

## PART 1 – EUROPE

### WWI

World War I was triggered when an Austrian prince, heir to the throne of the Austro-Hungarian Empire was murdered in Bosnia by a zealous nationalist. Did that cause WWI? No, it triggered WWI. There were other, larger causes like years of imperialistic foreign policy by the great European powers of the day. Four stood out – Germany, Russia, the Austro-Hungarian Empire and the Ottoman Empire. This created tensions only partially resolved in what became known as The Great War. In the end, Germany and Russia lost power and land and within fifteen years were ruled by genocidal sociopaths. The other two empires were divided into smaller countries.

#### Europe in 1914

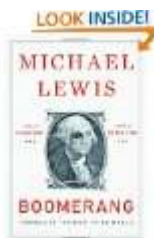


#### Europe in 1922



### Greece

Greece represents 2% of the Eurozone economy, less than 2% of Europe as a whole and 0.5% of the world economy. So, why are stock and bond markets around the world so affected by an economy of such insignificant size? Because, once again, the Balkans have become the trigger for widespread consequences related to much larger underlying issues.



I recently heard Michael Lewis on CNBC talking about his new book, *Boomerang – Travels in the New Third World*. He also wrote *Moneyball*, which became a worthwhile movie. I have not read *Boomerang* yet, it only came out Oct. 3, but it is the story of his travels to places hit hard by the financial crisis of 2008, like Greece, Ireland and Ireland. Each nation had in common that it was a massive borrower.

In Greece Lewis was told that corruption was such that tax collectors were fired if they collected the full tax. The Greek government also really cooked their books to show a false picture of financial health in order to meet the requirements for joining the Eurozone.

In a recent interview with a France 24, a French news station, Constantinos Michalos, head of the Athens Chamber of Commerce and Industry said, "Cleaning ladies and press officers at the [influential] finance ministry receive double the pay of their colleagues at other ministries . . . in

parliament, staff work for 12 months but receive 16 (month) salaries . . . civil servants get bonuses for dressing well and reporting to work on time.” According to the news story, Adedy, the Greek civil service union, “bonuses can account for nearly half of total state staff pay.”

The article also quotes an estimate that bribes in Greece total a billion Euros each year. “The average bribe was 1,355 euros in the public sector and 1,671 euros in the private sector, chiefly involving private clinics, banks and lawyers, according to the study, carried out by Public Issue for TI [Transparency International] Greece.” <http://www.france24.com/en/20100321-greek-debt-throws-spotlight-civil-service-excess>



Michael Lewis asserts that Greece has become morally bankrupt, creating an economy in which bribery, dishonesty and tax evasion are commonplace and citizens routinely game the system in order to get as much as possible. Politicians have resorted to financial chicanery, promised far more than they can possibly pay for and relied on other countries to bail them out. Of course, one could say the same about the U.S.

### **European Tensions**

Despite all this, Germany, France and the other Eurozone countries are determined to spend many hundreds of billions of euros to keep Greece from defaulting, to insulate European banks from losses from loaning money to Greece and to keep Greece in the Eurozone. Why?

Europeans, including the strongest countries, realize that they have a lot to gain economically from unity and therefore a great potential loss if that fails. A united Europe is a whole lot more powerful in a world economy dominated by the U.S. and China. Thus, Europe needs to join the movement toward centralized power and control. They would like to redraw the economic map of Europe to be one economic entity.

What they are discovering is that Europe cannot operate as one economic entity unless it is also a single empire politically and perhaps in other ways as well. A common currency and coordinated monetary policy are not enough. It is extremely difficult to develop the prosperity of certain countries without having control of their spending.

The second reason is that if large European banks become insolvent over losses in Greek bonds then they are back to the banking crisis of fall 2008. Italy is right across the Aegean Sea from Greece and though it is only 3% of the world economy it is the world's third largest debtor after the U.S. and Japan. Its bond market is far too big for Europe to save if Italian rates continue to rise in anticipation of contagion.

Talks continue over the International Monetary Fund's next payment to keep Greece afloat for another couple months and the EFSF, a 440 billion euro fund to guarantee Greek debt and recapitalize some European banks, mainly in France. Investors were cheered this week that the leaders are saying they realize the need to guarantee European banks. The details are another matter but they would like the IMF and each national to step up, avoiding the unanimity needed for Eurozone financing.

## PART 2 – GLOBAL RECESSION

Most of the world is seeing either slowing growth or contraction in their economies. Even mighty China has reported manufacturing demand not far above breakeven. Brazil and India have slowed their economies with high interest rates to combat inflation and are now being dragged down by weakened world demand for their products.

