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John Dessauer's Outlook

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FORGET INFLATION
THE GREATER RISK IS STAGNATION

The U.S. economy is growing, but too slowly. We need faster growth to create jobs and begin to resolve the core issues, especially bank lending and housing. The Federal Reserve is reported to be considering more Quantitative Easing or QE. That involves the Fed buying assets, mainly Treasury securities. The prospect of more QE boosted stocks but raised inflation fears. The yield on thirty- year Treasury bonds went up and the yield on TIPS or inflation protected Treasury securities went down. The Federal Reserve can print money. The classic fear among investors at home and abroad is that the Federal Reserve will solve the nation's debt burden by printing money and monetizing the debt. That has been done by other governments in the past, with disastrous consequences. The inflation fear is understandable. However, it is also misplaced. The Federal Reserve is dealing with a real deflation threat.

President Obama and the members of Congress do not have the power to print money. Fortunately we have separated the Federal Reserve. It remains an independent government agency. Separating the power to pile up debt from the power to pint money is extremely important. Consider Greece. Before the formation of the euro, countries like Greece that fell deep in debt simply printed money and allowed their currency to fall. Today Greece does not have that option. In the short run this means economic pain for the people of Greece. They have to sacrifice to get the nation's accounts back within affordable bounds. In the long run, however, Greece will reap significant benefits. Instead of a future of cycle after cycle with no real improvement in living standards, Greece can recover and begin the wealth creating process again. Membership in the euro currency will be proven to be a genuine benefit to the people of Greece.

Americans may not fully understand that our Federal Reserve is just as separate as the euro central bank. Presidents and politicians from time to time attack the Fed's independence. So far they have failed. As investors we should understand that as long as the Fed is truly independent, and uses the power to print money strictly for economic purposes, we are safe from the ravages of an out of control, politically motivated money printing press. Furthermore it would be very hard, if not impossible, for the politicians to strip away the Fed's independence. Imagine how investors would react to a politically controlled U.S. Federal Reserve. The current inflation fear would be nothing in comparison. Taking away the Fed's independence would immediately be seen for what it was: a drive to monetize the U.S. government's debts and deficits. We would be seen as worse than Greece. Interest rates on U.S. debt would soar and we would be unable to roll over existing debt. The federal government would be literally broke, paralyzed and unable to meet its payroll. There is no country, organization, or group of nations that would be able to provide the amount of financial aid the U.S. would need under such circumstances. As a practical matter the Federal Reserve's full independence would have to be quickly restored to solve the crisis. The more you study the lessons learned over the past four decades, the more you understand that the Federal Reserve and most other central banks know how to fight inflation. They will do what is required to prevent inflation from rising too far. The new challenge that has developed since the collapse of Lehman Brothers and the financial crisis is how to prevent deflation. Central banks can print money. They can't force banks to lend, consumers to spend or businesses to expand. That is where fiscal and other federal government policies come in. Economies need support from their political leaders. Big government with a top down attitude is a burden that slows economic activity. That is the lesson others have learned the hard way, and it is the lesson Americans are learning right now.

Predictions: Bush Tax rates will be extended. Economic growth will improve.

Because of the election results, I think the Fed will not have to do much more. The rate of economic growth will increase because the President and his colleagues in Congress have been rebuked by the voters. I predict we will see immediate improvement in consumer and business confidence. I also predict the Bush tax rates will be extended for all taxpayers. By the first quarter of 2011 the rate of growth will be above 3%. The best performing

assets will be stocks, especially in depressed technology companies like Microsoft.

The election is over but it will take time before we know if the winners really understand what must be done to create jobs and save the U.S. economy from a long period of high unemployment and economic stagnation. A candidate for the House of Representatives in my district in Florida said, during a debate, that he opposes all free trade agreements. He claimed that all they do is suck jobs out of the United States. Fortunately he did not win. Never the less I was startled by his position. He demonstrates a frightening level of ignorance of economics and history. Are there others so ignorant among the winners? Probably there are, hopefully only a few. The bigger question is how many among the winners really understand basic economics. For example, how many know the difference between tax rates and tax revenues? History provides plenty of examples to show that raising tax rates does not always increase tax revenue. Under some circumstances, higher rates mean lower revenues and vice versa.

