

# Investment Outlook

## The Misinformation Age

Newspapers are no longer the self appointed guardians of proper English. Case in point: Millionaire always meant a person worth \$1million. All of a sudden, the media is using millionaire to mean a person with \$1 million of annual income, as in “Democrats Propose Millionaire Tax”. Perhaps we need this change in definition so that “millionaire” will continue to mean “rich person”. Blame it on inflation.

Another case in point: The European debt crisis. “Crisis” means a crucial time in which a decisive change is impending. Greece was first bailed out in May 2010. This has gone on too long to be called a “crisis”. May I suggest “fiasco”? Whatever we call it, it has spooked investors.

The fiasco began when European Union member states were able to issue government bonds at very low interest rates. After Iceland required IMF intervention in October 2008, investors become more nervous about certain EU members creditworthiness. By spring of 2010, investors in Greek bonds were demanding such high interest that Greece was no longer able to keep up with its debt payments. Ditto for Ireland, ditto for Portugal. Despite intervention from the European Central Bank and the International Monetary Fund, interest rates on Greek bonds have not come down to levels where Greece can service its debt.

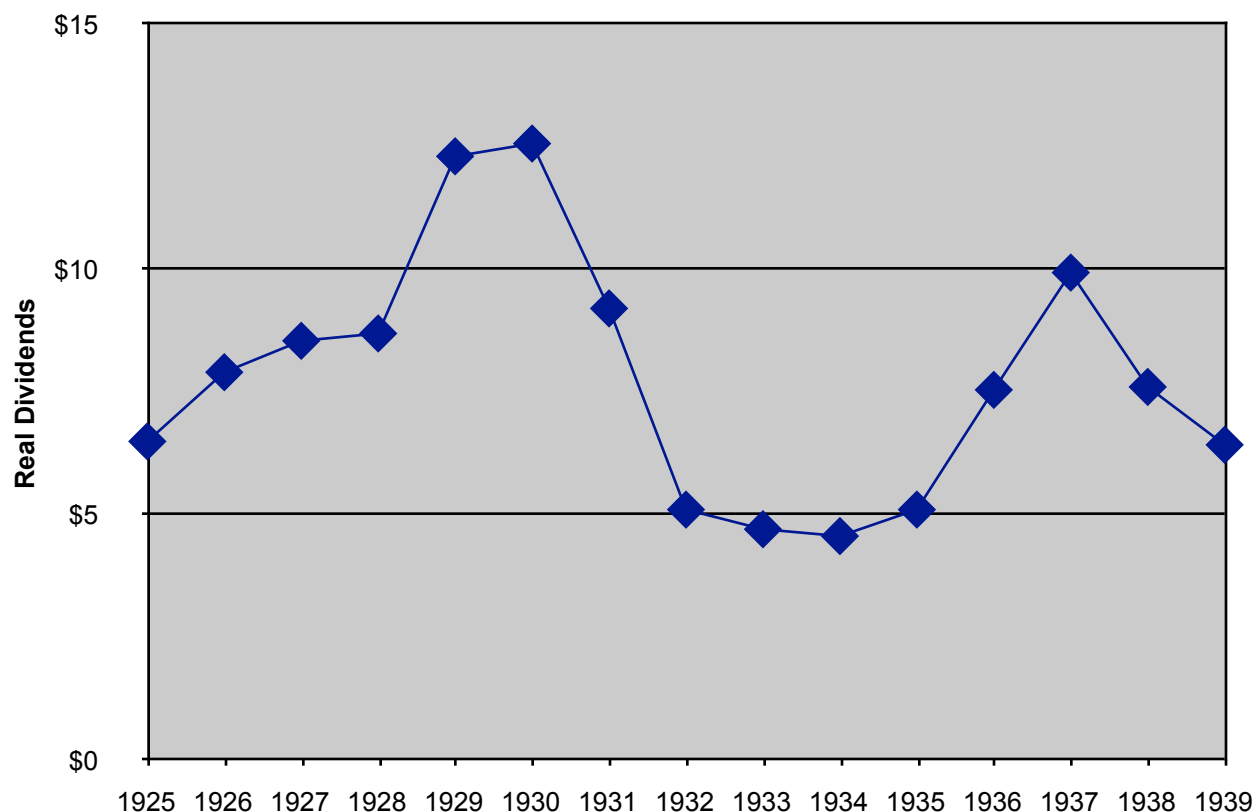
Since many European banks hold Greek bonds as part of their capital structure, a default would put a strain on the banks solvency. While Greece may not be large enough to cripple the banking system, the doomsday scenario is that the Greek default makes investors reluctant to lend to Ireland, Portugal, Italy, Spain and even France, thereby pushing each country into default. That would certainly push the European banks into insolvency, as well as many American financial institutions which have to make good on credit default swaps on European bonds.

