Capital Drain

Rick's investment opinion newsletter December, 2014 v.10 no.8

Before printing, think about the environment

Hi Readers,

This letter marks the 10-year anniversary of my first published newsletter. Since then, the economy, the markets, and the world have gone through some dramatic short episodes and long-term changes.

I hope my letter has been some help for you keeping up with and making sense of events. Even more fervently, I hope I can be helpful for you in the next 10 years or longer.

In my opinion:

Executive Summary:

- Rest of World (ROW) is in recession and turmoil
- Falling oil prices help us in many ways.
- US economy is pretty good
- Wages, inflation, and QE: how do they relate?
- Bad deflation, and good deflation
- End-of-year silly season.
- It's credit check time: Experian

The recovery continues, and many US companies are doing well, but the prices reflect high continued growth expectations. If you're holding shares of any of the conspicuous high-fliers, especially the "hot" new tech IPOs, you might consider selling into this enthusiasm. Better to risk a little less gain rather than a lot more loss.

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

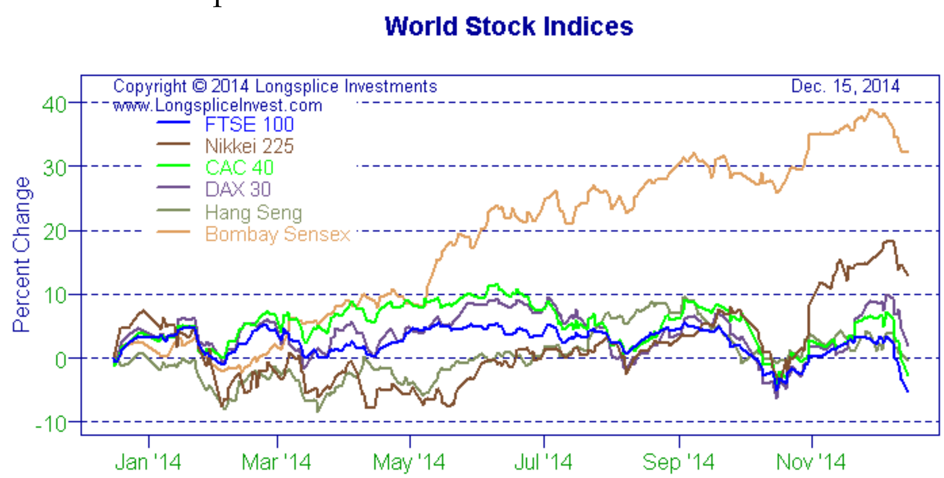
If you're inclined to pick among individual stocks, be conservative and be in the best of securities: stick to value, to safety, to short maturities (for debt), and call me to chat if you're concerned about anything you're holding.

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:

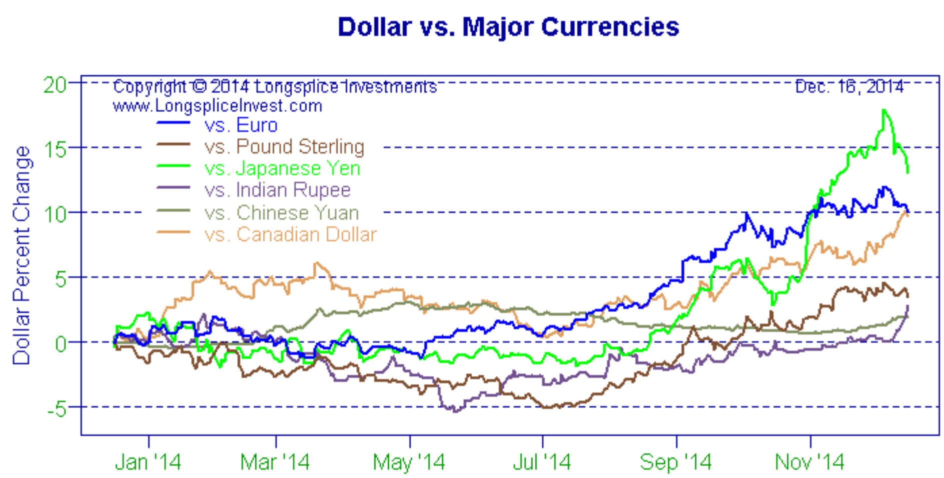
This year is ending as a **worldwide mess, economically**. The bright spot is us, but we're doing well, not great. Europe, Brazil, China, Russia-- each has significant problems to deal with, and likely will for at least most of 2015. I suspect you've seen the headlines. Each of these is in a recession or about to be. Brazil is probably the least troubled. China is probably the most able to act decisively. Europe won't collapse, even as their austerity policy makes their recovery more difficult.