It has been very discouraging to listen to the President and the Treasury Secretary talk about raising taxes on the rich. This is bad economics and pure political propaganda. Ninety years ago, faced with a large national debt and an economy in recession, Secretary of the Treasury Andrew Mellon said: “It seems difficult for some to understand that high rates of taxation do not necessarily mean large revenue for the government, and that more revenue may often be obtained by lower rates.” Mellon convinced Congress to cut tax rates. The result was an increase in economic activity and in tax revenue collected. We desperately need that kind of economic leadership today. We need leaders who understand that raising taxes on anyone is a very risky policy, and that cutting corporate tax rates would mean more investment, more jobs and more revenue for the government.

P.J. O’Rourke said: “This is not an election, it is a restraining order.” At the very least that will be the result from the election. The destructive Obama agenda will be stopped. That is good news. By raising uncertainty, the Obama agenda has slowed economic growth, limited hiring, and done more damage than good. There could be more good news. There is a report indicating that because of the election results President Obama is rethinking his position on taxes. He may propose making the Bush tax rates permanent for those making less than the $200,000-$250,000 threshold and extending

the tax rates for the “rich” folks for two more years. Apparently he has figured out that allowing the Bush tax rates to expire on December 31 would very likely push the economy back into recession. A new recession in 2011 would crush Obama’s chances for a second term. If he goes along with Republicans and strikes a tax deal that works, he can take credit when the economy improves. The President is a politician first and foremost. I believe he wants a second term and will craft a tax deal soon.

The economy needs both an end to the Obama agenda and an extension of the Bush tax rates.

The Bureau of Economic Analysis (BEA) says the U.S. economy grew at a real annual rate of 2% in the third quarter. That is a little better than the 1.7% rate of growth registered in the second quarter, but too slow to produce significant job creation. Worse is that much of the growth came from businesses restocking. There was a good increase in consumer spending, but that was satisfied through imports rather than domestic production.

Initially the recovery got off to a good start. In the second half of 2009 the economy bounced back from -4% to +1.6% and then +5% in the final quarter. In the final quarter of last year Fed chairman Bernanke was optimistic. In November 20009 he predicted “moderate economic growth” in 2010 with final demand strengthening amid a “broad improvement in financial conditions.” He was right about financial conditions. They have improved at all levels, consumers have reduced debt, businesses have strengthened balance sheets and banks are profitable. However, he has been wrong on the economy. I believe the Obama agenda, especially Obamacare, has had a negative effect on the economy. The President and the Democrat controlled Congress have raised the level of uncertainty for business to such a high level that hiring has all but stopped. Businesses have hoarded cash and improved technology rather than hire more employees. Stopping the Obama agenda is an essential first step and should lift Americans’ spirits. However, by itself that will not create jobs, reduce the deficit or get the economy growing at a faster pace.

CNN recently ran a story about unemployment. They say the real unemployment rate is 17%, maybe even higher. The official rate at 9.6% is flawed because it does not include people who simply can’t find a job. After a while, unemployed Americans are dropped out of the workforce

calculation based on the notion that they have given up trying to find work. That might make sense in a robust labor market. It makes no sense in an economy that desperately needs millions of new jobs. To change course the new Congress will have to adopt policies that significantly reduce our dependence on government spending, strengthen household demand and boost exports. It can be done. Americans like making money. They will seize opportunities if big government gets out of the way. If we fail, the risk is a long period of economic stagnation, with many millions of Americans unnecessarily suffering the pain of poverty. The stakes are very high. There are risks, but the most popular risk idea, namely that because of all the trillions of dollars printed by the Federal Reserve, we are headed for an outbreak of high inflation, is wrong. In fact the far greater risk is stagnation.

