Capital Drain

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Before printing, think about the environment

Hi Readers,

First, I'm happy to say that the kittens were placed in a new home with bright, friendly, cat-savvy people. Live long and prosper, Kono and Puma.

I'm happy for them, but still it's sad to not have their company in the office. Today during a writing break I'll vacuum up the scattered bits of kitty litter and scraps of feathers from enthusiastically shredded toys.

The big world was not as cute & cuddly. In my opinion:

Executive Summary:

- The world is confusing (more than usual):
  - Brazil disorganization, Turkey meltdown
  - UK and EU, anything is possible
  - China, Russia slowing and aging
- Our economy continues OK
- Donald Trump: a scary joker in the deck
- Where to invest: avoid risks.
- Economics: what is interest, anyway?
- It's Credit Report time again! This time, TransUnion.

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

Models of dynamic systems are at their best when they're describing events in the normal behavior range of those systems. Once some parts of the system depart to places beyond where you've seen them before, then the model predicting the behavior of the other parts becomes more like a guideline, and one needs to be wary of surprises.

That is true of physical machines, and far more true of the fuzzy mental models we use to guide investments.

Looking around the world, **Brazil** claims a spot as "best of the bad". Sure, it has a disease epidemic, runaway debt, a government restructuring on the fly as more corrupt politicians fall from office, exports are way down, Ohh!, and Honey did I tell you? The whole world is coming over in a few days to do the Olympics.

Remarkably, Brazil will probably muddle through it all, and come out stronger.

Not so **Turkey**, sadly. It wasn't many years ago that I thought of Turkey as part of the second tier of "BRICS", the countries about to take off economically like costume-changed superheros. Unfortunately, political trouble will undo their progress; it certainly undoes any easy predictions. Condensing the story, an old ethnic insurgency, an old political rivalry, a clash between the public and government-favored businesses, and a half-baked coup have caused/allowed Prime Minister Erdoğan to purge the press and the government and dramatically take control. That's seldom a good sign.

They are a NATO ally, and had been sporadically on track to join the EU. Add the fact that Russia is a neighbor across the Black Sea, and ISIS is right next door. On the hopeful side, they are a big country and have many strengths. We'll see.

After the BrExit vote last month, the **EU** and the **UK** shared some ill-considered barbs and unfeasible proposals, are are now sitting looking at themselves and each other wondering how this happened and what they could possibly do to make it better. As I said, the EU's economy will be less affected, and (except for Greece) seems to be haltingly recovering.

Through the last 60 years **China** and **Russia** have sometimes seemed similar, and sometimes seemed very different. For now, similarities affect their investment (un-)attractiveness. They are both authoritarian governments, and in each the top leader is gathering more personal power than has been typical of recent predecessors. They are both suffering recessions or uncharacteristically poor growth because of decreased exports. Their economic policies are capricious and wealth is very unevenly distributed. And finally, less often remarked on, they're both facing declining populations because of an aging baby-boom generation and low birth rates for decades. It is hard to manage growth and shrinking at the same time.

The Asian Elephant, **India**, continues moving forward at its own measured pace. It's seldom grown as fast as the Asian Tigers did, but neither has it had the same sorts of stumbles. They are the bright spot and the easy prediction.

The **US** economy continues to do pretty well. Never as well as we'd like, but never as badly as we fear. It's been agonizingly slow sometimes, but the recovery from the banking crash (nearly a decade ago!) continues. It's been a weird recovery, though, which makes the future less clear.

Conservatives in Congress have prevented us from having the big infrastructure building and education programs which have boosted previous recoveries faster. Instead, the Federal Reserve has had to counter the inaction by flooding the banking system with cash, in the hope that someone will borrow more and invest to create jobs, etc. As I've described before, no business builds a factory first and then looks for customers, not even when it can borrow for negligible interest rates. Because the public didn't have money to spare, there was no need for new factories, so job-creating borrowing didn't happen.

Wall Street, on the other hand, can be their own customers when there's cheap money. They have been bidding up the price of stocks, especially tech startups, and forcing the interest rate on government and business bonds lower and lower. Something has to change, but it's hard to see what will go first.

