Capital Drain

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Before printing, think about the environment

Hi Readers,

It's **Labor Day** weekend, nominally a chance to thank America's laborers for the hard work that has built the country. They're often ignored in our modern financialized economy, but don't be fooled. Bond issues don't build bridges, construction workers do. Whole Foods is now owned by stock market investors, but the freshness of your veggies depends *entirely* on stock clerks and truck drivers and field workers who earn hourly wages.

More than simply sparing them a thought this weekend, keep them in mind whenever you contemplate our modern economy.

So, in my opinion:

Executive Summary:

- I'm sticking with my current portfolio
- Finally, a clear foundation for decent growth
- Inflation still no problem
- Our overseas markets could help, not much scope to hurt
- All this talk about bubbles- what to believe? Three choices:
  - Continue slow, nothing much changes
  - Booming economy raises interest rates & destroys bonds
  - Relapse into recession destroys stocks
- Bonds can be dangerous
- The danger of choking off rise in wages
- Credit Check: EQUIFAX

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.

As confidence in the economy spreads, investing in all-market index funds becomes somewhat more attractive. We are likely reaching the phase where a rising tide will lift (almost) all boats. At the same time, overall valuations are high enough that a significant all-market correction is more likely that it's been for many years.

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 super-high P/E ratios.

The Details:

To make a long story very short, I'm **sticking with my current positions** in dividend-paying stocks. The position is doing well, and the dividend income is nice.

I'm holding tight because I continue to see the economy improving slowly.

It's too slow to call it a perfect "Momma Bear" economy, as many people are still out of work or working only part time when they'd rather be full time. It is, however, improving. As long as we get at least that then everything is OK for the portfolio.

The rate of improvement is also improving, finally, **solidifying the foundation** for continued growth. The number of new job losses each week is trending steadily downward. Jobs are being created, and overall the number working is rising. The GDP for the most recent quarter is up by more than expected, growing at the rate that's been average for the economy for the past several decades. Given recent history, average is good.

Inflation is not a current threat, and won't be unless the growth rate gets much steamier. In previous issues, most recently the Oct. 2013 issue, I've beaten the concept to death that money supply alone doesn't cause inflation. Our economy needs demand, not financing, so all that QE cash is sitting more or less harmlessly.

The recession was world-wide, to greater or lesser degrees. Some of **our trading partners**, particularly Canada, Mexico, and Asia, are doing well enough to help boost our exports and thus create some jobs and put some money in workers' pockets. Europe, on the other hand, is no help at best, and may even become a bigger drag if they slip back into recession. In good times, Europe is a major destination for our exports, but lately they've been weak for so long that continued weakness is not new bad news. If they recover strongly, that's great. If not, that's merely not helping.

Lately many financial commentators have been warning about **bubbles** forming in the markets. Stocks are pretty high given the slow growth, housing has bounced back quite a bit, and bond yields have been bid down to very low levels.

Briefly, I don't see the **stock market** as a problem unless the economy's growth seriously stalls or reverses.

House prices-- sheesh. Houses are places to live. Most people should not think of them as investments. Before the '70s inflation, the maximum financial impact was that they acted as piggy banks, slowly accumulating value as the homeowner paid off the mortgage. The 1970s' higher inflation made house prices look like they were going up a lot, and then the public was hooked. I don't think they're remotely back in bubble territory now, but I'd be a lot happier if people would stop expecting them to rise faster than inflation. The pre-crash mentality remains only slightly dimmed.

Bonds worry me. There, I can't brush aside the bubble talk, although that doesn't make the bubble talk true.

Let's review the nature of bonds:

- You give your money to someone, and get a promise.
- In the best case, you get your money back on time, with some interest.
- In the worst case, you get nothing, a total loss.
- That interest rate is supposed to compensate you for the use of your money (which you could have used yourself for something else), PLUS some reward for taking the risk of loss.
- Interest rates now are very very low.

Those super-low rates are dangerous for two reasons:

- Investors aren't getting a reasonable reward for the risk of outright loss. Junk bonds get rated as junk (“below investment grade”) precisely because they're risky. It's not a fashion label. Getting low interest rates for risky bonds is a problem waiting to happen.
- When rates go up, as they must, anyone who sells one of these super-low-rate bonds will suffer a capital loss. The extent of the loss depends on the maturity (length of time) of the bond, and the amount that rates rise. Given low rates to begin with, having that reduced further by capital losses is not good.

There's no way that I'd want to own bonds now. There are simply too many bad possibilities and too narrow a tightrope walk of good possibilities.

Pension funds, by the way, could lose a lot when rates rise. The workers who thought they were being paid partially in the deferred compensation of a retirement income-- could be royally screwed. That's a technical term. The only mitigating factor is that pension funds don't have to sell bonds, they can wait for them to mature. That way they don't take a (visible) loss, they merely failed to earn much. Even mere low return is bad for the health of pensions. Outright loss from some bonds defaulting, not repaying, could make it much worse.

Dividend stocks are not immune to rising rates, except by the fact that their rates are still high now, and dividends can rise as profits rise. The companies I hold are pretty solid performers, so I'm not worried that poor corporate profits will force reduced dividends. These stocks still seem to me to be the best return for the least risk.

As I mentioned in my foreword, this is Labor Day weekend, a holiday to celebrate our nation's workers.

I've already discussed the risk these workers face as a result of their pensions being underfunded and now poorly invested.

Obviously, many of them were financially mauled by the recent recession.

Finally, even the recovery could be turned against them. Economic theory says that workers' wages should rise as they become more productive. Their contribution rises, so their compensation should rise too. In the past decades, though, even before but especially during the recession, workers' average wages didn't keep up with their increased productivity, the increased value added by the labor. In fact, almost all of that increased value stayed with the employers, as wages stayed flat or fell.

Economic theory also says that the Federal Reserve should raise interest rates to prevent excess inflation, and be especially vigilant against self-perpetuating inflationary pressure. Unfortunately, workers' salaries are the classic example of self-perpetuating pressure. When workers get paid more, in the standard theory the employers have to raise the prices of their products. Those higher prices cause other workers to want higher wages to compensate. It feeds on itself, and it's difficult to moderate.

Thus, traditionally the Fed responds to rising wages by raising interest rates to slow growth and prevent labor shortages from giving workers too much bargaining power, or too much power to leave one job for a better one.

The problem is that America's workers, especially at the bottom, but really all wage earners, need to be allowed to catch up. Wages need to rise, more or less across the board, to keep the bulk of these workers in the middle class, the foundation of America's economic and political strength. Higher wages will be a good thing, even if it means a decreased rate of corporate profit increases.

Analogies abound. We can continue growing our economic pie, and share it more the way we did during the best decades of the working and middle classes, the 1950s and 1960s. We can calm the financial sea a bit so that a rising tide will once again lift all boats, and not only the yachts while the small boats are swamped and founder.

I think the current Fed Chairman, Janet Yellen, is more likely than her predecessors to see that, and try to make it work. She is aware that the economy is much more than the financial system, and that Main Street needs to be kept strong, if need be by pushing back a bit against Wall Street. We'll see.

Happy Labor Day.

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