Why inflation is not a present danger.

Inflation is defined as too much money chasing too few goods. The operative word is: "chasing." Have central banks pumped trillions into the U.S. and global economies? The answer to that is clearly: yes they have. Does that pose a significant **long-term** inflation risk? Once again the answer is: yes. Is the crowd correct to be investing today to hedge against possible future inflation? This time the answer is: no, the crowd is very wrong. The problem facing the United States and most of the developed world is that all the liquidity is bottled up. Consumers are not spending, never mind borrowing to "chase" goods. Even if Washington and other politicians get it right it will be several years before we have to start worrying about demand rising to an inflation risk level. That is true for China as well. In August China's key measure of inflation was up 3.3% from a year ago. That was driven by a 6.8% surge in food prices due to extensive flooding. Excluding food the inflation number was 1.6%. China's economy is still growing faster than any other but prices are not rising across the board. The reason is simple. China has an enormous capacity to produce goods. China's domestic economy however is still developing. Capacity far exceeds current and projected domestic demand. It probably will be at least a decade before China's domestic demand rises to a level that matches domestic production capacity.

There is no credit bubble.

One of the essential ingredients for an outbreak of high inflation is a rapid credit expansion or a credit bubble. Today we have the opposite: a

dearth of credit formation. Banks are reluctant to lend and borrowers - both business and consumer - are reluctant to borrow. Consumers are slashing debt. August was the 24th consecutive month that consumer credit card balances went down. They fell $3.34 billion, after falling $4 billion in July. Homeowners are also cutting back on borrowing. Mortgage lending peaked at $3.8 trillion in 2003. This year the total will be $1.4 trillion. The Mortgage Bankers' Association says next year mortgage lending will fall below $1 trillion, the lowest level since 1996. Business has also reduced debt and increased cash. There are now trillions of dollars sidelined on business balance sheets. Even with faster economic growth, it will take years to reverse course and get consumers and business borrowing again.

The foreclosure mess is a depressant.

The securitization of mortgages has created a paperwork nightmare. In the good old days of the 1960s banks held on to the mortgages they created. Titles were straightforward. There was never a problem producing the underlying mortgage or promissory note for a foreclosure. In the 1970s banks began to sell some of their mortgages. Investors liked the higher yields, steady stream of principal repayment and the relative safety of home mortgage loans. In the 1980s buying and selling mortgages became big business. Bankers and brokers packaged hundreds of mortgages together and sold the package in pieces to eager investors. The numbers are staggering, with trillions of dollars' worth of home mortgages involved. For collecting payments and keeping track of balances, the system worked well. However, unseen until the housing crisis, the system for keeping track of the underlying paperwork was broken. Instead of producing the promissory note and mortgage to support a foreclosure proceeding, bankers produce payment records and default notices. The paperwork mess is so bad that major lenders have suspended home foreclosures. There are cases where houses were purchased for cash in foreclosure sales only to have the foreclosures proceed anyway.

The biggest issue is who owns the mortgage. In the securitization process mortgages are bought and sold. They can change hands several times. Under the standard legal system at every sale there should be a document filed in the local county clerk's office showing the transaction and identifying the new owner of the mortgage. Given the high volume of mortgage transactions during the heyday of securitization, that was impossible. The mortgage industry responded by creating an electronic

overlay called Mortgage Electronic Registration Systems (MERS). The problem is that MERS is not as thorough as the paper based system and does not have the legal standing of documents filed in the clerk's office. Some judges have refused foreclosures based on MERS, hence the current mess. MERS executives say their system will overcome the legal challenges. I am sure it will because there is no alternative. We must proceed with clearing out the inventory of homes in foreclosure. Foreclosures are a drag on the housing market and on the entire economy. They depress home prices. The foreclosure mess is another reason inflation will remain in check for the next year or two, or more.

Inflation rates around the world remain moderate.