Traditionally, bonds have been safest, but at negligible interest rates they're more risk than reward. They are losing value to inflation, and if interest rates pop up they'll see sharp price declines, causing principal losses for investors not holding to maturity. I don't think that's safe.

Nor do I think the tech stocks or even the overall stock markets are particularly safe. Prices are high. They could stay that way, but we have seen short bursts of fear-based selling.

I am sticking with the investments I've liked since late 2010: big healthy companies paying good dividend rates out of reliable earnings. It's been doing just fine, and it lets me relax when the fearful storms blow by.

Oh, and obviously **Donald Trump** as president would truly end the world as we've known it, in that he'd quickly disrupt a lot of government and social institutions that he clearly doesn't understand at all. The rest of our lives would be in the After Trump era, and we'd have misty happy memories of Before Trump. Clearly his millions of supporters don't understand the problem either. That points *ahem* to a need for more education spending. That's all I can say.

The global phenomenon of low, zero, and even negative interest rates makes this a good time for a review.

Economics: What is interest, anyway?

I remember way back in Kindergarten in thrifty New England, the school had a program for every student to open a bank savings account and bring regular little token deposits from home. I particularly remember the teacher solemnly intoning "when you put your money in the bank, it gets interest." I had never heard the financial definition of "interest", so I imagined that by the everyday definition he was saying that people would look at the money and want it or something. It didn't make sense to me.

Twenty-one years of formal education later, "interest" once again doesn't make sense.

At the most basic level, "interest" is a reward for delayed gratification. Would you like to eat this marshmallow I've set on the table, or would you be willing to leave it there until I come back in five minutes and add another to it? That's a choice between instant gratification versus an interest rate of 100% per 5 minutes. That scenario is a standard psychological test for kids. Some choose one, some choose the other.

Imagine whether it would work if the interest rate were zero, meaning that if you are disciplined and wait for the researcher's return, you get... nothing more.

The financial system takes that basic concept, and makes interest the price for renting money (which theorists define as a store of value across distance and time). Do you want to:

- Save up to go to Disneyland? The bank will pay you a little bit of rent for holding your money while you save. That's your reward for delaying your pleasure.
- Borrow and go to Disneyland? You will have to pay the bank rent for the money you borrow, in addition (obviously) to paying it back. You get the pleasure first, and afterwards pay extra for the privilege.
- Skip Disneyland and keep saving for college? You'll add a lot of money-rental income to your savings by waiting so long. (Don't overdo it and become a pleasure-less miser.)

Modern finance calls that the "time value of money". It's the temporal version of "a bird in the hand is worth two in the bush." Money now is (in normal times) inherently worth more than money in the future.

Finance builds on this in many ways, getting away from the idea of gratification, and more about renting money. Say you want to build a house and rent it out. If you can borrow the building money cheaply enough, you can pay the interest and principal off from the rent you get, and still have a profit for yourself. Thus, it becomes (in the common-person sense) investment, not just consumption. Financial theory sometimes muddles that distinction.

That investment equation can be done backwards to calculate how much a stock should be worth. Picture your house again: Add up all the rent payments you'll ever get, and that sum is the value to you of owning the house, right? Well, no. Remember that the rent you get 20 years from now isn't worth as much as the rent you will get in a few minutes. That decrease in the immediate value of long-from-now money (called "discounting") is the reason that even if your house will generate rent forever, the immediate value is finite. At some point (even if you could live to collect) money way way WAY in the future would be so delayed that it's essentially useless.

That concept is the basis for pricing the pay-off value on your mortgage if you sell your house, the price for leasing cars, and the price for stocks, bonds, and derivatives, and much more.

But if interest rates are zero in the financial world, it means that a dollar 100 years from now is the same value to you now as a dollar you can spend right now. That's nonsense.

They work their way back to sense by pointing out that people assume that rates will go back to positive values eventually, so discounting will work on long time scales.

By the way, financial accounting completely ignores inflation. That would be madness for you or me, but that's the way everyone's books are kept. Otherwise, it gets really complicated. Supposedly, the interest rate for borrowing will always include an allowance for inflation, because who would ever agree to get back less than they lent?