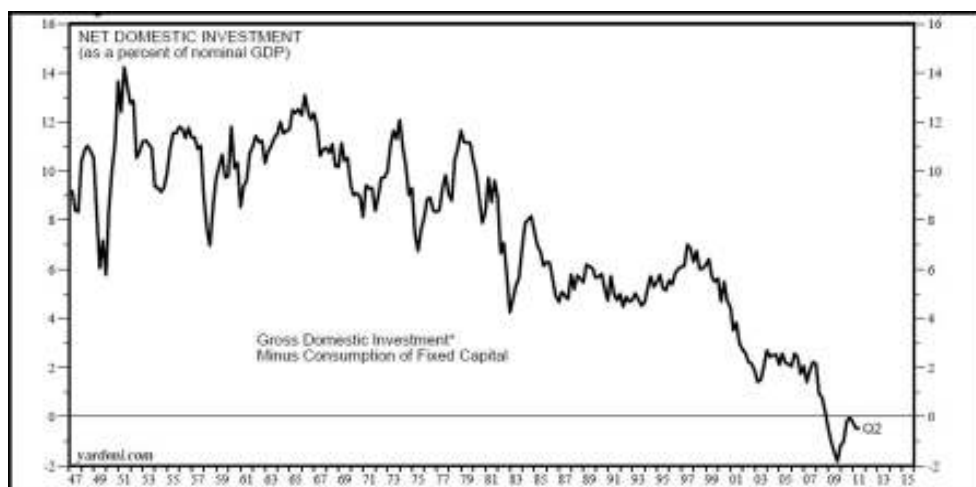
So far, manufacturing has been carrying the economy but as you can see that turned down earlier this year, not just in the U.S. (left side of the chart) but also globally (right side).

Not only is production at stall speed but new orders and order backlog look bad, too.

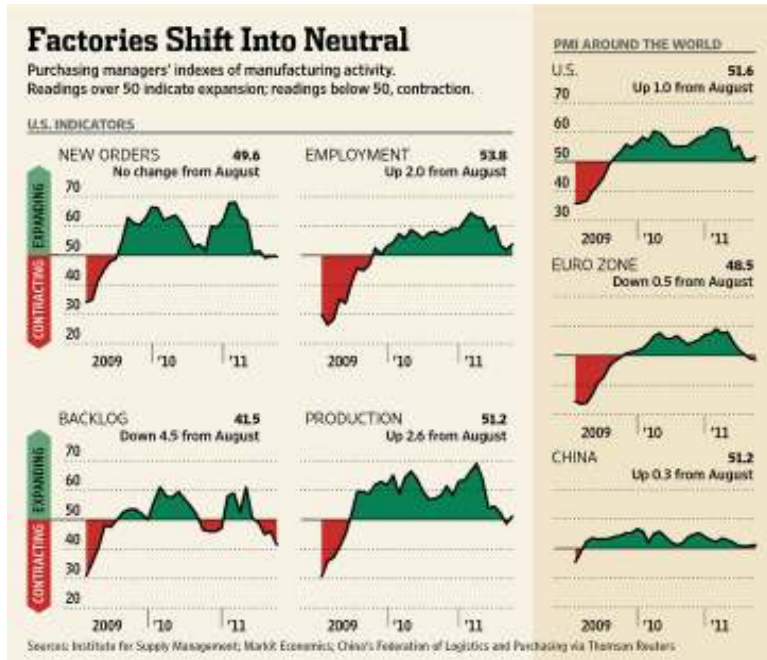
But wait, you say, the consumer is 70% of the economy and thus far more important. Yes, but not quite. According to economist Marc Faber, 70% of that 70% of consumption is for services like your haircut. That means services are only 49% of the economy.

Things related to production of goods thus comprise 51%. Production also has more of a multiplying effect. So, it is really production of stuff that drives the economic cycle. Since consumption of services is relatively stable, it is the rise and fall of manufacturing that drives economic growth and keeps us out of recession, not the consumer and not the government. I wish our severely anti-business president could understand that.

Business has been reducing its investment in the U.S. economy for many years. The biggest drop was two-fold, starting in 2000 in the late 1990s and continuing today (chart).