Russia-- well, they have serious problems. Foremost is the price of oil dropping, depriving them of a huge chunk of national revenue. Sanctions are also a factor, but if oil were high they could muddle onward. Most importantly, the combination of the government running out of oil money and sanction pressure make a lot of Russian businessmen question the fundamental stability of the Russian system. There is an enormous amount of money being moved out of rubles and out of Russia. That itself exacerbates the problems.



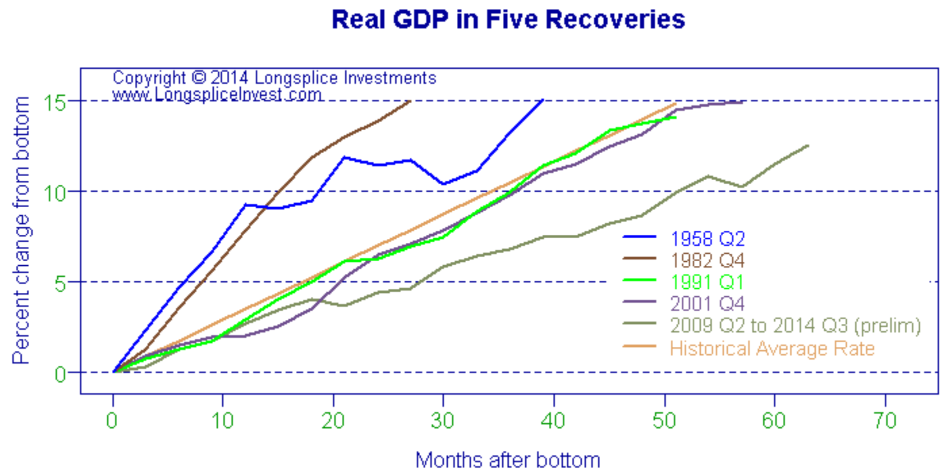
World stock markets are muted, except for India where slow and steady continues to win the race.

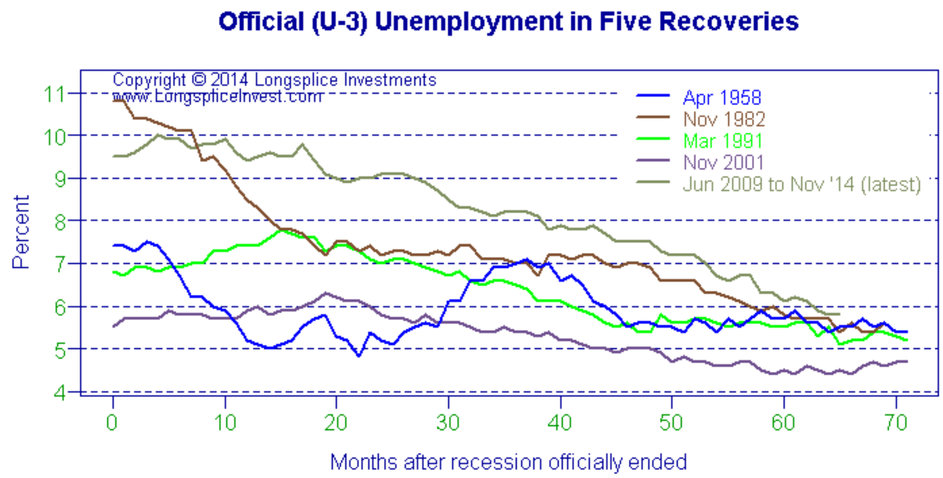
The sharp drop in the price of oil is great for importers-- us, China, Japan, India, and most of Europe-- but it's very bad for exporters, most notably Russia, Venezuela, and to a lesser extent Brazil and Mexico.