And yet you see that they're doing exactly that right now.

First of all, although the accounting ignores inflation, people do acknowledge it exists. They differentiate between the "nominal" interest rate, literally the rate that's named in the loan agreement, from the "real" rate that subtracts inflation, so the real rate is the actual increase in spendable value that you get back when you make a loan.

Right now, though, real rates are negative. In some countries, even the nominal rates for short loans are negative. How can that possibly be?

The answer is your mattress, and Apple's mattress, and Fort Knox.

Let me explain.

Let's say you have a dollar you don't want to spend now. If you just stuff it in your proverbial mattress, if there is any inflation you are forcing a negative interest rate on yourself. Your dollar becomes worth slightly less every day. We're OK with that generally, because maybe it's convenient to have the cash handy, or maybe we don't trust banks. Whatever. We do sometimes accept negative interest rates.

Let's say Apple has a trillion dollars they don't want to spend now. Not even Apple has a mattress that big. It's effectively not possible to save it the same way. For Apple, it's a real-world necessity to put it in a bank, even at zero nominal interest. Again recall, that means even at negative real post-inflation interest.

Putting it that way, if the bank demands a little payment as a condition for accepting and holding the cash at all, from Apple's perspective it's not a mind-blowing paradox anymore, it's just a little extra cost, a storage fee.

But couldn't Apple buy a trillion dollars worth of something much more valuable per weight and volume than bank notes, and store that at their Cupertino headquarters? Gold? Diamonds? SOMEthing?

Yes and no, and that brings us to Fort Knox. As you probably know, that's where the US stores most of the gold that it holds as financial reserves. So couldn't Apple do the same?

Forts are expensive to build, and expensive to run. One way or another you have to pay to have your now highly-concentrated wealth stored and guarded. That is, in effect, a negative real rate for holding that gold.

Just to close the circle, note that when you stuff cash in your personal mattress, you're either paying to insure it against fire or theft, or you're risking losing it all to fate. That too is, in effect, a negative real interest rate.

In a normal world, though, and in history until very recently, money does have time value, and interest rates are positive. Money is supposed to be valuable. That's the whole point.

While it's still pretty darned valuable to billions of individuals on the planet, who will quickly tell you that they don't have remotely enough of it, it is different for companies and the few individuals who have a lot of it.

Because of the world's central banks trying desperately to push money into the system to fund economic growth, the market price for renting money is at, near, or even below zero. In that sense, money is valueless unless you personally want to spend it on something. That is historically a very weird state.

Recall the basic idea of supply and demand. If people really want front-row concert seats, and obviously the supply is fixed, the price will rise. If a farmer brings hundreds of very ripe eat-it-now-or-never peaches to the market, and not enough people want a peach right that moment, the price will drop.

According to supply and demand, if there's a low or zero or negative price for renting money, there is too much money for the demand.

As I wrote last month, there is a growing recognition in policy-making circles that central banks can't solve the low-demand problem, and that governments, in our case conservatives in Congress, need to dump a bad theory that's caused a decade of bad results. If we can get back to fiscal stimulus, government spending to create demand, we can push the economy back toward normalcy. And hey, it would be nice if our bridges wouldn't fall down, too, and if more people got better educations.

As soon as the growth of demand really picks up, the central banks will have to drain all the excess money out of the system pretty quickly. Fortunately that can be done, as I called un-printing or Quantitative Tightening and described way back in the November 2010 newsletter, page 4.

This is important. It's **Credit Check** time again. I sincerely hope that my regular reminders and simplified instructions are helping you to check your credit report regularly.

With all the ID theft and fraud happening today, checking your Credit Report is a free way to assure that nothing is being done to you. Once per year per Credit Agency, you're allowed to get a free copy of your Credit Report, quickly, online. Do it now!

If you've been following along with my every-four-months (-ish) pace, you're ready to revisit TransUnion

I've taken notes from my own recent visit, so you can follow the instructions at www.longspliceinvest.com/CapDrain/TransUnion.pdf . I had no problems whatsoever.

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

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