At the depth of the recession the global economy was shrinking at a 3% rate. Recently the numbers show the global economy growing at nearly a 5% rate. That is a dramatic turnaround. The global economy is just about back at pre-recession levels. Of course there are wide variations among the participating countries, with emerging economies leading, and Europe and the United States lagging behind.

There are pockets of inflation, like India at 9.9% and Russia at 7.0%. However other fast growing economies have kept inflation under better control, with Brazil at 4.7% and China at 3.6%. Bad weather has played a major role in driving up inflation levels in Russia, India and China. Drought and fires in Russia, late monsoons in India and flooding in China injured crops and caused food prices to rise sharply. Walter Wriston, when he was chairman of Citigroup, often said that in a large economy some prices would always be rising while others are falling. Don't be distracted by the rising prices. Instead watch the whole picture and central bankers' activities. Central Bankers from China to Brazil are taking action to make sure rising food prices are both temporary and do not spread to the broad economy. China is showing success. Food prices have risen sharply but the overall inflation rate is 3.6%. Bad weather hurts crops until the good weather returns. With rising food prices central bankers are fighting a winnable battle against inflation.

Here in the United States inflation remains quite tame. The Consumer Price Index was up 0.1% in September and was up 1.1% over September 2009. The very low inflation rate was achieved even though some components were up sharply. Year over year fuel oil prices were up 11.8%

in September. Used car and truck prices were up 12.9%. This is more evidence that Walter Wriston's advice on inflation is correct. Some day inflation may become an issue again, but not today, and not for a long time. The United States and the global economy are suffering because of excess labor - otherwise known as high unemployment - too much slack in production, and too much money that is bottled up in safe havens and not driving economic growth.

Conclusions and advice

1. **Inflation is not a present danger and should not be a part of a current investment strategy**
2. **Stagnation in the U.S. economy remains the greatest risk**
3. **Plan on U.S. unemployment remaining uncomfortably high for the next twelve months**
4. **Stocks, especially in companies with significant international exposure, remain the best choice for income and gains.**

DESSAUER'S DIVIDEND

In the 1980s I devoted a section of every issue of my newsletter to highlighting a stock I thought was especially attractive. I called that section: "Dessauer's Dividend." During the course of my daily research I have become convinced that Microsoft is a compelling investment choice. I am not ready to make "Dessauer's Dividend" a regular feature because I don't know how many Microsofts I will find. For this issue, I am once again highlighting a specific stock. Over the last ten years Microsoft's sales have increased 174% and earnings per share are up 147%. The stock, however, is down 22%. Wall Street has been underestimating Microsoft for over a decade. That will change. At the very least Microsoft will be recognized as a value stock with enormous cash generation. There is little risk and enormous potential for long term gain in Microsoft.

It is show time for **Microsoft, NASDAQ, MSFT, $27.00.** Microsoft's new smartphone, called Windows phone 7, goes on sale in the United States on November 8. Last month when the launch was announced, Microsoft's CEO Steve Ballmer said: "This is a big launch for us - a big, big launch". It is big because Microsoft has fallen so far behind in the mobile communication space and because experts believe smartphone sales will exceed PC sales in 2012. Money manager Mike Holland said: "If Microsoft

gets this right, the stock is really, really cheap." The stock is cheap because analyst after analyst has downgraded the stock, even though for four consecutive quarters Microsoft has beaten expectations. The downgrades have been based on the idea that PC sales were going to slow down because pent up demand from businesses has largely been satisfied. Looking at Microsoft's first quarter results makes the analysts appear silly or out of touch with reality or just plain too pessimistic. Sales in the quarter that ended September 30 were up 25% from a year ago. Earnings per share were up 55%. All of Microsoft's divisions showed double digit sales growth. Earnings per share were $0.62, far above Wall Street's $0.55 estimate. Microsoft's management said they continue to see a healthy and sustaining business PC refresh cycle. The company ended the quarter with $44.2 billion in cash. After the excellent opening quarter earnings estimates for this fiscal year will be raised. The long term average P/E is a modest 15. Success with the new phone would certainly warrant a higher P/E. However sticking with a P/E of 15 and using a conservative full fiscal year estimate of $2.50 indicates a twelve-month stock price target of $37. That is enough to make Microsoft a buy.

