Capital Drain

Rick's investment opinion newsletter May, 2015 v.11 no.2

Before printing, think about the environment

Hi Readers,

I last wrote about three weeks ago, so not very much has changed in world and market news. In that letter I said I'd soon share an investment idea for the proceeds from the stocks I've sold in recent months. That, and the usual rumination, follows.

In my opinion:

Executive Summary:

- US economy continues well
- Other major economies not so well
- Don't overreact to ISIS
- Dollar still high
- US as the Consumer for the World
- buy HFEAX Henderson European Focus Fund

The recovery continues, and many US companies are doing well, but the prices reflect high continued growth expectations. Parts of the tech sector, particularly the profitless highly speculative social media companies, have been climbing fast-- too fast. 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. That applies worldwide, as well. The US is only 25% of the world economy; it makes sense to invest in other economically promising regions.

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 (if you don't avoid it completely), 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:

As I wrote in April, the **US economy continues to do well**. Other parts of the world are not doing so well now, but there are bright spots where growth is starting and should continue.

One topic that leaps into the headlines pretty often, but which I think you can safely ignore for our investing purposes, is the military rise of the Islamic State of Iraq and Syria (**ISIS**, also called ISAL or just IS).

Don't get me wrong, for Syria and Iraq and to a much lesser extent other small areas with radical Islamist rebels, it's a problem, and it will take quite a while to get it completely under control and quieted down.

Still, I don't think we need to treat it as any sort of imminent threat. Why not? Because ISIS, for all of their recent dash and daring, is only at most a few tens of thousands of troops. Meanwhile, right next door is **Turkey**, our NATO ally, with a population of 78 million and a well-trained and -equipped army of 500,000 active soldiers.[1] And Turkey is not freaking out. They're more concerned about the refugee problem. If Turkey sees no need to even prepare to go to war to deal with a threat on the longest portion of their land borders, I don't think that Europe and the Americas should be any more concerned. Keep an eye on it, but don't worry.

Back to investing, the **dollar** is still high relative to other major currencies. To some extent it's because of the Greece issue tainting perception of the Euro. Also, first Japan, then England, and now Europe have begun Quantitative Easing, while our Easing phase has already ended. There is a lot of flight to the dollar because of the monetary uncertainty.

There's good news and there's bad news in that.

What a high dollar means for a lot of our trading partners is that it's easier for them to sell their goods into the healthiest consumer market in the game, us, the US. That is already helping other advanced economies get back to tolerable growth.

The flip side is that a high dollar means that it's harder for our domestic manufacturers to sell to the outside world. That has already shown up in the statistics for new factory orders, for example. That will slow our domestic growth somewhat.

It's a trade-off, but an uneven one still in our favor. We need to export less urgently than Japan and Europe do. They'll gain more than we lose, and their gain will bring us back toward a normal balance. The currencies will return to more normal level, and we'll all be back to higher growth together.

1 "Turkey", Wikipedia, 22 May 2015 (UCT), Wikimedia Foundation, 21 May 2015 (PDT) <https://en.wikipedia.org/wiki/Turkey>.

One thing we want to avoid is a pernicious dynamic from the 2000-2008 expansion, the idea of the **US** consumer **as the Consumer of Last Resort** for the world. When other countries were investing heavily in productive capacity, rather than letting their workers share in the wealth and consume more, all eyes turned to the US as the seemingly insatiable market for consumer goods. It helped them grow, but it set us up for trouble.

It's not as if our middle and working classes were doing so well themselves. Our median income wasn't rising, and couldn't absorb all that stuff. The companies (domestic stores and distributors) that wanted to sell put a lot of effort into getting Americans to borrow to consume. Easy credit cards, cash-out refinancing of homes, and other ~~evil tricks~~ inducements persuaded tens of millions of people to live beyond their means. We know how that ended, with all that debt becoming an enormous millstone around the necks of millions of people.

I don't want to be a scold; I'm not your parents. None the less:

NEVER borrow for consumption, only for investment. Buying a car is consumption; they depreciate fast. Buying a house is an investment ONLY if you don't do cash-out re-fis. Whatever it is you want to consume, save for it rather than borrowing for it. You'll still get the goodie, just a little later. Get in the habit now, and when the next economic crunch hits, you'll have a lot less to worry about and a lot more options.

If you have any credit card or other high-interest-rate debt, paying it off is one of your best available investments, especially as rates are generally low. Talk to your bank about pulling the various revolving debt together into a lower-rate fixed-term consolidated loan. And then, Cardholder Sin No More. Yeah, maybe I do want to scold a little bit. If you don't pay off your credit cards every month, you don't actually have any money for investment or anything else.

Also, if you haven't refinanced your mortgage, rates won't get better, probably in your remaining lifetime. You can get a pleasant boost from lowering your monthly payment, without extending the maturity, and no need to take cash out. Just lock in the lower rate for a lower payment. Don't let the bank talk you into any shenanigans.

In the previous letter I mentioned that I was selling DuPont(DD) and Kraft (KRFT). Late last year I said when I was selling ConocoPhilips (COP) and about a year ago Pfizer (PFE). At the time I didn't see a clear choice for a new investment. It's not good to leave cash sitting around idle, but at the same time it's definitely bad to make investments just because you have cash. If you don't have confidence in the investment you're taking on, don't do it.

Where then to invest? The recent fastest-growing economy was the Philippines, but that country alone wouldn't be a good diversified pick.

I think that between the run-up of the dollar versus the Euro, and the general battering of sound European stocks because of the Greek debt trouble, that European stocks are a good choice now. The big economic engines (Germany, Italy, France, England) are getting traction. The whole of the Greek debt is actually small by comparison to Europe's economy; the problem is more one of politics and morality theater than any real economic threat.

With that in mind, in the next few days I plan to invest in a European region mutual fund, Henderson European Focus Fund (HFEAX). At Schwab it's no load and no fee; I'm not sure about other brokers. They're not an index fund, but they have a long history of doing well, with the same portfolio manager since 2001. Expenses are reasonable. I'll have about 25% of my portfolio there, but being a fund it's pretty well diversified across countries, industries, and companies. They look good to me.

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