

Investment Outlook

Investment Outlook: Really That Grim?

Corporate earnings in the second quarter were very strong, yet many stocks are trading at 30% to 50% below normal valuations. I look at this big discount and wonder, is the outlook really that grim? In this issue of Investment Outlook, I survey Housing, Employment, Gross Domestic Product, and the China Real Estate Bubble, to see whether corporate earnings are indeed headed down.

After the survey, I discuss how stocks may react to any new economic downturn as compared to the last economic downturn. Finally, I speculate as to the length and severity of any impending downturn, using the Great Depression and Japan's Lost Decade as a guide and ask whether even a calamity of those magnitudes justifies a 30% to 50% discount in stock values.

Let's start with the source of our current problems: the U.S. housing market. There remains a huge backlog of homes worth less than their mortgages. The fear is that housing prices will continue to collapse as these homes get foreclosed and put on the market.

I have always believed that a floor would be put in place under housing when home prices dropped to the point where real estate investors could get a good cash income from a rental property. I think we are at that point in many regions. For instance, I went on www.Craigslist.com and found a 3 bedroom house in Fairfield renting for \$1,200 per month. I then went to www.zillow.com and found that same house valued at \$145,000. If an investor puts 20% down, and finances the balance with a 30 year fixed mortgage at 5%, they would earn \$6,854 yearly on their \$29,000 down, a cash return of 24%. I have not included any expenses other than the mortgage payment, but even including other expenses, it is highly likely an investor will have positive cash flow, even as their tenant helps them pay off the mortgage.

Here in California, it has been many decades since single family homes could be bought at prices which permit a 10% to 15% cash return on investment. This should be bringing lots of new income investors into the market. This should also bring renters back into the homebuying market, because they can own cheaper than they can rent. So while a lot of foreclosures are waiting to hit the market, a lot of buyers are waiting to buy them at the right price.

I am quite frankly surprised that we have not yet seen any large operators coming into the single family housing market. I think it is just a matter of time before some multifamily REIT is brave enough to make a small foray into the single family rental business..

While July homes sales declined sharply, I believe this was a distortion resulting from expiration of the home buyer tax credit. The good news is that home prices continue to increase in most regions.

On the employment front, private employment has been creeping steadily upward since last January. As in housing, the July employment number was influenced by government actions, namely the termination of 140,000 census workers. But I see nothing in the numbers to suggest employment is weakening.

U.S. GDP declined in the June quarter to an annual rate of only 1.6%. However, the reason for the decline was an increase in imports. The American consumer is spending, but unfortunately we are not buying American. While this is bad for the U.S., the fact that spending is up is a net plus for the world economy.

That brings us to China, where some say a real estate bubble is bursting. I view China as an ongoing experiment, so no one really knows what could happen. The Chinese government statistics are showing only a miniscule dip in real estate prices for June. China continues to be an export driven economy, so I tend to believe the bursting of the Chinese real estate bubble will be less devastating to China, as compared to what the U.S. went through when its real estate tanked. I also note that Chinese exports are growing nicely, and the Chinese government has a huge surplus which it can use to aid the Chinese

economy.

To recap: Housing prices are moving up, Employment is going up, GDP growth is declining but remains positive, and China real estate has recorded one month of minimal decline. Hardly a doomsday scenario!

If the economy does falter, will it impact the stock market less or more than in 2008? Some suggest the government has exhausted its ability to apply stimulus, and therefore any downturn will be more severe. However, 50% of stimulus project funds remain to be paid out. Also, the Federal Reserve can continue to print money as long as inflation remains tame, regardless of whether the Tea Party captures Congress.

I am optimistic the stock market is more resilient now than in 2008. The crash of 2008 came on the heels of a 25 year expansion and caught most businesses and investors unprepared. The climate is totally different today. With the crash fresh in mind, more are prepared for a downturn. Corporations have much more cash and much less debt than they did in 2008. Also, the weaker stock investors have been flushed out; the remaining investors have deeper pockets. In 2008, a lot of investors were forced to liquidate holdings to meet their obligations. Today there are fewer investors playing with borrowed money.

If things do get bad again, how bad could it get? In the Great Depression the U.S. economy shrank by 27% over the course of three years, but by 1936 the economy had returned to pre-Depression levels. Of course we now believe our government made the Depression worse by shrinking the money supply and erecting trade barriers. In my view, if a stock is currently earning 20%, as are several in our portfolio, it will still be a good investment, even if there are three or four years with low earnings or no earnings before earnings return to normal. This assumes both the company and the investor can wait it out.

In the “Lost Decade”, Japan’s government kept banks from failing, with the result that the economy limped along at around a 1% growth rate for more than a decade. Again, this would not be bad news for an investor in a stock trading at a mere 5 to 10 times earnings. So if history is a guide,

the next recession will either be deep and short, or shallow and long. In order for stocks to be a bad investment at current valuations, we would have to see a long and deep contraction. I don't believe we have seen such an event in modern times, barring a political upheaval or other catastrophe.

Clearly there are risks out there which call for a more cautious allocation. However, I just don't see any reasonable justification for abandoning stocks. To the contrary, I am excited by the potential returns should stocks manage to merely sustain current earnings.



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