Capital Drain

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Hi Readers,

I'm still casting about for a new name for the newsletter, something a little less flippant without becoming truly boring.

What do you think of "Balanced Values"? I like the play on words, "balanced" and "value" being jargon for specific types of mutual funds, while "balanced values" tries to imply a search for a rational middle ground.

A close friend recommended that I pick a name that combines searching/discovery with synthesis, combining disparate ideas, and sharing/dissemination. Perhaps something like… I dunno. "Postcards from a Voyage to Wall Street"? "Lab notebook of a Financial engineer"? "Measure, Sift, Mix, Bake, and Serve"? There's got to be something more succinct.

I'm eager to hear any ideas that pop into your heads.

OK, saddle up & let's go. In my opinion:

Executive Summary:

Macroeconomics: This is how it starts. Inflation, once rumored to be dead, appears to be reviving. Protect yourself.

The Dollar: This inflation won't be good for the Dollar, and vice versa.

Social Security: The proposed reform is not at all what it claims to be. What happens when political dogma meets economic ignorance?

As before, I think everyone is best off with a broad diversification that includes at least 3/4 overseas assets, reflecting the distribution of world economic activity.

These are not the best of times, so investors need to 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 such as Google or Taser.

The Details:

"There is nothing more important than critical thinking, except perhaps good wine."
-- Robert A Collins, Professor at Santa Clara University Leavey School of Business

There's actually nothing so inherently awful about inflation. Does this sound absurd? No, seriously, there's nothing so inherently awful, *as long as everyone knows what that inflation will be, well in advance*.

Aye, there's the rub. Inflation does its considerable, familiar damage when it's not expected. If you buy a bond or sign a contract to receive fixed payments (labor, sales, rental, etc.) when inflation is low, and then inflation rises, you'll be hurt badly. You'll get the money you expected (measured in dollars), but it won't have the purchasing power you expected (measured in eggs or Escalades or expeditions to Ecuador).

In a slightly more subtle way, inflation is particularly damaging just when it starts to increase. People don't realize that it's increasing, so they misinterpret what they see happening in the economy. The worst of this is that businesses think, "Golly, I finally made that price rise stick; the economy must be improving, and I should invest in more productive capacity!" Tragically wrong. This is a big part of what fuels the business cycle of boom and bust— the economy was not improving, the new productive capacity is unneeded, and when inventory stacks up there will be decreased profits then layoffs then recession.

These past few years we've heard a lot about inflation's death, and even a little about the fear of incipient deflation. The Federal Reserve has kept interest rates very low, and the Administration has been able to lean on the rationalization that its budget deficits weren't hurting anything.

These past few months, we've seen the way it always starts. Producer prices edged up, then started rising consistently. Consumer prices started rising slowly, then these past few months accelerated.

The most recently announced core rate of inflation (excluding energy and food, as if you or I could exclude them from our expenses) was .4%. That looks tiny, but annualize it (add 1, raise to the twelfth power) and you've got 4.9%. I strongly suspect that none of you is earning 4.9% on your bond investments. In real terms, you're losing money to inflation.

So, to make a long story slightly shorter, what happens next? The Fed is running behind on raising interest rates, and will at some point have to raise them faster to catch up and get ahead of the inflation rate. Once they get ahead, the rising real (nominal minus inflation) rates will start to increase companies' costs. Between that and the inventory fake-out, the economy slows down, perhaps even shrinking. That soft landing or outright recession is bad for profits, bad for stocks, and bonds were already suffering because of the inflation. That is not a happy time to be an investor.

Those of you old enough to remember the inflation of the 1970s and early 80s will recall that rising inflation makes owning bonds and CDs a financial death trap, to be avoided.

Also, if you have an adjustable rate mortgage, seriously consider that your mortgage rate is likely to rise sharply. If you can, locking in the low rate now will save you some pain a few years hence. Paradoxically, borrowing at fixed rates now is particularly advantageous, as you'll be paying back the loan with future dollars which will have less value.

This is a good time to think about preservation of capital rather than big gains— avoid big losses. Your best bets from a limited set of options include inflation-protected bonds (TIPS, ideally in an IRA, 401 (k), or other tax-sheltered account), stocks of solid companies paying good dividends and— can you believe I got nearly to page 3 before chanting my mantra?— overseas assets.

The dollar. None of this is good for the dollar. The current negative real rates mean that investors, domestic or foreign, have no prospect of real gain from owning US bonds. The possibility of a recession means there might not be good gains from owning stocks. There are lots of good investments elsewhere in the world, so that's where smart people will invest. Foreign investors leaving dollar investments will help push the dollar down.