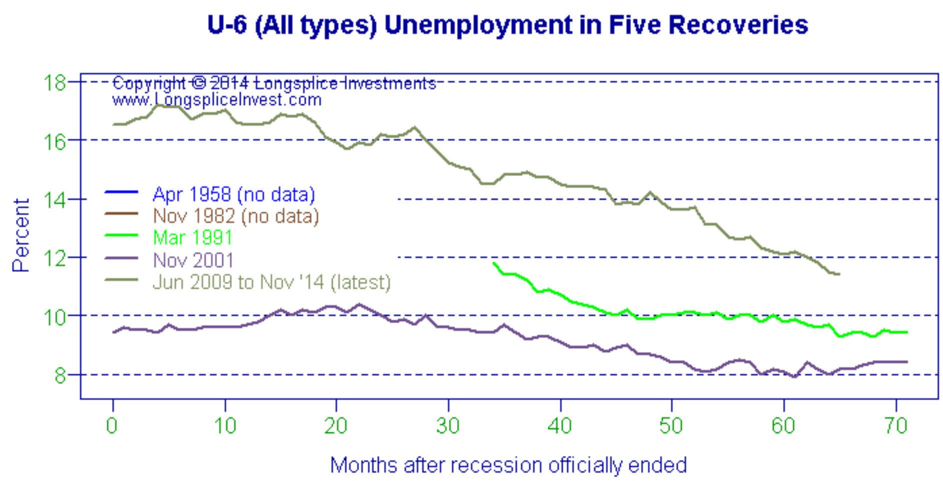
For us, the falling cost of gasoline means more money for people to spend elsewhere. That, increased consumer demand, is what we've needed most to get the economy growing again, and it is working. Our relative strength and stability compared to the rest of the world is also pushing the dollar up relative to other currencies.

Our **GDP growth and unemployment** are steadily **getting better**, and are back to non-crisis levels.



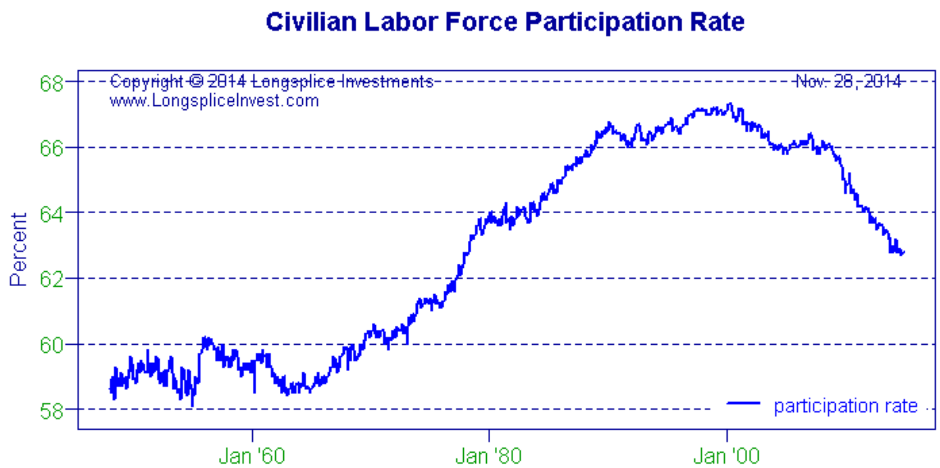


Even U-6, which includes discouraged workers, part-time workers who really want full-time jobs, etc., is improving and approaching the levels that we saw in previous 'normal' recessions.



