Balopole Investment Management Corporation

September 2019

Investment Outlook

A Time for Caution

With client portfolios hitting new highs, the stock market is repeating a pattern we saw last April, riding high on optimism for an end to the U.S.-China trade war. As I predicted last April, I continue to believe the trade war will not be settled soon or easily.

Warren Buffet predicted the “trade spat” between the U.S. and China would be settled because both sides derive so much benefit trading together. Warren Buffet is famous for spotting a good business proposition where others see problems, pessimism and panic. While I greatly admire Mr. Buffet, in this case he may be overstating the business logic and understating the geopolitics.

In the Rust Belt, China is blamed for destroying entire communities. With many Americans struggling to make ends meet, Globalization is blamed by people from both left and right wings of the political divide. Neo-Conservative groups oppose China simply because its rising power challenges American supremacy. Others oppose China for its human rights violations, believing repression will spread across the globe if China continues to be an economic success. George Soros just wrote an op-ed praising President Trump’s China policy for this reason.

I have not even mentioned the practices which form the legal basis for imposition of tariffs under US. Code Section 301, to wit: The U.S. Trade Representative has determined that the acts, policies, and practices of the Government of China related to technology transfer, intellectual property, and innovation…are unreasonable or discriminatory and burden or restrict U.S. commerce.

So from the U.S. side, there is a wellspring of anti-China sentiment which should restrict U.S. China trade for some time to come. From China’s perspective, China must be contemplating whether to wait for a new administration in Washington.

Consider President Trump’s tweet of September 3:

We are doing very well in our negotiations with China. While I am sure they would love to be dealing with a new administration so they could continue their practice of “ripoff USA”($600 B/year),16 months PLUS is a long time to be hemorrhaging jobs and companies on a long-shot And then, think what happens to China when I win. Deal would get MUCH TOUGHER! In the meantime, China’s Supply Chain will crumble and businesses, jobs and money will be gone!

The tweet suggests China has backed away from trade talks; why else would President Trump be warning China not to wait for "a new administration?" I think China believes the true goal of the Trump Administration is to curb China's power and influence, so China's desire is to see Trump turned out of office in 2020, not to give him a victory. On their domestic front, China's leaders cannot be seen as weak or bowing to American pressure. Western domination of China is a sore spot Chinese refer to as the "Century of Humiliation."

Of course, a new administration could be even more protectionist than the current administration. I believe China prefers to take this risk, rather than aid Trump's reelection by giving him a victory in the trade war. I continue to expect a long trade conflict with many unintended consequences and ripple effects. For example, as the Chinese economy slows the European Union is feeling more pain than the U.S. because the EU is more dependent on exports.

The growth in U.S. manufacturing has stalled since April, while the Core Consumer Price Index has been rising at a 3% annual rate. GDP growth rates are falling in the U.S. and throughout the world. Business investment has been dropping, though consumer spending remains strong.

Given these negatives, along with the potential damage from the ongoing trade conflict, we have been selling our more risky equity holdings and parking more money in money market funds. With record low interest rates and a flat yield curve, there is no reason to invest in longer maturity fixed income. There is also little reason to invest in foreign fixed income, as most foreign currencies are depreciating relative to the U.S. dollar.

We sold Western Digital, Nvidia and reduced holdings in Comtech, because current price earnings ratios were high and thus at risk should earnings fail to rise. We sold New York Community Bank because the flattened yield curve was hurting earnings. We sold Kinder Morgan because of rising pipeline construction costs, especially legal fees, and concerns that the Panama Canal has no room for Kinder Morgan's LNG exports. We sold Office Properties Income Trust in taxable accounts just to use the tax loss, and hope to reestablish these positions.

Saudi Arabia's largest oil processing facility was bombed two days ago, sending crude oil prices up 13%. Anonymous sources say U.S. Officials are sharing intelligence with Saudi Arabia showing Iran was the staging ground for the attacks.

U.S. sanctions have cut Iran oil exports by about 90%. The only significant buyer is China, but China can increase its purchases and keep Iran afloat. Meanwhile the World Bank estimates the Iranian economy will shrink 5% this year. Iran would be foolish to think its attacks will cause the U.S. to lift sanctions. Perhaps Iran's intent is to decrease the global oil supply so that other countries will buy Iran's oil.

Whatever the outcome, the current conflict is another big negative for investors.
If the Saudi oilfields cannot be defended from missile strikes, then the only option is to remove the threat from Iran. Hopefully this can be achieved through diplomacy rather than military action.

As if there is not enough bad news, today we have 45,000 United Auto Workers on strike at GM. It is hard to see how the market can continue to rise in this environment. We are therefore increasing our emphasis on companies with moderate debt levels and reasonable stock valuations in essential industries.

Here are our latest investment picks:

Quanta Services Inc. (PWR) maintains and builds electrical power grids and pipelines. Quanta is a $6 billion company and an industry leader. 90% of its revenues are from smaller maintenance type contracts which are repeatable and sustainable, and 60% of its customers are regulated utilities.

Power grids need to be updated to deliver energy from renewable sources, and reliability needs to be improved to enable 5G, electric vehicles, the data cloud, etc. Quanta actively recruits and trains it workforce in an industry with shortages of qualified workers. We were able to buy on a dip under $34, caused by a contract dispute in Peru, which we view this as a transitory event.

On September 10, Quanta announced "one of the largest contracts ever awarded to Quanta", an 1,800 kilometer transmission line in Ontario, Canada which will take four years to complete. The stock is currently just under $39.

Adjusted earnings have grown 14.5% annually from 2010 to 2018. The current P/E ratio is 17.5. The debt/equity ratio as of 6/30/19 is a fairly modest 39%.

Kulicke & Soffa (KLIC) makes bonding equipment for semiconductor assembly. It has about a 90% market share for ball bonders, and is also dominant in wafer-level bonders and wedge bonders. New products include APAMA, a thermos-compression tool for premium logic applications, and Katalyst, a high accuracy tool used in flip chip bonding. Kulicke & Soffa was one of the pioneers of the flip chip.

The company is most excited about its Pixalux tool, used to pick and place mini-LED's and micro-LED's in high resolution displays. This is a large new market for KLIC. The Pixalux tool is said to be 5x faster than competing products.

KLIC trades around $23, has no net debt, and has net cash of $8.75 per share. Since 2010 KLIC has been earning around $1.50 per year on average, so the current valuation is very reasonable, given KLIC's dominant position in a growing industry. KLIC has been buying back its stock at around $22.

Beware Health Insurance Scams

November 1 begins the open enrollment period for 2020 health insurance. The Trump Administration has drastically increased the availability of health insurance plans which are not compliant with the Affordable Care Act. These plans are cheaper than ACA compliant plans and are being heavily marketed, especially through robo-calls.

We strongly advise against purchasing non-compliant health insurance, unless you have an independent competent professional review the policy. Pre-existing conditions are often not covered, and there can be low policy limits per event with multiple exclusions. While a compliant policy will cost more, you are assured of comprehensive coverage. With a non-compliant plan you could find yourself bankrupt from uncovered medical bills.

A Final Word

As Balopole Investment Management Corporation begins its twentieth year, I am more than ever fascinated and challenged by the investment profession. There are always so many opportunities to investigate and so much knowledge to assimilate. It is especially gratifying to see our customers actually using their investment gains to enable a care free retirement, help children buy homes, or endow a favorite charity.

Thank you for your continuing support!

Robert Balopole, C.F.A.

Balopole Investment Management Corporation

1611 Borel Place

Suite 209

San Mateo, CA 94402

650-574-1307