Wall Street analysts are focused on the present state of the mobile, smartphone business. Microsoft has a small (5%) share of the mobile market today. Microsoft's CEO counters by saying that more people will buy smartphones in the coming three years than own them today. He says Microsoft is early because this business is in its infancy. He also says the Windows Phone 7 is a real winner. The new phone uses an entirely new way of navigating through the various functions. The touch screen is said to be genuinely better than the competition and far easier to use. Apple sold 20 million iPhones in the first year after launch. Microsoft's goal is to sell 20 million Windows Phone 7 units next year.

Microsoft is an immensely profitable company generating huge amounts of free cash flow. That will be the case for many more years even if Microsoft misses with the new phone. Cash flow is not the current goal. Microsoft knows that to stay in the center of the computing world it must conquer the mobile space as the world's information moves away from the PC and into cloud computing. CEO Ballmer and his team may be right. Sales of Window Phone 7 could reach 20 million and more application designers could be swayed by the new phone. Amazon is impressed and will have a Kindle application by year end. In my opinion Microsoft is a terrific

investment both because of its very attractive current valuation and because there is a good chance the company will succeed in the smartphone space.

AT&T, NYSE, T, $28.75, reported third quarter earnings from operations of $0.55 a share. That was a penny better than last year and in line with Wall Street expectations. AT&T will eventually lose the Apple iPhone exclusivity, but the company is well prepared for the coming competition. AT&T has restructured pricing plans, improved technology and continued to cut costs. The generous dividend, $1.68 for a 5.9% yield, is well covered. The dividend payments used up about 64% of AT&T's free cash flow so far in 2010. The balance was used to reduce debt. AT&T has $3.2 billion in cash and has cut debt by $1 billion. Earnings estimates for this year are $2.28 a share, rising to $2.50 in 2011. The long term average P/E is 14 indicating a twelve-month stock price target of $35. AT&T is a buy.

Bank of America, NYSE, BAC, $11.49, reported a third quarter loss of $0.77 a share. That was due to a non-cash accounting charge of $10.4 billion. From operations, Bank of America earned $0.27, well ahead of Wall Street expectations of $0.16 a share. Reduction in loan loss provisions was the primary driver of the boost in operating earnings. Analysts worry that the bank cannot keep earnings growing based on loan loss reserve reductions. At some point growth in lending and other activities will be needed to keep growth alive. I agree, but see the improvement in credit as an essential first step. Bank of America has partially resumed foreclosing on homes. Foreclosures are a major headache for banks. They will remain a headache until job creation increases. Jobs, homes, and mortgages are all connected. Foreclosing on a home is just the first step. To recover a part or the entire loan, the bank needs to sell the home to a qualified buyer. The high unemployment rate tells us there are too few qualified buyers. Hopefully the coming elections will mean change for the better in Washington and more jobs for the economy. Bank of America is a financial powerhouse, capable of dealing with the tidal wave of foreclosures. Earnings for all of 2010 will likely be slightly more than $1.00 a share. In 2011 there is the potential for a significant increase in earnings. With credit quality on the rise, I rate Bank of America a buy.

BP, NYSE, BP, $41.55, took another spill related charge in the third quarter. This time the charge was $7.7 billion due to the extra time taken to plug the well. BP now estimates the spill related costs to be $39.9 billion.

Including the charge, BP earned $1.8 billion in the third quarter. That is a major improvement over the $17.2 billion loss in the second quarter. On an operating basis results showed improvement. Adjusted replacement cost profit was up 18% to $5.5 billion well ahead of analysts' expectations of $4.6 billion. BP is on the road to recovery. I rate BP a buy at less than $40.