There has been some discussion that the unemployment picture isn't as rosy as it appears, because less-cited macroeconomic factors like the employment:population ratio (essentially, what fraction of the population works), the labor participation rate (what fraction of the potential workers works), and others are not improving as fast as unemployment itself.

Clearly, employment dropped (and population rose) but employment is rising again. Further, the E.:P. ratio is above levels that were the norm before the 1980s. Hardly the stuff of crisis.



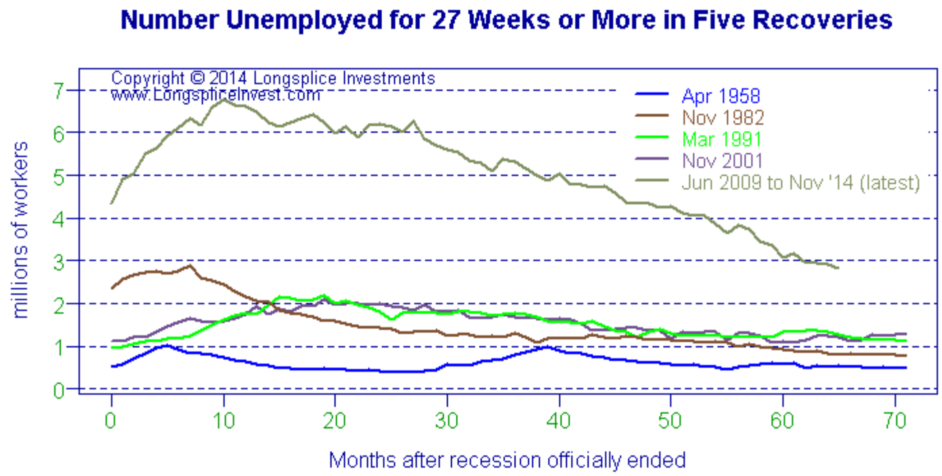
The labor force participation rate peaked late last century, and was dropping noticeably even before the credit meltdown. One important factor is that the Baby Boom generation is starting to retire. They count as 'potential workers', but they're no longer working. This ratio may rise again as the recovery matures, but may not. The social era famous for DINKs (Double Income, No Kids couples) is winding down, with more kids and more stay-at-home parents. It isn't a problem, just a shift.

If you don't like charts, skip down to the top of page 7.

The employment data all come from the United States Department of Labor, Bureau of Labor Statistics, by the way. (http://stats.bls.gov/data/)

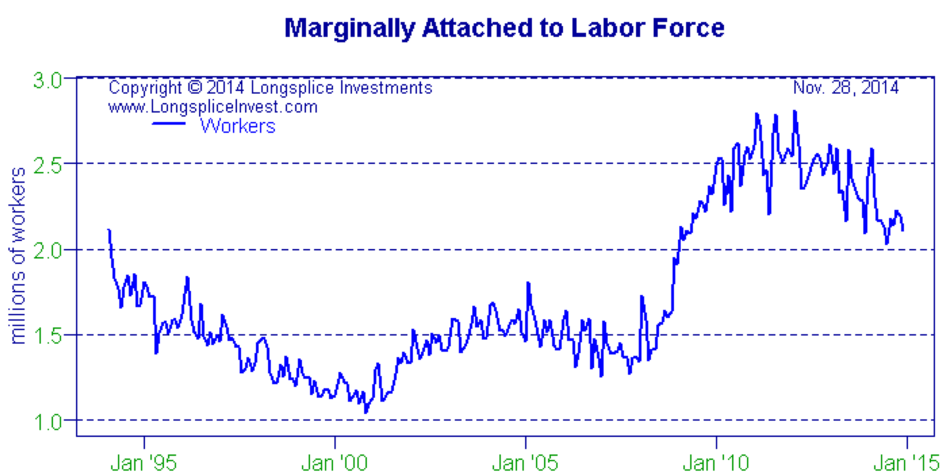
You may have noticed, I like charts.

Long-term unemployment was especially high in this past recession. Getting these people back to work is a huge boost for the economy overall.



