

# Investment Outlook

## Inflation Ahead?

Investors are increasingly worried over impending inflation, and rightfully so. The U.S. Government and the Federal Reserve have spent, lent, or guaranteed \$12.8 trillion on the financial rescue, according to data compiled by Bloomberg. That approaches the value of everything produced in the country last year. Yet U.S. Government debt has increased by “only” \$2.5 trillion since the close of 2006. The remainder of the \$12.8 trillion has been created out of thin air.

So why hasn't all this newly minted money caused inflation? It is because individuals and banks and businesses are sitting on their money, saving more, spending less, or paying off debts. Once people decide to resume spending these vast sums of idle cash, the potential for inflation is huge. What could spur people to resume spending or investing? For one, confidence in an improving economy. But spending can also be triggered by fear, fear that the dollar will lose its value. The point is that inflation can snowball if there is a panic to get out of dollars and into some asset, any asset, that will better retain value.

At this writing, the 10 year Treasury Bond yields 3.44%, proving that many remain unworried by inflation. Some believe the Fed will cut back the money supply once inflation ramps up. This might avert inflation, but would still raise interest rates and wreak havoc on existing fixed income investments. Some believe businesses can easily expand their productive capacity to meet rising demand without raising prices. On the contrary, I believe many business owners will react to increased demand by simply raising prices rather than expanding capacity. Not only is raising prices easier and safer, but business owners will not risk adding capacity if they fear that rising costs will rob them of profits on their expanded operations.

While the future inflation rate is subject to debate, the heightened risk of inflation is beyond dispute. To protect our clients from this risk, here at Balopole Investment Management Corporation we are investing in companies holding tangible assets such as real estate, oil, metals and aircraft. The good news is that one can protect against this heightened risk at very little sacrifice. Stocks of real estate, oil and gold mining companies are still selling at bargain valuations. One can easily find companies where the ratio of cash flow to stock price is 15% to 20% or even higher. If investors start piling into tangible assets, prices will be bid up and at that point a new investor will have to sacrifice earnings in order to have a safe haven from inflation. But for now, investors can enjoy inflation protection and good earnings to boot.

In the real estate sector, earnings of medical and multifamily real estate have held up best, but valuations are also the highest. Hotels and retail have fared the worst, and while valuations are very cheap, the risk is high. I believe the office sector has the best combination of moderate risk and cheap stock valuations. The attraction of the office sector is the five to six year average lease term. I focus on companies whose debts are mostly fixed rate, and companies having little or no debt coming due in the next two years. Office REIT's are

outperforming the general office market, because REIT's have better access to cash than the smaller landlords, and are thus better equipped to fulfill tenant requirements.

Oil stocks are also cheap; Exxon Mobil sells for a P/E ratio around 11 (not that I recommend XOM). Although crude supplies are not tight at the moment, longer term the largest oilfields are old and in decline. For example, crude exports from Mexico are down 40% since 2005. The new supply sources are expensive and slow to develop. On the demand side, while U.S. drivers are downsizing, the Indians and Chinese are waiting in line to buy their first car. This new market of perhaps 200 million new drivers should overwhelm fuel economy advances in the U.S..

In the technology sector, 2010 promises several exciting growth drivers which are already reflected in soaring stock prices. Hopes are high that low cost "netbook" computers will proliferate, especially in emerging economies, with sales subsidized by carriers in return for service agreements (the cellphone business model). Internet infrastructure needs to grow to accommodate increased numbers of users and increased transmission of video and high definition video. Soon-to-be-released Windows 7 should spur computer sales. Many businesses shunned Microsoft's Vista, and are now overdue to upgrade their PC's.

The nosebleed valuations of the tech stocks are cause for concern.

The second quarter showed strong sequential growth in revenues, but this was practically inevitable, following the unprecedented contraction in the first quarter. The big question now is how strong will third and fourth quarter sales be, as these are normally the strongest quarters in tech. The growth drivers listed above will not arrive in time to help 2009. If tech investors are disappointed by third and fourth quarter sales, tech could tumble and take the rest of the market down with it.

Despite the volatility, stocks with sound fundamentals remain attractive as a hedge against inflation.



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