Capital Drain

Rick's investment opinion newsletter July/August, 2005 v.1 no.7

Hi Readers,

I've often been amused by newsletter writers who start with a summary of their current computing disasters coinciding with a busy travel schedule. Ha! Now it's my turn. My old, still-primary computer declined to wake up from a nap yesterday, so I'm having to get this written with the info that was stashed on the other computers. To keep the tension high, I just last week finished classes for the summer, and tomorrow I will fly away on a lovely trip to Colorado. Does this mean I'm a real Newsletter Writer now?

Taking a page from the Car Talk portion of NPR's pledge drives, I would like to offer you all a PIP-- a Pathetically Insignificant Prize-- to anyone who helps me pick a new name for the newsletter:

To anyone who offers one or more suggestions that I consider interesting, I offer a free 1-month renewal.
To anyone who offers an idea I consider perfect (i.e., I use it), I'll give a free 3-month renewal.
Decisions of the Judges are Final.

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

Executive Summary:

The Dollar has resumed its fall. The media trumpeted China's revaluation, but missed the concurrent recycling.

Is the US economy doing great? It depends on who you are; it's much more great for a few than for most.

Is it the financial equivalent of the Atkins Diet, so good it sounds as if it can't be true? 'Save More Tomorrow" is a plan that works.

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, Google, (did I mention Google?) or Taser.

Sure, Google is doing great. So was Pets.com once upon a time. Google's a pretty good company, but at the current price you could only buy based on the Greater Fool Theory: "Sure, I paid too much, but I'll find a Greater Fool to whom I can sell it for even more!"

The Details:

"The real trouble with this world of ours is not that it is an unreasonable world,
nor even that it is a reasonable one.
The commonest kind of trouble is that it is nearly reasonable, but not quite.
Life is not an illogicality, yet it is a trap for logicians.
It looks just a little more mathematical and regular than it is;
its exactitude is obvious; but its inexactitude is hidden; its wildness lies in wait."

-G. K. Chesterton

So, they finally did it. China let the Yuan peg loose, if only a little, allowing the **Dollar** to fall. As I wrote a few weeks ago, the importance of this change is not the token 2% revaluation at the time of the announcement. Rather, the important thing is that the new system allows for the exchange rate to continue changing in the future without any further big drama, only the daily decisions of “managed float.”

The Yuan can now float gracefully up against the Dollar, responding to market forces, but under the watchful eye of the Chinese authorities. If they think it’s floated too far or too fast, they reserve the right to intervene, temporarily forcing a “peg lite.” Thus far, they haven’t needed to, and may never need to; the explicit right to step in may be enough to ease the government’s fears.

Meanwhile, other Asian currencies, whose governments have been trying to hold a de-facto peg to the Yuan, now feel some breathing room to intervene less, and let their currencies appreciate relative to the Dollar as well.

All this means that the valve is open, allowing the levels of the Dollar and the Yuan to find a happier equilibrium. The fall of the Dollar has resumed, this time against all major currencies, not just against the already-free-trading Euro.

The other thing China has been doing conspicuously but not explicitly has been to recycle their massive and still growing stash of Dollars into something valuable. As I described in [numbing?] detail a few months ago, they’ve been piling up a huge hoard of Treasury Bonds, for lack of a better option. They had excess cash dollars from their sales to the US, and they had to buy something. US Bonds seemed a safe bet. As I also explained, if the Dollar is going to depreciate, those Bonds aren’t a safe bet at all; they’ll lose real spending power from the overseas perspective.

What the Chinese have been doing is turning up the pace of purchases of real assets with the excess Dollars. If they can turn some of those excess Dollars into ownership of, for example, Unocal, then the devaluation won’t hurt; they’ll still own an oil company.

For political theatrical reasons, the Unocal purchase was obstructed by Congress et al., but the concept remains valid. The Chinese now have to balance between a) trying to not buy anything too noteworthy, like Unocal, b) trying not to overpay too much, as the Japanese did in the 1980s, c) trying nonetheless to find $200 billion worth of stuff to put in the shopping cart (that’s a lot; Unocal was “only” $1.8 billion), and d) having to hurry a bit to turn dollars into Stuff before dollars turn into dimes.