CareFusion, NYSE, CFN, $22.94, reported a disappointing opening quarter for the new fiscal year. Sales were down 2% and profits at $0.30 a share were below last year and below expectations. Carefusion said the lower results were due to lower sales in the International Surgical Products business. This is a unique case where international business hurt rather than helped. CareFusion will benefit from hospitals' efforts to reduce errors and hospital-acquired infection. Both are major concerns in the United States and abroad. Management confirmed prior guidance that earnings this fiscal year will be between $1.58 and $1.68 a share, up 11%-18% on a mid single digit rise in sales. Taking the midpoint of the guidance and using a P/E of 18 arrives at a stock price target of $29. CareFusion is a buy.

Cheesecake Factory, NASDAQ, CAKE, $28.91, reported a solid third quarter. Earnings at $0.37 a share were up 37% from last year's third quarter. Comparable store sales were up 2.9% at Cheesecake Factory and 1.4% at Grand Lux. The operating margin rose to 7.5% from 6.8%, showing that management's menu changes and cost controls are working well. Debt was reduced by $30 million in the quarter, leaving only $40 million of long term debt. At the end of the quarter Cheesecake Factory had $59.8 million in cash. During the quarter the company bought back 911,724 shares, bringing the 2010 total to 2,068,882 shares. Earnings for all of 2010 are estimated at $1.40 a share. For next year, estimates are for earnings of $1.60 a share. The long term average P/E is 18.5, indicating a twelve-month stock price target of $30. Cheesecake Factory is a very well managed company with solid growth prospects and a strong balance sheet. At the recent price I rate Cheesecake Factory a hold. I would buy more at $25 or less.

Citigroup, NYSE, C, $4.15, also reported a better than expected third quarter thanks to credit improvement. Citigroup earned $0.07 a share. Wall Street analysts were expecting $0.06. Citigroup has been selling off non-core assets. This process has a long way to go. While the long term looks bright for Citigroup, I am keeping my hold rating on the stock until the restructuring process is nearer completion.

General Electric, NYSE, GE, $16.09, reported third quarter earnings of $3.16 billion or $0.29 a share. That was an increase of 29% over the third quarter of 2009. Wall Street analysts were looking for $0.27 a share. While sales were down 5%, overall results were slightly better than expected. GE is building up its industrial base and working out the remaining financial stress points. Earnings for this year are now headed for $1.15 a share. The long term average P/E is 17, indicating a stock price of at least $20. Earnings estimates for 2011 are currently $1.25. I expect that will be raised thanks to the better than expected third quarter. GE has plenty of cash. I expect the dividend, which is currently $0.40 a share, to be raised before the end of this year. GE is currently undervalued and has above average potential for long term gains. I rate GE a buy.

Halliburton, NYSE, HAL, $32.33. Halliburton's stock price fell sharply after a news report that a judge found fault with drilling cement supplied by Halliburton in the BP oil spill. You can be sure there will be other faults found involving other companies before the investigation is over. If the stock falls far enough it will become a buy. Halliburton reported third quarter earnings of $0.60 a share, more than double last year third quarter's $0.29 a share. Wall Street analysts expected $0.56 a share. Revenues were up 30% over last year. The boom in revenues and profits was due to drilling on land in the United States. There is a shale-drilling boom in the USA, with 2,500 to 3,000 unfinished wells. The offshore drilling ban has been lifted. Drilling in the Gulf of Mexico is likely to resume. For all of 2010 earnings are expected to be $1.70, and that was before the third quarter was announced. Earnings for this year are more likely to be $1.85, possibly better. The stock came down after earnings were announced. That was pure profit taking, because the stock has been quite strong prior to the earnings announcement. The long term average P/E is 16 indicating a stock price of $30. Halliburton is a very attractive long term investment. My buy target price is $28.