Source: Ed Yardeni as cited by Marc Faber



Source: WSJ 10/4/11 A2 Reliable Engine of Recovery Loses Steam

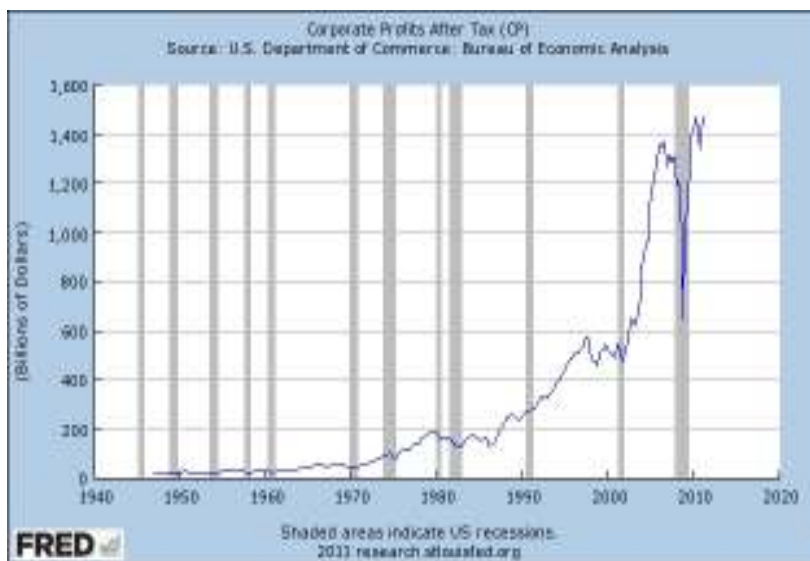
Did business just quit investing? No, it went overseas. That's where production is cheaper and that's where the biggest growth is. That's why it would help our economy tremendously to get production growing again. There is a trickle starting. Whirlpool and Otis Elevator are two companies that recently announced they were bringing production back home.

Consistently increasing regulation including but certainly not limited to Sarbanes-Oxley, Dodd-Frank and Obamacare, Elizabeth Warren's new uber-agency as well as government-mandated increases in health care costs, uncertainty over taxes government antagonism toward business and wealth are making things worse for business. In general, what's bad for business is bad for jobs, the economy and tax revenues. Spend all you can promise on government spending; it does not solve the core issue of corporate pessimism toward the near future.

## PART 3 – INVESTMENTS

### Corporate Profits and Cash

As proof of the problem one need look no farther than the record-setting profits and cash that businesses have today. Profits and cash are up because spending on plants, equipment, jobs and research have been scaled way back. Without those costs, profits are up in the short term.



The flip side is that profits in the future are harmed. It is expansion that mainly drives future profits. Three years of cutting costs like jobs, inventory and research has about run its course.

With the increasing economic slowdown, profits are about to go down. Estimates of \$110 in earnings for the S&P 500 companies are coming down fast. Earnings reports start next week.

A person who wants higher revenues to go toward reducing the federal budget deficit would be tempted to redistribute the profits pictured above. But, look at it in the light of what I have just written. **This is in large part a picture of missing investments in jobs and business expansion** In that light, when things do get back on track **that is fuel for the economy**, a lot of fuel.

### Stocks

Stock prices have been coming down with this slowdown in the economy and expected reduction in corporate profits. So far, the decline has been roughly in proportion to the haircut I expect for corporate profits next year.



In addition, there is the continuing soap opera in Europe I wrote about above. Even with better news this week (not counting rating agency downgrades of the credit of Italy and Spain) I wonder if the market will really feel better until after Greece has defaulted, banks are being recapitalized and Italy makes more progress on bettering its economy and seeing its borrowing costs fall. That will take a while.

The intermediate trend is obviously down. The next nearest support level is 1020. We are at 1144 today. The next support is at 920. If the trend stays in place, a downward continuation will not likely be a straight line down. Be encouraged that sentiment is awful right now, October is the most common months for market bottoms and the 4Q is usually the best quarter of the year.

This week was constructive but I am not yet sure that we have done much than move up in the recent trading range. I have much more cash than usual in client accounts but am looking for bargains. They're starting to appear, though.

### What to Buy

Speaking of bargains, here is a list I compiled of blue chip stocks with dividends mostly above 3% (some well above), low valuation, low debt and decent growth prospects. Some are low volatility, high income stocks, others are very oversold (financials, energy, materials) and some are just good combinations of low value, good yield and good growth. Call me to get the scoop on each stock.

