has worsened recently, however, and that region is still struggling.

Looking ahead, we believe the U.S. economy will continue to struggle, but we are optimistic that the actions of the Fed and other policymakers will help to restore some measure of confidence.

*Source: BlackRock*

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## 2011 Taxes Remain in Limbo

Congress returned to Washington in mid-September with relatively few "must do" items on its list. But the one topping that list is a biggie: dealing with impending tax increases that could affect virtually every American.

The Bush-era tax cuts enacted in 2001 and 2003 are set to expire at the end of 2010. If Congress does not act, most Americans will see a tax increase in 2011 as income-tax rates rise, taxes on capital gains and dividends increase, and the estate tax—currently at zero—returns in a big way.

The deadline isn't a surprise to lawmakers—it's been looming for years. However, as the calendar turned from summer to fall, there was little indication that a solution was coming anytime soon. Congress will wait until it convenes after November's midterm elections in a "lame duck" session to resolve the tax conundrum.

Here's our analysis of the likely outcomes of the tax debate, and the political hurdles that must be overcome to reach agreement.

**First possibility:** Congress does nothing (Odds: 10%).

Under current law, all of the tax cuts are set to expire December 31, 2010, with rates reverting (in most cases) to their pre-2001 levels. The 10% bracket would disappear completely, and the other tax brackets would rise (see chart below). In addition, the per-child tax credit would fall from $1,000 to $500, and the "marriage penalty"—married couples filing jointly getting a smaller deduction than if they filed separately—would return.

Capital gains taxes would increase from 15% to 20% for all taxpayers, and dividends would be taxed as ordinary income. The estate tax, which was eliminated at the beginning of 2010, would return at a rate of up to 55% on estates valued at more than $1 million.

If Congress can't agree on an alternative proposal, the old tax provisions would be restored on January 1, 2011. In the pre-election atmosphere, this worst-case scenario will be a popular talking point on the campaign trail, as candidates from both parties point the finger of blame at each other for possible tax increases in 2011.

Realistically, however, once the election is over, it seems highly unlikely that lawmakers will let taxes go up for nearly everyone, particularly given the economy's continuing struggles. Serious negotiations on a compromise solution will take place shortly after the election.

And even in the unlikely event that the current Congress does nothing, expect the new Congress to act in early 2011 to implement some sort of fix that's retroactive to the beginning of the year.

**Second possibility:** Congress approves President Obama's proposal (Odds: 30%).

President Barack Obama has stuck with his long-standing position of allowing taxes to go up only on individuals earning more than $200,000 and couples earning more than $250,000. Under his plan, only the top two tax brackets would increase: The 33% bracket would return to 36%, and the 35% bracket would go back to 39.6%.

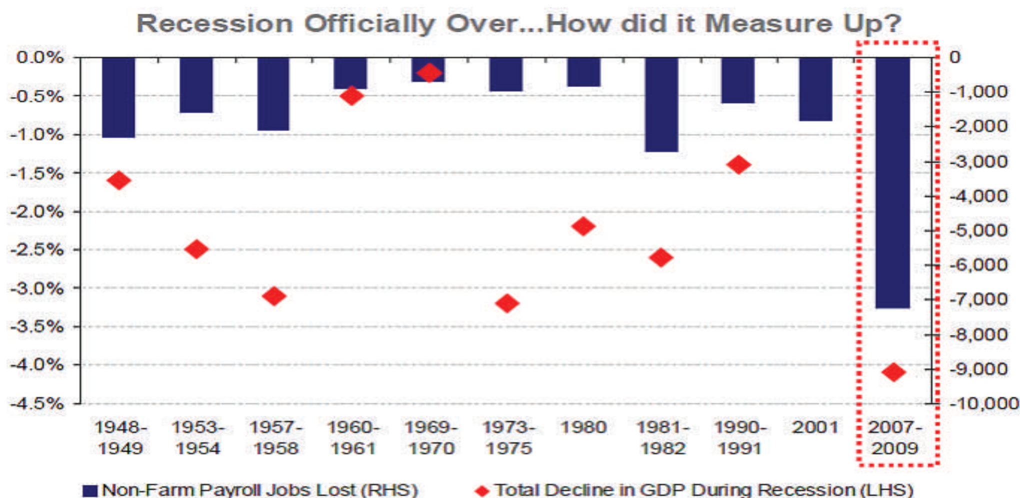
In addition, the president has called for taxes on dividends and capital gains to increase from 15% to 20% for filers in those top two tax brackets only. Most filers would see the rate remain at 15%, while the lowest tax bracket would continue to have 0% tax rate on capital gains and dividends.