Much was made of the discouraged workers during the long slow recovery.

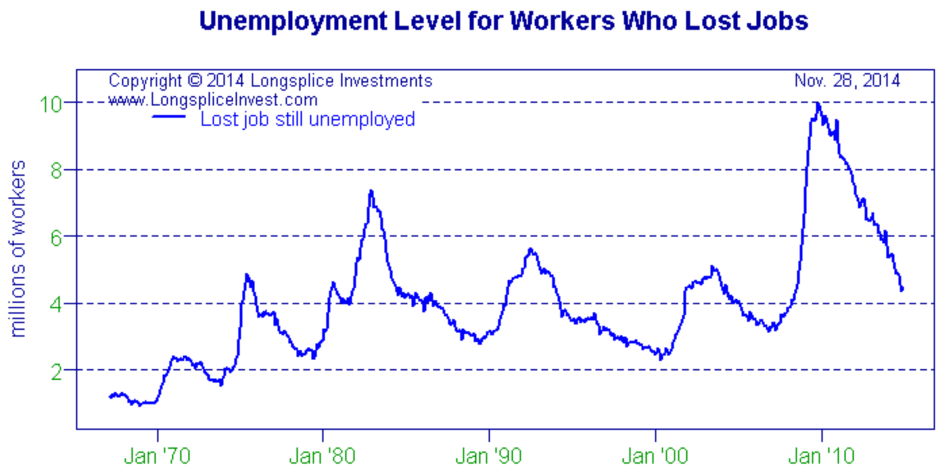
There were a huge number of them, compared to the 2001 recovery or before. Their number has decreased toward normal levels.



"Marginally Attached" means "looking for a job, but not aggressively as the jobs clearly aren't out there."

That too was very high for a while, and is dropping.

The reason I keep going on about employment and unemployment is that this recovery has been all about rebuilding consumer demand. It's been a slow bootstrapping process as newly-rehired workers started spending again, causing more re-hires, etc. The Federal Reserve's low interest rates contributed roughly nothing.



Losing a job is usually a surprise, and it takes a while for the worker to get effective at job hunting. Meanwhile, others are also losing jobs, and competing to find the same new ones.

Graduating into a recession is especially frustrating. A couple of wasted years of un- or under-employment can set a young person's career potential back substantially.

Under-employment hurts both by under-using skills, and by putting far less than a living wage into the consumer's pocket.

The most determined job seekers, who take crappy (a technical term) jobs rather than have no job, hobble their further job search while not actually solving their unemployment problem.

Some employers take advantage of this, hiring armies of part-timers rather than full-time workers.

OK, no more charts. To reiterate, the US economy is recovering still, but still slower than we would like.

Have you ever wondered why the Federal Reserve, and economists in general, talk about the preferred rate of **inflation** being around 2% (for example)?

After all, at 2% inflation, compounded for about three decades, the purchasing power of the dollar drops by half. From birth to retirement, the value of a dollar drops by 75%. From birth to average live expectancy, the value of a dollar drops to 1/8 its starting value-- a dollar from your birth year will be worth only 12.5 cents at your funeral.

Why is that a desired outcome?

Two reasons.

The first is related to what we've seen lately: when there's a recession, the Fed wants to be able to lower interest rates to create more investment. That assumes first of all that the Fed keeps interest rates higher than the rate of inflation (positive real rates) which it has not done for quite a while. It also assumes that lower rates will spur more investment. In a normal business cycle, it will. After a financial crash like we just experienced, it won't. Still, the normal business cycle is what the normal monetary policy is tuned to work with.

The second reason for positive inflation is seldom mentioned outside business schools: inflation is used to slowly, imperceptibly, decrease the real wages of workers. The theory here is that wages are "sticky", meaning that sometimes labor can demand and get higher wages, but it is very difficult for businesses to simply say "starting tomorrow I'm paying you all less." (Although we've seen that happen lately).

It's up to labor to then reclaim their lost spending power by demanding higher wages again, and they won't be able to do that until the economy is really humming and the labor market favors workers in negotiations.