Intel, NASDAQ, INTC, $20.44. A few weeks ago Intel's CEO said the third quarter would be a record for the company. After the stock market closed Tuesday, Intel delivered record results that beat Wall Street expectations. Third quarter revenue was up 18%, to $11.1 billion. This is the first ever quarter with revenue at $11 billion for Intel. Looking ahead to this quarter, management says they expect revenue to be up again, to $11.4 billion. Third quarter earnings were $0.52, a share up 59% from the third quarter a year ago. Wall Street analysts were expecting earnings of $0.50 a

share. Intel has been beating Wall Street expectations for the last several quarters. The third quarter was a record in spite of dampened demand for PCs. Solid demand from corporations and growth in emerging markets gave Intel the surge in revenues and profits. The stock is up from its lows but still trading at a very low valuation. Intel is a buy.

McGraw Hill, NYSE, MHP, $38.23, beat all analysts' expectations. The average estimate was for earnings of $1.10 a share. McGraw Hill reported earnings of $1.23 for the third quarter. Actual earnings were 13% better than a year ago. Revenue was up 5.5%. Education provided the biggest boost to revenues and profits. Revenue from underwriting was also strong. For example, revenue from new issues in the global high-yield bond market was up 11.1%. Wall Street analysts remain skeptical about future prospects for McGraw Hill. The third quarter results tell us the skeptics are too gloomy. Earnings for all of this year are expected to be $2.65 a share rising to $2.85 in 2011. After the good third quarter I won't be surprised if 2011 estimates are raised. The long term average P/E is 17 indicating a twelve month stock price of $48, based on current 2011 expectations. McGraw Hill is a buy.

Nokia, NSE, NOK, $10.40, beat analysts' earnings estimates for the third quarter. Nokia reported earnings of $0.18 a share on a sales increase of 4.7%. In the third quarter of last year Nokia reported a loss of $0.20 a share. The better than expected third quarter shows that Nokia is making progress dealing with intense competition and the transition to smart phones. Earnings estimates for next year will be raised. They are currently $0.88-$0.90 a share. The stock remains controversial. Opinions range from sell to strong buy. Standard & Poor's has the strong buy rating and says: "While near-term risks are high, we think expectations are low and view Nokia's valuation as compelling." I agree. I rate Nokia as a buy with a twelve-month stock price target of $14.

Novartis, NYSE, NVS, $57.45, reported a strong third quarter. In constant currency terms, sales were up 16%. That is remarkable for a large pharmaceutical company. The new acquisition, eye care company Alcon, helped, boosting sales by 5%. Profits, excluding items, were $1.37 a share. That handily beat analysts' expectations of $1.17 a share. Earnings for all of 2010 are expected to be $4.55 a share. Next year earnings are currently forecast to rise only 4.4% to $4.75. After the excellent third quarter I expect the 2011 estimates to be increased. The long term average P/E is 14

indicating a stock price of $66.50 based on current 2011 expectations. I expect the stock to reach $70 in less than twelve months. Novartis is up from its low, but the valuation is still attractive enough to warrant a buy rating.

Pfizer, NYSE, PFE, $17.48, reported third quarter results that still contain charges from the Wyeth acquisition. Excluding charges earnings were $0.54 a share, three cents better than analysts' expectations. Profits are benefiting from cost cutting, which is proceeding faster than expected. Management raised full year guidance to $2.17-$2.22 a share. The Wyeth acquisition is turning out to have been a very good decision. The long term average P/E is 13 indicating a stock price of $29. Pfizer is a buy.

Texas Instruments, NYSE, TXN, $29.30, reported a booming third quarter, but warned of a coming brief but sharp slowdown in PC demand. Third quarter revenue was better than analysts expected and 30% better than a year ago. Earnings per share were $0.71, two pennies better than expectations and 70% better than the third quarter of 2009. For this quarter management says earnings will be between $0.59 and $0.67 a share. The third quarter got its usual boost from back to school spending. That will not be repeated this quarter, hence a fall in both revenue and profits. For all of 2010 earnings will likely be $2.50 a share or slightly better. There is a wide range of estimates for next year. Argus Research has an estimate of $2.89. That is above the $2.55 average among other analysts. The long term average P/E is 20. Even at the lower 2011 estimate the stock is trading at 11.3 times earnings, well below the long term average. Texas Instruments is back on a growth track. That means the P/E is likely to rise. I expect a P/E of 15 on 2011 earnings of $2.60 or better. My twelve month stock price target is $40. Texas Instruments is a buy.