The European banks have a patchwork of deposit insurance schemes which are not as comprehensive as America’s FDIC. Consequently we are already seeing depositors fleeing European banks. In order to forestall a run on European banks, I believe the ECB will print as many euros as needed to provide member banks with unlimited euros to meet withdrawal demands. The Federal Reserve has announced it will

swap an unlimited amount of dollars for euros with other central banks. In other words, both American and European monetary authorities are prepared to debase their currencies to plug the hole in bank balance sheets left by devalued government bonds and fleeing deposits.

This continuing currency debasement does not bode well for fixed income investments denominated in euros or dollars. What about stock investments? Just how bad will a shaky banking system and a shaky currency be for businesses? Let's take the Great Depression as a guide to see just how bad things can get. Look what the Depression did to corporate dividends:

**Dow Jones Industrial Dividend Payout 1925 - 1939 Adjusted For Inflation**



The 30 stocks in the Dow Jones Industrial Average paid an average dividend of about \$7.92 during years 1925 through 1928, before briefly spiking to about \$13.00 in 1929. Thereafter, in the worst four years of the 1930's , the dividend dipped to \$4.88. I don't think anyone can claim we are at the top of a spike in dividends or earnings at present, so let's ignore the spike and focus on the dividend drop from \$7.92 to \$4.88, a drop of 38%.

Let us assume that each of our stocks experiences a 38% drop in earnings. Let us further assume that the market will revert to its historical average price/earnings

ratio of 15:

SYMBOL	CURRENT PRICE	CURRENT EARNINGS	EARNINGS MINUS 38%	FUTURE PRICE @ P/E OF 15
ADM	25.91	3.13	1.94	29.10
BASFY	66.12	9.02	5.59	83.85
TEVA	37.58	4.69*	2.91	43.65

\* Non-GAAP

So if we assume a drop in earnings equivalent to the drop in dividends during the Great Depression, and if we assume a reversion to historical P/E ratios, we can expect an increase in stock prices, not a decrease. In other words, the current stock price implies a drop in earnings greater than the Great Depression. Note: I used dividends as a substitute for earnings because earnings were not widely published in the 1920's.

I doubt the coming storm will be as bad as the Great Depression. Unlike the 1930's, we have large emerging economies in growth mode. Unlike the 1930's we have maintained world trade. Unlike the 1930's, we have tools to preserve the banking system and grow the money supply. Plus the rate of technological advance has accelerated. There are also some negatives. Personal debt levels far exceed the 1930's, and we have new environmental concerns. But all in all, the situation today seems far better.

As the Federal Reserve continues printing dollars and the European Central Bank continues printing euros, fixed income investments will likely fail to keep up with inflation. Stocks will be challenged by slow economic growth, or even a contraction. Given these risks, we think it foolish to hold all fixed income or all equities; better to have some of each. However with Treasury Bond prices at record highs, and stock prices at record lows relative to earnings, we lean more to stocks. Within the stock universe, we continue to seek companies which can best ride out a poor economy.

Hoping for the best but preparing for the worst,

Robert Balopole

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