The Bush administration has made much recently of the rising GDP, the rising number of jobs, and other positive economic reports. Are **macroeconomic** things actually good? Well,
a) it depends how you measure, and
b) it depends who you are.

A good economy-- compared to what?

Compared to last month or last year, this economy and job market are gaining strength nicely. For people with short (or no) memories, that's the whole answer.

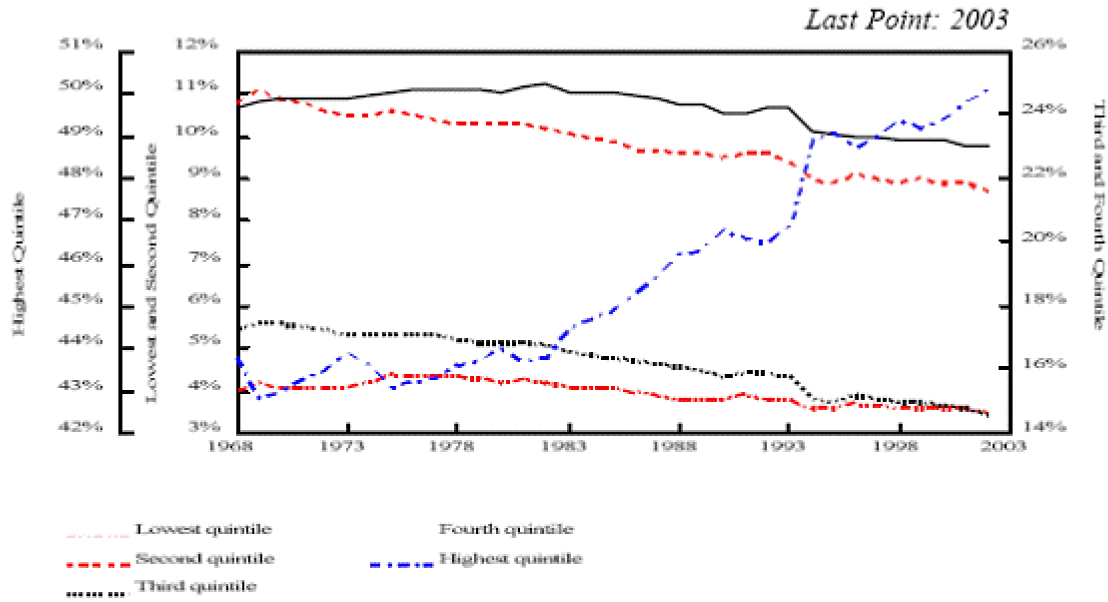
Compared to the average recovery from a recession, this economy is weak, anaemic, jobless, disappointing-- in short, no, not so good.

Join with the cheerleaders: "Hey! It's better than a recession, right?"

Maybe not. For a huge swath of America's workers, the answer is that it is still a recession, or looks just like one...

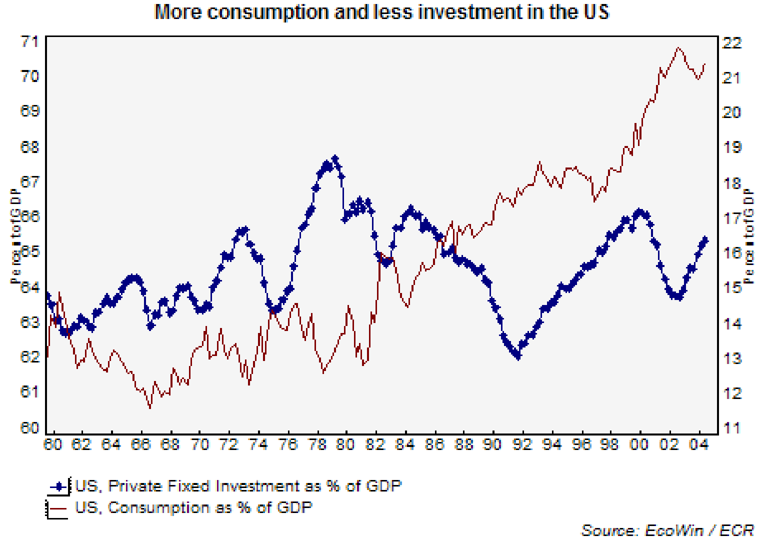
If you're rich (as is almost everyone the President has ever met), then the answer is yes, things are fabulous.