Finally, President Obama recommends that the estate tax be made permanent at a 45% rate on estates valued at more than $3.5 million ($7 million for couples).

Senate Democratic leaders put forward legislation that mirrors the president's proposal in late September. However, several key Democrats have publicly expressed concern about raising taxes on anyone given current economic conditions. It doesn't

*Continued on page 4*

## Chart of Interest




*According to the National Bureau of Economic Research, the recession officially ended in June of 2009. Lasting 18 months, the "Great Recession" was the longest recession since the Great Depression and resulted in a loss of 7 million jobs and a decline in gross domestic production of 2.8%.*

## Landmark Financial Reform

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The provisions are designed to help prevent problems that led to the 2008 financial crisis from recurring. In some cases, the legislation enacts specific measures; in others, it authorizes the creation of regulations that will be determined in coming months.

The following is a summary of key provisions of the legislation:

**Regulatory supervision**

- Eliminates the Office of Thrift Supervision and transfers its functions to the Comptroller of the Currency.

- Authorizes the SEC to review how investment brokers, dealers and investment advisors are regulated and impose a universal fiduciary responsibility standard if appropriate. It also establishes within the SEC the office of Investor Advocate.

- Establishes a Consumer Financial Protection Bureau within the Federal Reserve to oversee financial products and services from mortgage lenders, banks and credit unions with more than $10 billion in assets, payday lenders and check cashing services (but not loans from auto dealers and pawnbrokers).

- Requires hedge funds and private-equity advisors to register with the SEC and disclose to the SEC information such as amount of leverage, investment positions, and counterparty risk. The SEC also will study whether to establish a self-regulatory organization to oversee the industry.

- Creates an Office of Federal Insurance, reporting to the Secretary of the Treasury, to recommend changes in the patchwork system of insurance regulation, and monitor the industry to determine which insurers might be threats to the overall financial system.

**Credit and lending practices**

- Requires lenders to determine a borrower's ability to repay a loan--for example, by verifying income and other data on a mortgage application.

- Limits prepayment penalties when a borrower repays a loan early.

- Restrains lenders from providing financial incentives that induce mortgage brokers or loan originators to steer customers to a higher interest rate mortgage simply to increase their commission.

- Orders the Federal Reserve to look at reducing fees charged to retailers for consumer use of debit cards, and permits retailers to offer a discount for payments not made with a credit card.

- Requires a lender to retain at least 5% of a loan on its books if the loan is sold or and/or securitized, though some relatively low-risk mortgages, such as fully documented loans with a fixed interest rate, are exempted.

**Monitoring and management of systemic risk**

- Establishes a Financial Stability Oversight Council to assess and manage risks that could threaten the entire financial system. The Council would consist of the Treasury Secretary and heads of various existing agencies, such as the Securities and Exchange Commission (SEC), Federal Deposit Insurance Commission (FDIC), and Federal Reserve Board, as well as an insurance expert appointed by the President.

- Establishes a procedure for the FDIC to liquidate a troubled financial institution whose failure might affect the stability of the nation's financial system.

**Investment and banking provisions**

- Makes over-the-counter derivatives more transparent and easily monitored by requiring that they be traded on a public exchange or clearinghouse. Nonstandard derivatives could still be traded privately, but would be reported to a central authority.

- Restricts banks' ability to engage in proprietary trading in their own accounts (this is the so-called Volcker Rule).

- Requires banks to hold additional capital to cover potential losses and set up separate operations to handle risky derivative trades such as swaps.

- Increases the fees that large banks pay to support FDIC deposit insurance, and redirects unspent funds from the TARP program rather than charging banks and hedge funds a fee to cover the costs of implementing the new legislation.

- Allows states to adopt restrictions on national banks that are more stringent than federal standards, and gives state attorneys general the authority to enforce some of the Consumer Financial Protection Agency's regulations.

**Miscellaneous**

- Makes permanent the $250,000 ceiling on FDIC insurance for bank deposits.

- Modifies the accredited investor standard to exclude the value of a principal residence from the $1 million net worth threshold, and provides for periodic subsequent reviews of the definition of "accredited investor."

- Gives the SEC the ability to oversee and discipline credit rating firms, fining those that issue too many faulty ratings over time. The SEC also will determine whether a new governmental agency is needed to oversee credit rating agencies.

- Allows investors to sue credit-rating agencies for issuing securities ratings that they knew or should have known were flawed.

