Capital Drain

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Hi Readers,

I've had a rather enjoyable summer break, combined with a sometimes unhurried beginning to my mutual fund project. The coding is going well.

I'm still looking for a name. Perhaps some weekend after Labor Day I'll get a bunch of friends together in a cottage by the beach and sip wine while we brainstorm names and marketing stuff. Beats working. Let me know if you're interested in participating.

OK, on to investing. In my opinion:

Executive Summary:

It's a nuisance to do, but important: check your credit report! The ID Theft people get cleverer and more audacious daily.

- **We're still headed toward a likely case of a mild stagflation.**
- **Mild though it may be, the stock market isn't going to like it one bit.**
- **It's quite possible that the bond market won't like it either.**
- **The overseas stock markets will, at least for a while, like it even less.**

As before, I think everyone is best off with a **broad diversification** that includes at least **3/4 overseas** assets (easily purchased via US mutual funds), 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.

The Details:

You really ought to check your **credit report. It's free**, once per year per credit agency, to get a copy of your report. Since there are three agencies, that means that you can go to one agency every four months.

This month I'll go through the **step-by-step instructions to visit Equifax**.

- Go to https://www.annualcreditreport.com
- Where it says "Start here," select your state and press "Request Report"
- Fill out the online secure (https) form, then click Next
- Select Equifax, the click Next
- click Next again
- Now at the Equifax site, confirm the info shown and click "Continue"
- Answer their security questions (usually asking you to confirm that you know some info about one of your accounts) then click "Continue"
- Click "No thanks, I don't want my FICO score." It costs $8 if you do want it. What we're getting is the free report.
- Now on Equifax Step 2 of 3, click "Submit"
- Now on Equifax Step 3 of 3,
    - make a note of the transaction code, **FACTnnnnnnnn** where n is a digit. You can use this to review the report anytime in the next 30 days.
    - halfway down the page where it says "Product," click "view my product"
    - You should also get an email from them, with a link to view this report.
- Read through the report for anything suspicious. You don't need to be sure it's up to date, or that the outstanding balances are precisely correct; just be sure there are no accounts you never had, no unpaid balances you know you paid, etc.
- Save a copy so you can compare it from year to year.

DO try this at home! (NOW) It takes less time to do than it took me to write this.

About the economy:

The pundits all breathed a sigh of relief when the Federal Reserve decided not to raise interest rates another quarter point. "Look," they said, "the economy is already slowing, there's no need for higher rates!"

Well, yes, and no.

The Fed's main job is actually to protect the currency from inflation; keeping the economy running smoothly is only a secondary and at times contradictory goal. Sometimes the commentator hype and the political pressures completely lose track of this order of priorities.

Inflation is currently at least 3% per year, depending on how you define and measure it. This well above the Fed Chairman's stated "comfort zone" of 1-2%. Even the "core" inflation which ignores the energy and food costs (as if you or I could ignore them) is at least 2.5% over the past year. That's not good, and it implies that the Fed may still need to raise rates some more to force the inflation rate back down to its proper low range.

The traditional argument is that a slowing economy is *per se* an indication that inflation will fall. That's just not true, as anyone who experienced or studied the 1970s can attest. Very low economic growth and high inflation can definitely happen together, and may be happening again now. Mercifully, the mess is not yet as bad as 1970s levels.

None the less, the message is that inflation may not be contained yet and interest rates may yet be raised again.

There are two lines of investment message from this:

1) Notice how everyone suddenly agrees that the economy is slowing. For half a year the bullish pundits have denied that it could happen, even as indicator after indicator started to show that it was likely to happen (the leading indicators last peaked in early 2004 and are now falling fast again) or was starting to happen (the coincident indicators, i.e., the current rate of growth, have been falling since early this year. http://www.martincapital.com/chart-pgs/CH_cbind.HTM)

Also, the interest rate yield-curve inversion that I mentioned last December and again in February has continued and deepened. The longer and deeper the inversion, the more likely a recession becomes.

Now the economic slowdown is too obvious for even the perma-bull cheerleaders to ignore.

This is important:

- A slowing economy is likely to mean decreasing profits, or even losses (think Ford or GM.) The stock market is unlikely to continue its equanimity in the face of this decline. This would be a REALLY GOOD time to take some of your profits in stocks. Take a lot. Take enough unrealized losses, too, if you have them, to decrease your tax bite. Move the money to relatively short-term treasury bond funds or money market funds.
- If it makes you feel better, think of the stock sales as prudent re-balancing to keep a conservatively high proportion of your assets in bonds.
- When the rest of the world realizes that their biggest customer, us the US, is buying less stuff, they will quickly see that our economic downturn is also their economic downturn. I think overseas stocks will fall, too, but sometime after the US stocks start falling. With a bit less urgency then, take some profits in your overseas stock fund holdings. A good overseas short-term high-quality bond fund to switch to is PSAFX, The Prudent Global Income Fund.
- Domestically or overseas, I emphasize short-term bonds because it's not completely clear what will happen as various central banks continue to raise short-term rates. Overseas, long-term bond yields are rising, causing prices to

fall, causing capital losses. Domestically, long-term yields have fallen, but they could yet rise if the bond market becomes really scared that inflation will take hold long-term.

- **In summary, sell stocks, buy short bonds, or even money-market funds.**
- As ever but more so, the dollar is likely to fall, so overseas investments get a boost.

That's all I have to say today. I hope it helped someone.

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 who may be interested.

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