CLOSING THOUGHTS
THE BALANCE OF PAYMENTS MUST ALWAYS BALANCE

President Obama, Treasury Secretary Geithner and all who are upset about the U.S. trade deficit with China should be careful what they wish for. The U.S. trade deficit is one component of our national Balance of Payments. Trade is included in the "current account" and makes up just about all of our current account deficit. Politicians and trade union leaders are fond of hyping the trade deficit as an evil, job killing phenomenon. Ordinary Americans frequently swallow such lines without question. It is true that over the past several decades we have given up jobs making all

sorts of things such as television sets, computers and batteries. Our trade deficit today is largely due to the fact that we must import goods that are no longer made in the USA. Pressuring China over the exchange rate on the yuan will not change these fundamentals. What has been forgotten in the demonizing of trade deficits is that they are offset dollar-for-dollar by the capital account surplus. The two parts of our Balance of Payments are the current account and the capital account. Over the long haul, net capital inflows have provided all sorts of benefits including hundreds of thousands of jobs for Americans.

Dr. Mark Perry (http://mjperry.blogspot.com/) calculates that since 1980 the United States has attracted almost $8 trillion of foreign investment. That capital has financed start ups, allowed existing businesses to expand, generally contributed to our nation's financial system and created hundreds of thousands of jobs. Some of the $8 trillion has been in the form of direct investment - Honda and Toyota factories, for example. The flip side of our trade deficit is the beneficial capital account surplus. Trade is not a one way proposition where we lose jobs to foreign makers and get nothing in return. Trade is very much a two way proposition and both sides usually win. The whole process of international trade and international capital flows is very complex. It does not lend itself to easy sound bites to impress voters. Singling out one bilateral trade deficit, as is the case with China today, can have unexpected and unwanted consequences. Micromanaging a complex economic system is never a good idea. There are real benefits from our trade with China. For example American consumers get goods they want at an affordable price. That plus the consequent capital inflows should not be ignored.

There is a lesson to be learned from our current account deficit. No matter how much historical evidence supports popular pessimism, the crowd can be totally wrong. The U.S. current account deficit is running at about 3.3% of GDP. That is why we haven't heard anything about the current account in a long time. A few short years ago, in 2004 and 2005, the phrase "current account deficit" was widely used as a rallying cry for pessimists. It made headlines every week. Back then our current account deficit was at 5% of GDP and growing fast. History told us that no country had ever run a current account deficit above 5% of GDP without suffering a currency collapse followed by an economic calamity. Pessimists latched on to the historical facts and confidently predicted an imminent dollar collapse with skyrocketing inflation. I wrote article after article in my newsletter pointing

out the benefits of the huge capital account surplus. I predicted that our current account deficit would shrink with no adverse consequences to either the dollar or U.S. inflation. The U.S. current account deficit did not continue to climb to a destructive level. On the contrary it has shrunk to a far more modest 3.3% of GDP. History that seemed so compelling turned out to be no help forecasting the dollar or the U.S. economy. My point is that the tale of the U.S. and its rising current account deficit really was scary and really did have history on its side. Yet, what seemed impossible became reality. We survived the current account deficit crisis. The rush into gold today - based on ideas that U.S. government debts and deficits cannot be corrected - could turn out to be just as wrong as the past current account deficit theories. The future has a funny way of not repeating history exactly. There are always differences. As investors it pays to keep an open mind and not be seduced by popular pessimism even when it is supported by lots of historical data.

Next issue: The December issue of John Dessauer's Outlook will be ready on Wednesday December 1, 2010.

Next weekly hotline: Wednesday November 10, 2010

All the best,

John Dessauer

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