Shares of Aggregate Income
by income quintile



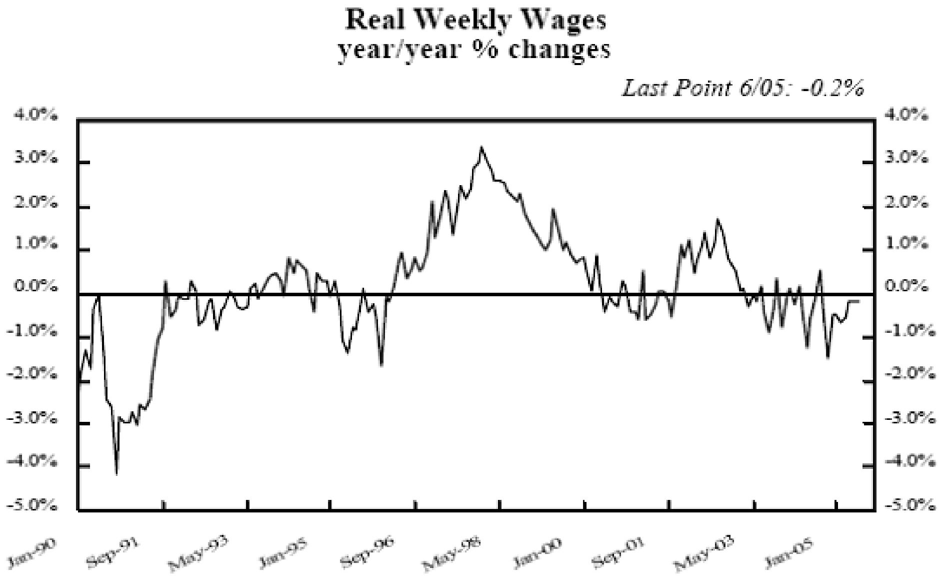
Jeepers, Mr. President, it looks like rich people are doing great and poor people are doing worse than ever! But weren't your tax cuts (predominantly for the rich) supposed to create lots of investment and jobs for the workers (the poor)?

More consumption and less investment in the US



Oh. As it happened, the rich knew perfectly well that the problem in the recession was that there had been too much investment, not too little. Of course they didn't invest their tax gain. It would have been dumb.

And thus, the worker was left with little prospect of more or better jobs. Real (inflation-adjusted) wages have actually fallen for years.



Source: Bureau of Labor Statistics

Partly, that has been because of Globalization, and the inevitable-- really, it's *not* avoidable-- inclusion of billions of Asian workers in the global labor force.

Still, if I were, hypothetically, a head of the US government, I might pick a different approach to the problem than has been taken. It would be better for the country and the economy to concentrate on policies that genuinely improve the economy and the economic health of the American working class.

It's not news, not even to academics, that humans sometimes lack the willpower to do what they know they ought to do. That's right at the heart of the issue of Americans, on average, saving far too little for their retirement. The question for Finance academics is, "How can you work around human nature?"

One idea that's been contributed by the **Behavioral Finance** crowd is called "Save More Tomorrow" (SMT).

The usual routine runs: "I promise that I'll save more. And floss my teeth. And wax the car. And lose that belly-jelly roll. And…" And, of course, none of that resolve lasts more than a few minutes or the first temptation, whichever comes first.

The SMT trick is simple: you won't miss what you never knew you had. When you get your next raise, or bonus, or promotion, set up your automatic deposit so that half of that new money goes to your savings. You still get to enjoy the other half! Instead of taking something away from yourself, it's sooo much easier to just hide it from yourself.

The SMT trick also helps you keep your lifestyle in check. With every pay raise you get to live a little better… but you also save a little more. You rescue yourself from allowing your lifestyle to expand to fill the entire income.

> [Note: I know my current readers aren't in the danger group, but if this letter finds its way to someone who lives beyond his/her income via credit cards or home equity loans: buddy, you've got a serious problem. This letter is about investment and can't help you at all. Find a credit counselor, ASAP.]

Obviously, this trick only makes a significant contribution to your saving if you start when you're relatively young. That's just an inevitable nuisance of the retirement-saving game: it has to be done over most or all of your working career, accelerating as you cruise through your prime earning years (typically 40-60).

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
