Balopole Investment Management Corporation

December 2018

Investment Outlook

Market Correction or Major Downturn?

The S&P 500 is down 10% from its peak at the end of September, erasing all gains of 2018. Optimists claim the stock market had run way ahead of earnings and was due for a correction, while pessimists see the stock market drop as a predictor of recession.

According to economist Robert Shiller, the Price/Earnings ratio of the S&P 500 is now 21.56, compared to a mean average over the last 150 years of 15.73. While the S&P is still high by this standard, it is in the middle of its 1993 to 2018 range. If we believe the last 25 years are the new normal, then the S&P 500 is reasonably valued.

Real corporate earnings grew about 10% in 2018, which is far above real GDP growth of 3.5%, suggesting other factors are at work. Repatriation of foreign earnings and the cut in corporate tax rates are probably responsible for most of the growth in corporate earnings. Unfortunately these are temporary factors. The surge in business investment made possible by the repatriation has already slowed. Over time, competition should whittle away most of the benefit of lower corporate tax rates.

I believe it is therefore probable that corporate earnings growth will slow from its torrid pace. Whether this will further depress stock prices is anyone's guess; with current sentiment so negative it may already be reflected in price levels.

So are we headed for a recession? The stock market is considered the best predictor of a recession, but just because it is the best of a bad lot does not mean it is very good. There have been about 73 corrections, defined as a 10% drop in stock prices, since 1945. Yet there have only been 12 recessions. The stock market is a very poor predictor of recessions.

A flattened or inverted yield curve is usually followed by a recession, but sometimes it takes years. For instance, the yield curve flattened in 1995 but the recession did not hit until March 2001. Many people believe we are due for a recession simply because we have not had one since 2009. We are on the verge of tying the record for the longest expansion in U.S. history.

We do not see any financial bubbles that could lead to a major downturn. The housing market is just now getting back to 2006 price levels, but the lending standards today are more strict and the banks are better capitalized. China could be a bubble about to burst, but as we all know China is not a major buyer of U.S. goods and thus the U.S. does not have much direct exposure.

As of this writing, the Mueller investigation hangs over the country. While there may be chaos in the political realm, it is hard to see how that could spill over into the economic realm. Recall that the Clinton impeachment was a boom time in both the economy and the stock market. To those who fear the administration will be mightily distracted from running the country, it seems we are already at that point today, yet the economy keeps chugging along.

All these predictions aside, we are finding many compelling values in the current equity markets. Over the last few years, growth stocks, (Facebook, Amazon, Netflix, etc.) have appreciated sharply while value stocks (our focus) have been sluggish. Yet the market decline since September has affected all stocks, so that stocks which were cheap before are now super-cheap.

We focus on companies whose stock price is well supported by current earnings. Most of our holdings are maintaining earnings and some are even growing earnings, yet most are being unfairly punished in this broad market pullback. We expect as investors become more cautious they will gravitate to value stocks as a more defensive investment than growth stocks.

We expect our value portfolio to recover much more quickly than the broad market, as it did in the 2008 downturn. Meanwhile our clients get a healthy revenue stream from dividends as we wait.

Here are a few of our current recommendations:

New York Community Bancorp (NYCB) specializes in lending to rent-controlled apartment complexes in New York City. Non-performing loans are a miniscule 0.14% of total loans, compared to an industry average of 1.0%. This is because these rent-controlled apartments have very low vacancy rates.

NYCB had been keeping below the $50 billion threshold above which it was subject to additional regulation as a “Systemically Important Financial Institution”. Last spring this threshold was raised to $250 billion, and NYCB has been raising money to acquire more banks, believing it can profitably lend whatever deposits it can acquire. NYCB pays a 7% dividend.

Arlington Asset Investment Corp. (AI) invests in Mortgage Backed Securities issued by Government Sponsored Entities “Fannie Mae”, “Freddi Mac” and “Ginnie Mae” which guarantee repayment. AI uses considerable leverage. While a rise in interest rates decreases the value of its mortgage portfolio, management offsets this risk by investing in interest rate futures. AI pays an 18% dividend, which management states is paid out of net interest income without reducing the net asset value. The CEO and Chairman of the Board purchased shares on the open market in October.

Brandywine Realty Trust (BDN) is a Real Estate Investment Trust which owns and operates office buildings around Philadelphia, Washington D.C., and Austin. We have been investors in BDN since 2013. In 2016 the stock became a bit pricey and we began to reduce holdings where possible without triggering taxable gains. Recently the stock has declined to levels last seen in early 2016, yet BDN continues to advance on most financial metrics. Same Store Operating Income is up year over year 3.4% on a GAAP Basis and 13.7% on a Cash Basis. Net debt to total gross assets has been reduced to 39.1%, well below the industry average.

BDN has an excellent debt structure. 98.5% of its debt is fixed rate, with an average interest rate of 4.05% and an average maturity of 6.8 years. 83.4% of its debt is unsecured. BDN sells for less than 10 times Funds From Operations, and pays a 5.6% dividend.

Thank you for your patience in this volatile market. We have seen this movie before and are confident that the underlying quality of our investments will carry us through this time of turmoil.

Happy Holidays,

Robert Balopole, C.F.A.

P.S. We are moving across the street on January 7. Please note our new address, below:

1611 Borel Place
Suite 209
San Mateo, CA 94402
650-574-1307

Disclaimer: This newsletter is informational only, and does not constitute investment advice or a solicitation. Investments and investment strategies recommended in this newsletter may not be suitable for all investors. Balopole Investment Management Corp. and Robert Balopole may hold positions in the securities mentioned within this newsletter