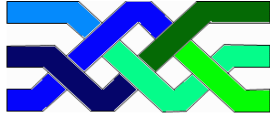


Capital Drain

Rick's investment opinion newsletter October, 2016 v.12 no.4

Before printing, think about the environment

Hi Readers,

Well, this is going to be interesting. In a week and a few days, we'll see the US election results.

I'll offer a quick summary for now, and then we'll all see what the future brings after the 8th.

So, get comfortable. In my opinion:

Executive Summary:

- Our economy continues to do well but not great.
- Unemployment is down, employment is up, and earnings are rising.
- Interest rates will rise. How bond funds will be different from bonds.
- The election, and its aftermath
  - Whatever happens, don't stampede.
- Credit Check: EQUIFAX

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:

The **economy this year has been improving steadily**. Jobs are being created, layoffs are rare, unemployment is falling, and average wages are finally rising a little. That's all good, it's necessary, but many are still disappointed.

First, obviously, many people who lost jobs (and houses) as long ago as 2008 are still feeling economic pain. The recovery has by no means been so strong that its returned people to the full financial health they had before the crash. People lost houses, cars, jobs obviously, and drew down their savings for a long while-- if the savings lasted that long.

Even when people are back to work, or back to jobs as good as they had before, it takes a long time to rebuild, and that's what people are doing. There are some economists who profess to be puzzled that consumer spending isn't picking up faster. After all, the big banks were all better (except for the fines they're still paying and whining about) more than half a decade ago.

The banks did get an effective bailout. The working class did not. Even when a job finally turns up, it takes a while to pay remaining debts, re-establish some basic home comforts, and re-build family rainy-day funds. In short, we'll have to keep going like this for a while before the lower middle class breaths a sigh of relief and starts spending freely again.

A big infrastructure-rebuilding program could speed that up a lot. Almost everyone in Congress agrees that our infrastructure needs work. Unfortunately, Republican obstruction has prevented any such bill from passing; they demand big cuts in social programs as a pre-condition. That would have been devastating for needy people post-crash, and it would even subtract from the benefit that re-building would create.

By the way, let's review how US Federal appropriations work. The president's administration, working with his or her party in congress (currently the minority Democrats), propose a budget with the programs they believe are needed. All spending bills have to come from the House of Representatives, and that has been the choke point. The majority Republicans deride and discard the administration's request, and do their own thing from scratch. They control the entire process, and can prevent bills they don't like from even coming up for discussion. They're not powerful enough to destroy Social Security or the Affordable Care Act (although they talk about it enough, and have tried dozens of times to kill the ACA) but they are more than powerful enough to see that nothing stimulative passes. So here we are.

Nonetheless, there has been a recovery. Company profits grew, and stocks rose strongly. This year has been disappointing, but stocks are about where they were a year ago, and well above the low they dove to during the winter, and far far above the post-crash low. Now it's probably time for stocks to pause until the economy really hums.

Part of the financial system's rescue was the Federal Reserve's unprecedented low interest rates, including never-before-done direct bond buying to extend the lower rates out to longer maturities. Almost all Treasury bonds now are paying less than the current (and expected) rate of inflation. Corporate bonds pay a little more, and risky corporate bonds pay another little bit more than that.

Rates will rise soon, quite likely starting this December. The Fed has been waiting eagerly to start getting back to normal, and now the conditions are good enough. Barring a fresh disaster, rates will rise, and will keep rising until they're back to a normal relationship to inflation.

The Fed Governors aren't crazy, though. They will certainly watch the economy, and not raise the rate so fast they would hurt our jobs and spending growth. The low rates haven't been doing much to help those anyway, but the Fed will be careful.

When interest rates rise, bond prices fall, by definition. If new bonds pay a higher rate, older bonds get marked down from face value enough so that the effective rate going forward is the same as the new bonds. Otherwise, who would buy them, right?

Many bond owners won't mind the lower prices. The classic example is life insurance companies. They know that in exchange for accepting premiums now, they'll be paying out benefits long from now. They can buy long-term bonds with the full expectations that they'll never sell them; they'll hold them to maturity when the borrower pays off the bond.

It's very different for bond buyers who intend to sell the bonds before maturity. They will suffer a real decrease in the value they'll get back, because they'll have to sell for less than the bond's face value.

Most of my readers don't buy bonds directly anyway, but (if at all) own them through **bond mutual funds**. Now the decreased prices matter, because bond funds are actively managed, buying and selling bonds based on market prices. Some of that selling will be at lower values, at losses. Those losses can decrease the return of the bond fund, or even make the fund lose money if the losses total more than the interest that was earned in the year. Even if you're planning to hold the fund forever, gains-- or losses-- are passed to the fund holders annually.

Investment markets run on many different heuristics, commonly called rules of thumb, guidelines that are almost always right, so people don't need to analyze more closely. One of those rules of thumb was that housing crashes are local, not national. Oops. That one tripped over a situation were it was no longer accurate enough.

The rule of thumb that concerns us now is that bonds are the safe, all-weather, buy-and-hold investment. That is not true when rates are rising, especially for people who are not holding the bonds to maturity.

Some of you can remember the great inflation of the 1970s, and the high interest rates that bond issuers (including the US Treasury) had to pay in order to borrow. Since then-- that was four decades ago-- interest rates have in general steadily fallen. All

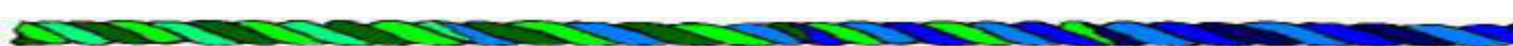
through that epoch, bond prices rose, they didn't fall for long. Only the oldest bond traders remember how much bond prices fell as rates were rising before the peak.

Forty years is more than long enough to get people to stop questioning the details behind a rule of thumb that's been working OK.

That's ending. In my opinion, **the time to hold bond funds is over for a while**. When rates have risen into the normal range, then they'll be OK again. For now though, money from those should go into a portfolio of selected dividend stocks, which are pretty darned stable, and pay better rates anyway. I'll make a new list for the next letter.

And now for the elephant in the room, so to speak, **the US election**. If Trump wins, perish the thought, the markets will plunge. If Clinton wins and Congress is solidly Democratic, stocks may drop from fear of "socialist" excess, but not as badly. It's not like Democrats are actually as dangerous as some campaign slogans or Faux News say. If it's Clinton and a solid Republican congress, it pretty much means more of the past six years, not horrible prospects, but not that good either. The sweet spot for the economy is Clinton and enough Democratic power to start getting stuff done by peeling centrists (admittedly a vanishing breed) out of the opposition. The market may still flail for a little while, but it would most likely be higher by year end, and the ends of a few years after that.

Whatever happens, don't join a stampede in any direction. Any stampede will both be too late for individual investors to join, and likely to overshoot and slowly recover anyway.



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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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