- Gives shareholders of publicly held companies a nonbinding vote on executive compensation. Also, the SEC will review whether to mandate that shareholders be able to nominate their own candidates for a company's board of directors.

*The Dodd-Frank Wall Street Reform and Consumer Protection Act made permanent the $250,0000 ceiling on FDIC insurance for bank deposits.*

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## Stock in the News: Qualcomm (QCOM)

Qualcomm is the innovator of code division multiple access technology, a key communication standard used in wireless networks. The company has leveraged its CDMA expertise into the semiconductor market, where the firm is a key supplier of chips to wireless handset makers and also generates royalty revenue by licensing its intellectual property. CDMA is one of the two main wireless standards used by the telecommunications industry to enable cell phone usage and connectivity. Qualcomm holds more than 10,000 patents related to CDMA.

Essentially phones are unable to connect to the CDMA network without paying a royalty to the company. Qualcomm's licensing arrangements with virtually every handset maker allows the firm to collect about 3 to 5% of the total price of each handset unit sold.

All 3G wireless networks are CDMA-based. As wireless carriers upgrade to 3G in order to provide greater bandwidth Qualcomm should see a boost in royalty revenue. Qualcomm appears poised to profit from 4G technologies as well, as the company has already signed 4G royalty deals with Nokia, Samsung and LG even though 4G technology adoption is in its infancy.

Analysts expect a modest upside surprise from Qualcomm in fiscal 4Q10 to be reported early in November. Qualcomm should benefit from the overall growth in 3G networks and handsets, the accelerating growth in smart phones, and the position of several of its leading customers in these market trends.

| Key Statistics: QCOM | |
|---|---|
| *Price* | *$45.13* |
| *Trailing EPS* | *$1.90* |
| *Estimated EPS* | *$1.86* |
| *EPS Growth Forecast* | *15%* |
| *Current P/E* | *16.97X* |
| *PEG Ratio* | *1.13X* |
| *Dividend Yield* | *1.7%* |
| *Market Cap* | *$72.44 B* |
| *52 Week High* | *$49.80* |
| *52 Week Low* | *$31.63* |
| *Beta* | *0.83* |
| *ROE* | *19.1%* |

*Sources: Morningstar, Argus*

## 2011 Taxes Remain in Limbo *Continued from page 2*

appear right now that the necessary super-majority of 60 votes in the Senate (where Democrats currently hold a 59-41 majority) is attainable. That could change after the election.

**Third possibility:** Congress extends all of the tax cuts for one or two years (Odds: 50%).

The outcome that appears most likely—though far from certain—is that Congress simply extends all of the tax cuts for one or two years. Republicans would unanimously support such a proposal, and several Democrats have signaled their support for the idea. If faced with a choice between letting the tax cuts expire and extending all of them for a year or two, most observers think Congress would choose the latter.

The big stumbling blocks are the budget deficit and an obscure rule governing budgetary items. Extending all of the tax cuts, even for just a year or two, would increase the budget deficit, which is already approaching $1.5 trillion. Many lawmakers are deeply concerned that the massive debt the U.S. is compiling is creating a hole that may be almost impossible to escape.

Further, under rules known as "pay as you go," any tax cut must be offset with either spending cuts or tax increases. There are a number of exceptions, including one for income-tax rates for taxpayers with income up to $250,000 ($200,000 for single individuals).

Also, keeping the capital gains and dividends tax rate at 15% would technically require Congress to find approximately $100 billion in offsets, which seems unlikely in the current environment. Congress could just ignore the "pay-go" requirement, but some Democrats are reluctant to do so, since it was they who pushed for this new statutory requirement at the beginning of 2009.

**Fourth possibility:** Some other compromise emerges (Odds: 10%).

None of the three options described above yet enjoys broad support. That may change in the weeks ahead, but it also leaves the door open for another proposal to be put forward to resolve the issue.

Some lawmakers have proposed letting the estate tax return to where it was in 2001, while preserving the other tax cuts. Others have proposed dealing just with income tax rates, while allowing the capital gains rate to return to 20% for everyone and dividends to be treated as ordinary income. Other proposals could emerge. At this point, though, the three scenarios outlined above are the main players.

The final complicating factor is the election itself. Republicans are widely expected to make significant gains in both the House of Representatives and the Senate, narrowing the current large margins and possibly even taking control of one or both chambers.

While newly elected members will not take office until January, the lame-duck session looming in November and December is likely to include a number of lawmakers who have lost their seats. Freed from political repercussions, these members could vote in unpredictable ways.

There are numerous moving parts to the tax endgame, and it remains very difficult to predict the outcome.

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