# Capital Drain

Rick's investment opinion newsletter March, 2006 v.2 no.2

Hi Readers,

I'm still looking for a name, but mostly I'm still finishing school. I'm about to start my final quarter, which includes a very demanding class with a big group project. I expect to be pretty busy, but I also expect to have time for this and other future-oriented investment projects.

June. Graduation. The future awaits.

OK, let's get to it. In my opinion:

## Executive Summary:

Gold is on a tear, and the Dollar is slip-sliding away.

Stocks had a surprisingly good quarter, but there's little reason to expect that to continue. The bulk of the good news is already old news.

Inflation keeps rising. That's not good news.

Interest rates are rising. That's good or bad, depending on what you do about it. Choose "good."

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, Whole Foods, 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:

Last month I mentioned that the price of gold had settled down a little from its recent high, so it might start rising again. Not in my wildest dreams did I imagine the rise it has since had. Why does this matter? I'll answer that in the final paragraph.

The world has absorbed its fill, or more, of excess Dollar IOUs, a.k.a. Treasury Bonds. We've bought tons of stuff with dollars, and sold far less abroad. Even more dramatically, the Federal Government continues to accelerate the widening of the deficit, the flood of new borrowing.

What do you do if you have too much of something, and someone is trying to get you to buy more? Well, you could demand to pay a lower price. You could even sell some of your excess rather than buying more. That's what our major trading partners are doing. As much as they like selling stuff to us, they have more dollars saved up than they no what to do with. So, they lower the price they'll pay for a dollar; that is, they raise the dollar price for their goods or their currency. The value of the dollar is falling everywhere now, not quickly, but steadily. The fall is likely to continue.

But what does that have to do with the price of eggs in Chicago? Next to nothing, now. Domestic goods purchased with dollars won't change much immediately. It has everything, however, to do with the price of our imports. We import so much stuff, when those prices rise our entire average price level rises. That's especially true of the rise in the price of oil. Obviously, gas costs more. In the longer run, the price of every good and service that uses oil (i.e., almost everything) will rise, too. US food production, by the way, is highly mechanized and uses a lot of oil. Eventually, the increased prices of imports affect everything.

Three paragraphs ago I was talking about foreign exchange, but the train of though ended in inflation. Inflation is rising. Those of you who remember the inflation of the 70s and 80s probably cringe when you hear that. Do you recall what worked back then? That was the era that brought Money Market mutual funds to prominence. Short-term rates were able to keep up with inflation, even as long-term bonds suffered devastating losses.

And then there are stocks. Stocks prices tend to reflect people's expectations about the future of the economy, or more specifically the future of corporate profits. The economy is still doing pretty well, but the easy days of dramatically increased profitability are passing behind us. We're now in the steady state of a relatively mature expansion. If analysts are projecting that profits will continue to rise as fast as they did as we did in the early recovery part of the expansion, then they're likely to be disappointed. A disappointed stock market is a falling stock market.

What everything so far adds up to is:

- This is not a good time to have too much of your money in dollar assets.

- This is not a good time to have your money in long-term bonds.
- This is not a good time to have too much of your money in stocks.

Sheesh, is anything left? Well, yes.

- There are mutual funds that make it easy to buy overseas stocks and bonds. The recovery is less mature in many overseas regions, and interest rates are unlikely to rise as much.
- There are money-market and ultra-short bond funds in the US, currently yielding about 4-5%. That may not seem like earning much, but it's better than losing a lot.

And gold? Well, it is really volatile, and most people wouldn't sleep well watching the roller-coaster ride even when the trend is solidly up. Even if you don't buy gold or gold-mining shares, though, there's information here:

Gold is priced on a world market, so its dollar price rises if the dollar falls. US investors, including the thoughtful fraction of the professionals, are also looking at the disappointing prospects for US stocks, bonds, and currency. Many of them are buying some gold or miners as a way to be effectively out of stocks and out of the dollar.

The world prices of all manner of raw materials are rising as world consumption rises. Gold is no exception. A definition of inflation is that the money price of stuff rises. As with the inflationary 70s-80s, owning real stuff, including perhaps high-value metals, can be more rewarding than owning money.

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That's it for now.

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.

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Take care,

Rick

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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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A collection of fine industrial Boilerplate, but true:

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