

Investment Outlook

Uncertain Times

Our Investment Outlook begins with a survey of global economic growth, followed by a closer look at positive and negative developments in the U.S.. We then revisit comments made in our prior Investment Outlook to see how our predictions panned out, and finish with a look at global debt issues. Throughout 2009 we have been trimming back equity positions in response to heightened risks. Nevertheless our clients in aggregate have achieved investment returns of 50% year-to-date through November 30, which is more than double the return on the S&P 500 for the same time period.

A fragile economic recovery is underway. Sequential third quarter GDP growth in the U.S. was 0.7%, Eurozone growth was 0.1%, while Japan had a 0.9% nominal contraction. China is reportedly growing about 2.2% and India is growing about 3.5%. Mexico was up 0.7% but Canada was up only 0.1%. The figures above represent just one quarter, so you have to multiply by four to get the annual rate quoted in most press reports.

The high growth rate in China and India, representing 40% of the world's population, suggests that demand for food, energy and natural resources will remain firm. Foreign trade is only 10% of India's economy, which seems to have benefited from lower commodity prices in the wake of the global recession.

As I write this on December 4, the U.S. just received an early Christmas gift: November non-farm payrolls declined by only 11,000. This relief is none too soon, as the unemployed continue to run out of savings, unemployment benefits and COBRA benefits, pressuring the economy to contract further. At least half of the growth in GDP can be attributed to temporary government stimulus programs. Meanwhile the core problem of a stressed banking system remains.

Encouragingly, U.S. home prices have risen modestly for four straight months. However, the number of mortgages 90 days past due or in foreclosure just hit a record 14.41%. So the supply of homes for sale should continue to increase and keep a lid on prices. The only factor which can boost demand enough to outstrip supply would be high inflation. Rental properties still do not generate enough rents to attract investors, but if inflation rears its ugly head, I believe real estate investors will lower their standards and buy property with little or no cash flow, just to get inflation protection. October inflation was 3.6% annualized and has been in this range since August. Of course, inflation leads to higher interest rates which make financing more difficult, so the demand for real estate may be a tug of war between cash rich investors and traditional investors dependent on mortgage financing.

In our prior issue of Investment Outlook last August we expressed concern over the risk of inflation.

Since that time, the Consumer Price Index has accelerated to an annual inflation rate of 3.6%, and gold is up over 20%. Since we cited ExxonMobil as an example of oil stocks being cheap, ExxonMobil is up 8%. We thought office REIT's were a good investment, since then the BBREIT Office Property Index is up over 20%. We expressed concern that the nosebleed valuations of technology stocks did not factor in a disappointing fourth quarter. Sure enough, early reports say holiday sales are generally lackluster.

In September we decided to sell some stocks and increase the fixed income portion of our client accounts from about 30% to about 45% on average. We do not normally change allocations in response to market events or try to time the market, so this was unusual for us.

We were grateful for the strong comeback our investments made in the first 9 months of 2009, and wanted to secure these gains. We also felt there were more dominos to fall in the world financial system, and that the market was being overoptimistic in declaring an end to the recession.

Since September, the S&P 500 is up about 5%, so the change in allocation shaved about 1% off our 2009 performance. We feel this is a small price to pay for reducing risk. Just this week, Dubai World announced they are seeking to reschedule their debt, sending shock waves through the financial world. Dubai World was viewed as rock solid, and if they can default, it calls into question the value of corporate debt in many emerging markets.

The outlook for fixed income is grim. Ultra-safe fixed income such as U.S. Treasury Bills are paying less than the inflation rate. So the investor is really paying the government for the privilege of holding a safe investment. It is extremely rare for interest rates to be below the inflation rate, so we feel quite confident that interest rates will rise. For this reason we are avoiding long term bonds, and sticking with the short term, even though the returns are the same as stuffing money in the mattress.

With so many stressed situations, we believe it's not a question of if, but when, the next entity will blow up. Even mighty Japan, the world's second largest economy, seems headed for a day of reckoning, as their level of government debt becomes unsustainable. Japan has the world's highest level of government debt relative to GDP, yet their new government seems intent on increasing that debt, even as their economy is contracting at a 4.5% annual rate and their working population is shrinking.

About 95% of Japanese government debt is held by Japanese, so the rest of the world won't be holding the bag. However, if Japan fails to grow their economy to keep up with their debt, they face a painful deleveraging that must dampen world economic growth. Japan's neighbor Korea is also worrisome given their reliance on electronics exports. The semiconductor industry continues to become more mature, more competitive, and less profitable. A lot is riding on Christmas season, which at this juncture seems to be as much of a bust as last years.

For the longer term, drivers of economic growth remain intact. Technology continues to progress, trade continues to flourish despite rising protectionism, and consumerism continues to sweep every corner of the globe, spread by the gospel of television and the internet. While the

restriction of credit will slow growth , it also means that investors face less competition when pursuing opportunities. Adversity creates opportunity!

In conclusion, the economic trends are good, but many bad debts remain unresolved, and it is by no means clear that the western economies can keep growing after the government stimulus programs end. Meanwhile, continued high growth in India and China suggest prices for basic commodities will remain strong. We therefore think it prudent to keep some stock investments with the potential for high returns, while keeping a healthy reserve of short duration fixed income , in case the dreaded “double dip” materializes.



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