

Investment Outlook

Why We Continue to Hold Stocks

Our last two issues of Investment Outlook were entitled “Taking Away the Punchbowl” and “\$4 Gasoline Dampens Outlook”. Despite these gloomy titles, we retained substantial stock investments due to lack of good alternatives. The primary alternative to stocks is fixed income, and fixed income is vulnerable to inflation. In this issue, we focus on the U.S. Federal debt and why it stokes inflationary expectations. We will also discuss some upcoming events affecting specific stock holdings.

Aside from lack of good alternatives, we hold stocks because we believe many to be great bargains. The world economy is growing at an unprecedented rate in absolute terms. The emerging economies of the world are not saddled with debt issues or aging populations. Companies which are tied into this growth should do just fine if they can make it through some slow periods. Please keep this in mind as we proceed to discuss problems within the United States.

Federal government debt may have reached a tipping point where the debt threatens to bankrupt the government. Let's review the figures. Our Federal debt is about \$14.3 trillion. Of this, about \$4.6 trillion is intergovernmental debt, because the government has borrowed from the Social Security Trust Fund and the Federal Employees Pension Fund and given these Funds IOU's which pay interest. So this \$4.6 trillion represents funds withheld from employee paychecks, and thus should be included in our calculation as a real debt.

With interest rates at record lows, interest on the Federal debt currently runs about \$415 billion per year. However, if interest rates were to rise to 8%, the interest expense on \$14.3 trillion would be \$1.1 trillion per year. Government receipts, exclusive of Social Security taxes, were only \$1.3 trillion in Fiscal 2010. Thus, if the interest rate on the federal debt were to rise to 8%, interest expense alone would consume 88% of government receipts exclusive of Social Security.

Can interest rates go that high? Rates on 1 year Treasury Notes were above 8% for much of 1974, and remained above 8% from 1978 to May of 1985, peaking at 15.2% in September 1981. So yes, rates can go that high. How fast can rates rise on the Federal debt? The maturity schedule of the Federal debt is:

Maturity	Portion of debt
<1 year	33%
1 to 5 years	37%
5 to 10 years	19%
More than 10 years	11%

As you can see, rising interest rates will effect 33% of the debt within one year, and 70% of the debt within five years. If rates go up substantially, the government will have the following alternatives to pay the added interest expense:

1. Raise taxes and tariffs,
2. Cut spending,
3. Borrow more,
4. Sell government owned property,
5. Print more money,
6. Default.

Raising taxes and cutting spending are needed just to reduce our current \$1.5 trillion deficit. That is \$5,000 for every citizen. To go beyond \$1.5 trillion may be politically impossible. Borrowing more in response to higher interest rates will eventually create a death spiral of increasing borrowing and increasing rates. Selling government owned property may help, but the asset value may not be enough. According to the 2007 U.S. budget, federal lands are worth only \$919 billion and mineral rights \$392 billion. Hard to believe.

This brings us to “Print More Money”. This is the scenario which will lead to huge inflation and crush the value of fixed income investments. Printing more money can only be accomplished with the cooperation of the Federal Reserve, so it is not a foregone conclusion. The Federal Reserve is charged with maintaining full employment, keeping prices stable, and maintaining the stability of the financial system. The choice will be a hard one, because if the Fed decides to fight inflation by tightening the money supply, it could result in more job losses and bank failures. If the Fed decides to continue increasing the money supply, it will fuel further inflation.

For now the Fed continues to print money. Chairman Bernanke admits inflation exists, but says it is not yet ingrained. The Consumer Price Index has been rising at a 5% annual rate over the last five months. If we strip out the housing component, inflation has been running at a 7% annual rate. Bernanke blames rising commodity prices on supply/demand imbalance, not inflation. It appears the Fed will continue its easy money policies until such time as inflation does become ingrained, at which point it will be hard to dis-ingrain. Meanwhile, Congress struggles to bring our \$1.5 trillion deficit down by a paltry \$100 billion or so.

The dollar enjoys special status as the world's reserve currency and the standard currency of international trade. However, this special status will only last as long as foreigners trust the dollar will maintain its value. If the dollar continues to lose value, foreign investors will want to get rid of their dollars, which will make the dollar lose more value and a terrible snowball effect could ensue. This is why we consider fixed income investments tied to the value of the U.S. dollar as risky.

Fortunately there are some fixed income investments that offer a degree of protection against inflation. Treasury Inflation Protected Securities receive principal adjustments based on changes in the Consumer Price Index. Corporate floating rate notes adjust to rising interest rates. Foreign government bonds denominated in foreign currencies will benefit from any drop in the U.S. dollar exchange rate. However, our trading partners have a strong incentive to keep their currencies on a par with the dollar, so they may seek to minimize any rise by mimicking the U.S. loose money policy.

While stocks face some economic headwinds, it is fixed income which is especially vulnerable to the woes of the U.S. dollar. We have shown how rising interest rates could cause the Federal debt to become unaffordable, and how the Federal Reserve may be forced to run the printing press as the only solution to a dire situation. We don't think a 1.5% interest rate on a 5 yr. Treasury Bond is anywhere near adequate compensation for this risk.

Future Events

Axion Power is expecting the Department of Energy to announce by July 1, 2011 whether it has been awarded a grant to develop batteries for hybrid autos with a Big Three U.S. automaker. Axion's largest shareholder has been steadily selling shares and putting the stock price under pressure. At some point this shareholder will stop selling and this pressure will abate.

Infinera has a new generation of PIC chip which it plans to launch in the fourth quarter, as a prelude to volume shipping in the first half of 2012. Customers have been holding back purchases in anticipation of the new chip, so there should be substantial pent-up demand.

China Valves Technology has been looking to hire a Big Four audit firm, ever since their credibility was undermined last January in a negative report by a short seller. The announcement of a new auditor should be a big plus.

Silvercrest Mines has two pieces of good news coming. On May 31 it filed its registration statement with the SEC, which is anticipated to become effective 60 days after the filing date, or earlier if accelerated by the SEC. This will allow U.S. investors to resume trading

the stock. Also due out are first quarter results, which should show a continuing ramp up of mining operations toward full production by June.

With the broad market on a losing streak in May and June, we certainly welcome some good news from our stocks.

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