Further, a falling dollar exacerbates US inflation, as foreign-made goods become more expensive. The latest import price reports concur; it's happening. This is a vicious cycle, with inflation and dollar devaluation feeding one another. This cycle could run for quite a while, even decades, depending on how the Fed, the Government, and other trading-partner governments respond.

You, as US investors, can protect yourselves and profit by buying a diversified portfolio of overseas value stocks and top-quality bonds. This is a good time to be conservative, and to be global. US inflation needn't be global inflation. In fact, as the dollar falls, the rest of the world will benefit from falling prices of US-made goods (there are still plenty of those, contrary to much doom-mongering) and dollar-denominated commodities (such as oil.) The US experienced this same brake on local inflation during the 1990s when the dollar was rising and import prices were therefore falling; that will now run in reverse.

Incidentally, about one-third of economists in a recent Wall Street Journal poll predicted that China will begin appreciating the Yuan (allowing the dollar to depreciate) within the next three months. Another 1/3 think that will happen within six months. Fewer than a fifth think it won't happen at all. Nearly half think the dollar will have to fall by 30% or more to have the desired rebalancing effect.

On another topic, **Social Security** could certainly use some repair. It's long been known that this pay-as-you-go system would be stressed to pay for the retirement of the big Baby Boom generation. There have been a variety of reasonable suggestions for ways to deal with the stress.

There has also been the current Administration's suggestion. It is remarkably wrongheaded, and has been presented in a way that's remarkably misleading.

They have pushed for "accounts that belong to you, that the government can't mess with or take away." Accounts like that are a great idea, available to you now. It's called "saving." Everyone should do it, at least until they've put away enough for retirement.

That is NOT, emphatically NOT, what the Administration is offering in their so-called Social Security Reform Private Accounts.

It was my great pleasure recently to see Yale finance professor Robert Shiller speak at UC Berkeley's business school. He had taken the time to dissect the Private Account plan, and he presented it in summary. (A paper is now available from his website. To see the paper, you may need to set your browser to allow popups, and log in to the popup security window as user:guest, password:guest)

Social Security is an extremely popular program, because it provides a guaranteed floor under retirement income. It's a very low floor, but it's something.

To preserve that guaranteed floor, while offering the Private Account as a supposed way to earn more, the plan tries to use the same dollars two ways at once: funding a floor for existing retirees, and funding additional investments for future retirees.

In the fine print of the plan, the trick emerges: the money that you (if you're young enough) might be able to put into your Private Account is lent to you, from the portion of your payroll tax you would otherwise have paid to the "old" Social Security system. Lent to you— here's the surprise— at 3% real interest, i.e., 3% higher than the inflation rate!

That's a pretty high rate. At the moment, for example, it's 7.9% based on the latest monthly inflation. It is more than you can earn from any current Treasury bond, or even from any but the riskiest junk corporate bond. Thus, you must go to riskier investments to hope to gain anything. Stocks, for example, can get a better average return over very long periods, but cannot be depended on to do well in any short period. Meanwhile, once you opt in to the Private Accounts, you cannot opt back out. As you approach retirement, your choices are to risk losing money quickly via stock investments, or the guarantee of losing money slowly via bond investments. Because that loan rate is so high, it just does not make any sense.

If your Private Account does not earn more than that, enough to pay off the loan, then you gain nothing from the Private Account, and end up with less overall since you have to give up some of the old Social Security in order to get into the new Private Account.

If it passes, avoid the Private Account option. If you have a moment to spare, please write your Representative and Senators to ask them to send the plan back for re-design. Social Security is an important program, and deserves better than an ideological knee-jerk redesign.

Some other time & administration, it would be nice to make a sensible transition from a pay-as-you-go current-workers-support-current-retirees system into one where each worker substantially pays into his own fund, which compounds into a significant retirement nest egg.

The awkward part of the transition is that sooner or later, some generation, or short series of generations, will have to both pay for the existing retirees and start saving to pay for themselves. In retrospect, the late 80s and 90s when the Boomers were in their peak earning years and the economy was doing well would have been a good time, but that opportunity has, alas, passed. There's nothing wrong with the concept of shifting to a paid-ahead model, it's just necessarily trickier and costlier than the current Administration's proposal is acknowledging.

Meanwhile, remember: you can always save for your own benefit, and should.

It's time to wrap it and ship it.

If you have any questions, please please write or phone. If you want to read more, I've got a web site with old editions of this letter and some links to other interesting sites.

Please feel free to forward this to any friends or associates who may be interested.

For those of you getting this sample gratis, I charge $120/year for this newsletter. If you're not sure you like it, you could subscribe for 3 months for $40. Your checks, mailed to the address below, are always welcome, will be appreciated, and can be claimed as a tax deduction as an investment expense.

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