You hear some business managers talking about rising wages as if that were necessarily a bad thing, to be stopped as quickly as possible. Not so. As the current inflation/interest rate theory paints it, wage gains are a necessary part of the cycle.

Paul McCulley, a once and now once again executive at the bond fund company PIMCO, has written a very interesting piece on this topic. It's not technical-- no formulas-- and it's written in a light folksy way, but it is a serious bit of thinking about economic theory and the effect on our real working world.

I heartily recommend that you read it: MACRO PERSPECTIVES: Principled Populism

The flip side of a discussion of inflation is **deflation**, in which prices decrease. Most economists, and especially central bankers, seem to live in mortal fear of deflation.

There is certainly good reason to be wary. When consumer demand drops too low, businesses start to cut prices. When price cuts start to happen, consumers (already strapped for cash) start to delay even affordable purchases in anticipation that prices will be lower in the future. That can feed on itself to bring an economy to a crisis eventually, when prices simply can't be lowered further, and businesses close. We can see this in recent history in Japan, in our own history during the Great Depression, and currently in the austerity-afflicted Mediterranean European countries.

That's the bad side of deflation.

The good side is that sometimes prices fall for good healthy reasons, and there isn't any need to compensate by lowering wages or causing unemployment.

For example, the current drop in the price of oil will bring a deflationary windfall to consumers. It's tough for oil producers, but they can deal with it. Likewise for great year for farming: food prices can go down, and it's beneficial to consumers. Those two examples are common enough occurrences that economists exclude food and energy from their calculation of 'core' inflation. Food and energy can drop so much that overall inflation is negative, but core inflation may inch downward but still stays positive.

There are other cost cuts that are beneficial but not excluded from core inflation. For example, in the US the cost of medical care could drop by about 50% and reach the average level of the other rich countries of the world. If we made the system more efficient, that would happen, and the magnitude of the consumer savings would be huge. But, it would look like deflation, and it would slowly ripple to lower other prices as well. Typical economic thinking paints that as bad, deflation, and would try to prevent it by goosing the economy to produce inflation (in other things) to compensate. I argue that deflation like the medical example is good, and should be celebrated.

That's just a quick example, for a quick touch on the topic.

In summary, policy makers shouldn't assume that falling prices feeding into a falling Consumer Price Index are necessarily bad. They're only bad if they adversely affect demand and cause producers to fold. We need to be alert that some deflation can be good.

December and January tend to be **Silly Season** for Wall Street. In December, there's a lot of window-dressing, meaning that investment managers buy stocks that have done well, so they will show up in the annual report of holdings. That's just bogus, but it does cause a momentum-like boost to some stock prices.

Tax-related selling is more balanced, as some profits are taken, balancing with loss-taking.

January is when pundits compete to predict the trends for the coming year. My prediction: they're almost all wrong. They almost always have been. Still, the rush into and out of sectors can move prices, at least temporarily.

As long-term investors, you should ignore it all. Spend time with your loved ones. Read a book by the fire. Go skiing, or to the tropics to bask in the sun. Just ignore the stock market gyrations.

If you want to give me a holiday present, promise me that next year you won't watch the cable news financial shows. At all. I admit that I've seen (on YouTube) interviews they've had with respectable rational investors. For the most part, though, the breathless moment-to-moment latest-latest-thing hyperventilating obsessive ADHD is a toxic atmosphere for real investors.

It's **Credit Check** time again.

Why? Identity theft has become a big big business, with professional thieves adapting daily. Your best hope for protecting yourself is to keep an eye on all your financial accounts, watching for suspicious activity.

How? Once per year per Credit Agency, you're allowed to get a free copy of your Credit Report. If you've been following along with my every-four-months pace, you're ready to revisit Experian. Experian A world of insight

It's easy. I've taken notes from my own recent visit, so you can follow the instructions at www.longspliceinvest.com/CapDrain/Experian.pdf .

It's time to check the spelling and ship this to you.

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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"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: