Capital Drain

Rick's investment opinion newsletter July, 2015 v.11 no.4

Before printing, think about the environment

Hi Readers,

This is just a quick note to reassure you that all the tumultuous headlines don't require you to change your investments. Stay calm and carry on.

In my opinion:

Executive Summary:

- Tumult, but Same Old investment environment
- Greece temporary calm
- China market tumble- overdue and not our problem
- US GDP and employment- good enough
- Fed will act soon: 2 variables , rates & money supply: return to normal
  - Inflation and wages
  - Inflation and monetary policy

The recovery continues, and many US companies are doing well, but some 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.

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 usually do when I sit down to write a newsletter, I just re-read the previous one.

For all the **tumult**uous headline ink that's been spilled, there's so little that has changed that I'll just give you a link to it: CapDrain June 2015 . If you've already read it and remember it, you needn't read it again. If not, do please read it, as this will save me from writing the same things again.

Now I can do a very very quick summary of what's changed:

A new bailout agreement for **Greece** (for the banks that lent to Greece, actually) was made, solving nothing and kicking the can down the road.

China's stock markets have fallen further, but they really needed to, and were going to sooner or later. A bit of actual news is that China's economy seems to be slowing down more. We'll watch that.

The past month has brought another good but not great **GDP** increase, a pretty good national **Employment** Report, and four more good New Unemployment Claims reports. The US economy is still recovering, but still doing so slowly for the reasons I've previously discussed.

The one thing that's actual new news is that it's clear that the **Federal Reserve** will start to reverse the emergency monetary accommodation that they've made in the past eight years.

They will most likely raise the Federal Funds rate, which has officially been 0-0.25% since December 2008. Any change by the Fed causes market gyrations as pundits make absurd predictions years into the future. The markets will settle back down. The actual number of the Fed Funds rate is, for now, just a detail.

What's important is that they need to return our monetary system to something like normalcy. Our super-low interest rates (lower than inflation for all but the longest bonds) are definitely not normal. The enormous money supply created by Quantitative Easing in all its forms is definitely not normal.

Until it gets back to normal, the Fed and other economists will not know for certain that the recovery has staying power. Further, until it gets back to normal the Fed will have no idea what it would do next if it needed to apply more stimulus.

Inflation is far below the target level. Business investment is far below what one would expect given the cheap money.

Why would we want inflation, anyway? One simple reason is that hitting zero, no inflation, is a very narrow band. Even if zero were the conceptual goal, the Fed would end up aiming for a band ranging perhaps plus or minus a half percent, or a range from slight deflation to slight inflation. Over time that could average to zero.

I mentioned the 'D' word, though. Because it's been central to some of the ugliest periods in economic history, economists hate and fear the thought of deflation. I would argue that a little bit, part of that average-to-zero process, would be OK. However theorists fear that any deflation could lead to big deflation. That would be a huge problem to our entire structure of debt as the center of finance. Thus, they want to avoid it.

Another reason that's less prominently mentioned for wanting positive inflation has to do with wages. Back in the December 2015 newsletter (page 7) I wrote more about inflation, and particularly the classical thinking about wages. In short, economists have the theory that they need to use steady inflation to continuously lower wages. No joke. They believe that that's the way to keep labor from being too expensive in the next recession.

As we've seen in this recession, the cost of labor has NOTHING to do with the lack of recovery. The erosion of working-class incomes has become part of the problem, not part of the solution. We have a severe shortage of consumer demand, because consumers have a severe shortage of money. That's what's keeping inflation down, and what's keeping business investment down.

A lot of economic policymakers believed that the huge pot of cheap money that the Fed has created would necessarily generate more business investment. After all, they reason, how can you lose with free money?

Well, economists may think that way, but business people know better. Even if you borrow free money, as soon as you start spending it to create or expand your business, you incur the likelihood of real losses. If you build a new factory or open a new restaurant, and no one (or too few) come and buy, you lose money. You will likely never ever recover the initial costs that you invested, but you certainly still owe that 'free' money to the lender. That is why business investment is not a function of the availability of capital funding, but of the availability of customers with funds of their own to spend.

As I said, the Fed wants to return to a more normal monetary environment, meaning higher interest rates and a lower money supply. They can do that, and it probably won't slow the economic growth down much at all. The (glacial) growth we have is coming from the virtuous cycle of more workers with more money creating more consumer demand.

There's no chance that the current Congress will help the situation by spending money on, for example, repairing infrastructure or improving health or education. The nominally 'conservative' Republican factions would ordinarily fund those things, but they're holding those hostage as they demand cuts in other ('socialist') progressive programs that promote the common wealth of the nation. The political gridlock that's prevented meaningful fiscal (government spending) stimulus for the past half-decade is what's holding back the compounding pace of the virtuous cycle.

We can only hope that we get back to normal in more ways than the Fed usually means: back to normal monetary policy, back to normal employment and GDP growth, and also back to normal political dynamics, back to normal economic policies, and specifically back to using an historically normal dose of fiscal stimulus to boost the economy back to robust strength.

That's it. I hope you've enjoyed it and found it useful.

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