Capital Drain

Rick's investment opinion newsletter July, 2014 v.10 no.4

Before printing, think about the environment

Hi Readers,

If you have a moment, I'd like to hear from you: do you like the charts? Or do you think of them as a nerd thing that you just skip past?

As you may have guessed, I like them because they show me how things are changing, but then I'm a nerd. I could just as easily describe what I see without making you look at them. Do squiggles make you dizzy?

So, no charts today for a change. In my opinion:

Executive Summary:

- Just sit tight.
- Russia: it's now the B~~R~~ICs
- Other 'BRIC-ly' countries
- Unemployment claims and other indicators
- summer doldrums
- Fed tightening and a possible stock dip
- Reflexivity: thinking about what they're thinking about what we're thinking

The recovery continues, many US companies are doing well, and the prices reflect at least modest growth expectations.

I remain leery of the conspicuous high-fliers, especially the “hot” new tech IPOs. Maybe I'm just too stodgy to go for what I think is glamor with insufficient substance. If so, lately the rest of the market has started getting stodgy, too, both here and in China.

As confidence in the economy spreads, investing in all-market index funds becomes a bit more attractive. We are likely reaching the phase where a rising tide will lift (almost) all boats.

If you're inclined to pick among individual securities, be careful: stick to value, to safety, and call me to chat if you’re concerned about anything you’re holding. At the moment I wouldn't want to be holding bonds; the risk is high and the reward is extremely low.

Above all, avoid the investments that are at all-time extreme valuations: junk bonds, developing-country bonds, and headline-grabbing stocks with high P/E ratios.

The Details:

There's certainly a lot of dynamic news these days, but in my opinion, **just sit tight** with your investments. I am with mine.

Most of the events in the news are not actually likely to affect our economy, thus our stock markets. That's not to say that nothing will happen; on any given day there's some chance that you'll get a house dropped on you. That will come out of the blue with no warning, in the unlikely event that it comes. The domestic politics and worldwide conflicts are a mess, but in the ways that matter to investments they're more predictable.

Oh, Vladimir. It was all fun and games, wasn't it, until someone got an eye poked out.

Regular readers know that I've recommended against investing in **Russia as a BRIC**, one of the group of (once) up-and-coming large countries that had potential for rapid growth, Brazil-Russia-India-China.

Now Russia is out in almost everyone's eyes. No one can make excuses or call it a local uprising in Ukraine when the "locals" swat a packed civilian jetliner down from 30,000 feet with an advanced anti-aircraft rocket system. Putin is now plainly the very model of a modern psychopathic dictator. I won't be looking at Russia again until he's out of office, ideally dead, and his successors have made several years of successful changes.

China is certainly not a rogue on that scale, but I still don't trust that their path to being a developed country will be smooth. It's still a risky place to invest because the rule of law is so malleable, with foreigners near the bottom of the list of "who gets protected from whom." Longer term, it will be quite a trick to end the sole rule of the Communist Party, but they can't last forever. The longer they hold on, the more chaotic the transition is likely to be.

That leaves Brazil and India, neither of whom is doing really well right now. That's OK. That's what the BRIC concept started out as: countries with huge potential and no impediments to continued progress. Recall that the recession was worldwide and laid low some countries that usually are much stronger. Both will continue to advance in leaps and pauses.

Meanwhile, other countries are being added to the **BRIC-like list**. Back in the August 2011 issue (middle of page 5) I wrote very briefly about candidates. Since then, sadly, Argentina has gotten more desperately mired in bad policy. Turkey and Thailand have some serious internal political issues to deal with, although the economies aren't doing too too badly. Indonesia, Mexico, Malaysia, and the Philippines are making progress, each in it's own way and despite it's own obstacles.

Given the near-collapse of the Euro and the lack of common progress among the EU nations, I think it's worth thinking about Poland independent of the others. They're big, competent, industrious, and have a history of good development. The only obvious risk is that they depend on imports of Russian gas. That shouldn't be a big problem, but could be.

Some analysts are looking at South Africa as a new BRICoid as well.

I'll keep you posted as I give this more thought.

Meanwhile here in the US, things are looking better and better, slowly, despite the political dysfunction. The most recent GDP advance estimate for the April-June quarter is quite good. (If you miss looking at the charts, you can see them online here.) **New Unemployment claims** are dropping to new lows for this recovery, and lower than most recoveries at this point. Unemployment itself is dropping. The Federal Reserve Board's Index of Leading Indicators is nearly as high as it's gotten in previous recoveries. All that is good; it means we can expect the economy to continue to improve. I believe that as employment continues to recover, consumer demand will recover, and eventually we'll get back to normal growth, where demand and investment in new supply boost one another.

There are some seasonal patterns in the stock market. One of those is a rash of summer “analysis” articles about **summer** being less good (on average) for investors than other months. Maybe so, but it's not such a strong correlation that you should worry about it. Some summers have been just dandy for investors.

Today the new unemployment claims number was announced, **great news for the economy, and the stock market dropped a lot. WHY?** We see this every time we start (or might start) to get back to normal growth after a recovery.

On the one hand, a good economy is a good thing, so everyone should be pleased and optimistic about the future.

However the other hand is that the Fed will soon start raising interest rates. It's true, they will. The part that gets exaggerated is the drag that will supposedly be put on the economy. Traditional thinking, untethered by actual data, holds that rising rates necessarily mean lower profits, because borrowing costs will be higher, period.

It's never that simple. For starters, the Federal Fund rate now is extraordinarily low. It can go up two percent (that's a huge number in this context) before it even gets back to a low-normal level. Second, what's holding back the recovery isn't the cost of investment, it's the lack of demand. The cost of business borrowing is not going to be a drag on growth at all.

Third, it will be a while before they actually raise anything. The Fed will still be buying bonds (having an effect opposite of raising rates) through September or October. THEN, eventually, not necessarily right away, they might start selling some of the bonds they've been buying. That also needn't have a big effect on interest rates, depending on the rate of sales. ONLY after that, after all the phases of Quantitative Easing have been reversed, will actual rate raising be their only choice.

(For a quick review of Quantitative Easing and its reverse, there's a description in the November 2010 issue, starting around the middle of page four.)

The last two topics touched on **Reflexivity**[1], an aspect of market psychology or Behavioral Finance.

This can be made to sound complicated, but the essence is simple: finance is not solely about the fundamental numbers. People are involved.

What those people decide to do will affect the markets. The effect could amplify what the numbers (macroeconomic or company specific) seem to indicate, or it could nullify a 'rationally expected' market movement, or it could create market movement out of nothing but imagined glimpses of shadow.

The first through Nth levels of complication are that people know that people are involved. Sometimes the expectation of others' actions is itself the cause of actions. This can get as complicated as you have the desire and patience to make it. Alternatively, you could admit that crowd sentiment is unpredictable but also fickle. If you invest based on the fundamentals, you're in a good place to wait while the crowd's whims and vapors dart about before settling down.

It's time to check the spelling and send this on its merry way.

If you have any questions, please write or phone. If you want to read more, the company web site has archived editions of this letter, lots of charts, and links to other interesting sites. There's also a web log where I discuss the process and progress of starting the mutual fund, along with occasional economic or investing thoughts..

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Take care,

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1 https://en.wikipedia.org/wiki/Reflexivity_(social_theory)#In_economics

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"Our doubts are traitors,
And make us lose the good that we oft might win,
By fearing to attempt."
--W. Shakespeare

A collection of fine industrial Boilerplate, but true:

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