Capital Drain

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Before printing, think about the environment

Hi Readers,

The stock markets have been pretty volatile, and all manner of interesting crises are erupting in the world. In economics and in world affairs these events have created a lot of contradictory opinions about the future. They can't all be right, so many investors are stuck, uncertain about the future. Markets hate uncertainty.

In my opinion:

Executive Summary:

- Don't just do something-- stand there.
- The US stock market dip-- no problem.
- China's stock market plunge-- no problem for us.
- China's Yuan devaluation-- no problem.
- China's economic slowdown-- maybe but not much: banks and jobs.
- Our economy- doing well.
- Federal Reserve Bank interest rate rise-- or not-- no problem either way.
    - The normal case versus the extraordinary case
- Credit Check: EQUIFAX

The recovery continues well enough, 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.

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:

There is quite a lot going on in the world, and especially if you watch TV news you may get the sense that you need to do something to protect your investments.

You don't.

First of all, remember that TV news is in the business of selling your eyes to advertisers. Good information and good advice can tempt you to watch, but it's only incidental. They know that they get more viewers when they can create a sense of excitement and apprehension.

"Coming up next! The factoid that may save your retirement money! Right after these commercial announcements! Don't go away!"

There is no reason to make big changes in your investments right now. **Relax**. If it helps, consider that you've already done the right thing, ahead of the crowd.

The **US Stock markets** have jumped up and down and partway back up. Broadly speaking, though, they're **back where they were at the start of the year**, and where they were a year ago. That's just fine. Stock markets don't go up steadily forever. The drop was not actually that big (except for some of those tech stocks I keep warning about), and the recovery from the drop has been good.

China's stock market drop is a much bigger deal-- for the Chinese stock investors. It's really an immature market, where 'investors' have no clue about company fundamentals and treat the whole thing as a big casino. Some western investors do the same, but the Chinese markets have been much worse. The markets will not cause a noticeable change in the Chinese economy, much less ours.

Similarly, **China's sudden devaluation** of their currency, the Yuan or Renminbi, was startling, but it's not a big deal. It was only about 3%, which is very small compared to deliberate devaluations by other countries historically. Further, the actual mechanism of the devaluation is a decrease in the government's direct control of their exchange rate. That's a good thing. This change helps China deal with their economy, but it's not a huge factor for them or us.

The one factor in the world economy that is potentially a big deal is the slowdown, actually a **decrease in the growth rate, of the Chinese economy**. This is certainly affecting the Chinese, and the countries that have been selling them raw materials. Unless something surprising goes wrong, it won't be bad for us, or for Europe.

China's banks are at some risk because there's been a lot of loose lending, especially on development projects in the hinterlands. If many of those projects fail, banks will take serious losses. That needn't cause as big a crash as it did in the West in 2007-8; the Chinese government is much more willing to get deeply involved in controlling the economy. Some banks many be allowed to fail, but the system will not.

The other problem China potentially has to face is unemployment. I say "potentially" because I can't find supporting statistics. If it were any other country, though, a slowdown in big domestic construction projects, and a slowdown in exports of factory goods, would cause unemployment. Whether China has the capacity to put enough people into other work remains to be seen. It's worth noting, though, that for years factories had been complaining that it was hard to get enough qualified workers. Perhaps a slowdown won't actually put a lot of people out of work.

Our economy continues well, a story that has happily become boring: more jobs, more workers, more income, higher GDP even than earlier expected, fewer unemployed, and economic leading indicators predicting more of the same, etc. It's good, don't take it for granted forever, but for now it looks durable.

The talk of the town, the biggest domestic question mark, is whether the **Federal Reserve will start to raise their benchmark overnight interest rate**. I propose that in this situation it doesn't much matter either way.

As I mentioned in the previous letter, part of what the Fed has to do is to get back to a normal monetary environment. The massive program of Quantitative Easing had never been tried before, and it has never been unwound by anyone, ever, anywhere. Likewise for the near-zero interest rates. It's all new; we have plenty of theories but no experience.

Many of the theories one hears are actually draw from normal experience, which is very different. In a normal economic cycle, the economy builds until growth starts to cause accelerating inflation, then the Fed raises interest rates enough to get businesses to back off from some of their growth plans. This is sometimes referred to as the Fed "taking away the punch bowl once the party is really going."

Those higher rates cause a slowdown in growth, or even (often) a recession. That's why you hear some pundits saying that an interest rate rise will endanger our growth or tip us back into recession.

We're not in that situation, though. First of all, it's hard for me to imagine that any company that was planning to borrow money for a growth project would stop because interest rates rose-- from almost zero to just a little above almost zero.

More importantly, the limit on our growth now is the slow rise in consumer spending, which makes it generally not urgent, at best, for companies to invest in growth. Raising the rate won't change that, and obviously not raising the rate will continue to not change that.

The other aspect of the normal scenario was inflation. We've got the lowest inflation we've had in my lifetime, by far. There is no indication that our growth rate will start to cause inflation any time soon. Thus, the normal reason for raising the Fed rate simply isn't there.

The other oft-quoted reason for raising rates is simply that our current rates are so extraordinary. Many economists want to raise them just to get back to a more normal-looking situation. As I've said, I don't think that would have any effect, so changing just for appearance's sake would be harmless.

A variation of the return to normalcy argument is that the massive money supply reserve created by Quantitative Easing is supposed to cause inflation sooner or later. That may be true, but I'd argue that the Fed's best action to prevent that would be to start to mop up some of that excess money. Back in the November 2010 newsletter (starting in the lower half of page 4) I described how that would work.

If the usual situation is like taking away the punch bowl, the mopping-up is like cleaning up a garage strewn with oily rags, rather than waiting for something to spontaneously ignite. That does sound prudent.

In any case, I don't thing the change or lack thereof will affect our economy, so in the long run it shouldn't affect our stock markets. The day of the announcement, the herds may stampede all over the place, but markets will return to normal pretty quickly.

So: don't worry about it, and **don't join any stampedes.**

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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