### **BLUE CHIPS -- LOW VALUATION, LOW DEBT, GOOD GROWTH, GOOD DIVIDENDS (+ A FEW GOOD GROWTH STOCKS)**

<b>Company Name</b>	<b>Symbol</b>	<b>Stock Sector</b>	<b>Projected Earnings Growth</b>	<b>PE/ Growth Rate</b>	<b>P/E</b>	<b>Forward Dividend Yield %</b>
Aflac Inc	AFL	Financial Services	11.3	0.43	8.83	3.34
Apple	AAPL	Technology	41.99	0.64	14.82	0
Arcelor Mittal SA	MT	Basic Materials	3.6	2.56	6.86	3.78
AT&T Inc	T	Communication	9.07	2.56	8.19	5.96
Bhp Billiton PLC	BBL	Basic Materials	35.35	---	6.01	3.99
Caterpillar Inc	CAT	Industrials	25.13	0.81	11.66	2.44
Chevron Corp	CVX	Energy	15.89	1.42	7.85	3.31
Deutsche Telekom AG	DTEGY	Communication	-2.93	---	28.3	7.96
Duke Energy Corp	DUK	Utilities	3.39	3.86	12.8	4.97
E I Du Pont	DD	Basic Materials	18.22	1.1	10.66	3.97
General Mills Inc	GIS	Consumer Defensive	16.72	1.68	14.54	3.14
GlaxoSmithKline PLC	GSK	Healthcare	-15.07	---	20.27	4.99
Google	GOOG	Technology	42	0.65	17.88	0
Home Depot	HD	Consumer Cyclical	10.74	0.94	14.23	2.96
Intel Corp	INTC	Technology	17.87	0.78	9.46	3.78

IBM	IBM	Technology	54.33	1.36	14.07	1.67
International Paper Co	IP	Basic Materials	14.35	1.3	7.73	4.35
Johnson & Johnson	JNJ	Healthcare	9.61	1.96	14.85	3.57
JPMorgan Chase Co	JPM	Financial Services	9.72	0.68	6.12	3.19
KLA-Tencor Corp	KLAC	Technology	24.43	0.99	7.99	3.59
<a href="#">Koninklijke Philips Electronics NV</a>	PHG	Technology	---	4.52	NM	4.95
Kraft Foods Inc	KFT	Consumer Defensive	2.84	1.7	18.9	3.36
Mastercard	MA	Financial Services	42.24	0.89	19.26	0.18
McDonalds Corp	MCD	Consumer Cyclical	19.39	1.56	17.41	3.15
Merck & Co Inc	MRK	Healthcare	-3.33	1.54	33.95	4.65
Microsoft Corp	MSFT	Technology	34.67	0.73	9.12	3.14
Norfolk Southern	NSC	Industrials	11.07	0.64	12.66	2.71
<a href="#">Novartis AG</a>	NVS	Healthcare	8.4	1.73	12.9	3.53
Oracle Corp	ORCL	Technology	21.65	0.82	15.88	0.81
Pfizer Inc	PFE	Healthcare	2.87	2.42	16.2	4.45
Procter & Gamble Co	PG	Consumer Defensive	9.13	1.54	15.99	3.3
Qualcomm Inc	QCOM	Technology	12.11	0.91	19.53	1.72
<a href="#">Royal Dutch Shell Plc</a>	RDSA	Energy	11.7	---	6.66	5.34
Sandisk Corp	SNDK	Technology	---	0.59	7.34	0
<a href="#">Sanofi SA</a>	SNY	Healthcare	3.09	4.18	14.36	3.9
<a href="#">SAP AG</a>	SAP	Technology	15.02	1.53	22	1.16
<a href="#">Schlumberger NV</a>	SLB	Energy	14.6	0.8	15.31	1.63
<a href="#">Siemens AG</a>	SI	Industrials	10.12	1.42	12.49	2.85
Simmons First National	SFNC	Financial Services	5.83	2.77	9.87	3.53
Southern Co.	SO	Utilities	2.89	2.97	17.88	4.41
<a href="#">Telefonica SA</a>	TEF	Communication	---	2.17	6.36	8.72
<a href="#">Teva Pharmaceutical I</a>	TEVA	Healthcare	11.47	---	10.41	2.13
<a href="#">Total SA</a>	TOT	Energy	11.55	3.02	6.04	3.05
<a href="#">Unilever NV</a>	UN	Consumer Defensive	---	3.13	14.75	3.39
Verizon	VZ	Communication	2.08	3.4	16.3	5.38
<a href="#">Vodafone Group PLC</a>	VOD	Communication	3.76	---	10.94	7.35
<a href="#">Volkswagen AG</a>	VLKAY	Consumer Cyclical	23.92	---	3.47	1.82
Weyerhaeuser Co	WY	Real Estate	27.26	4.41	5.31	3.73

Foreign-based companies are in [blue text](#).

Sources: Charles Schwab, Standard & Poors, Morningstar

Gold, after a 14% correction is again a buy for the short term. It will mostly trade opposite of the news out of Europe. Bad news is good news for gold. It can, though be a “risk-on” trade.

Bonds are not a good buy here. However, high yield and corporate bonds are getting into buy territory for the long term if the recession is not deep. Municipal bonds are also a good buy, but be careful.

Dave Hoshour