Capital Drain

Rick's investment opinion newsletter May, 2007 v.3 no.5

Hi Readers,

It's been a busy month here on the waterfront, and a busy month out in the big world, too.

I've been plugging away at my fund project, making pretty good progress.

The world, or more precisely the US capital markets, have been making pretty good progress toward a Wiley Coyote moment-- chasing the elusive Roadrunner, the coyote has run off a cliff, but having not yet realized what he'd done, he had not yet started to fall. When realization comes, down he plunges. OK, the US market probably won't plunge, but that's the extent of the good news.

OK, ready to run? In my opinion:

Executive Summary:

Housing is still falling and will for a while.
The dollar is still falling and will for a while.
Recent stock-index records make no sense to me.
To the extent that you want to hold some US stocks,
look for US stocks with strong overseas sales.

As I've written 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 and Exchange Traded Funds (ETFs)), reflecting the distribution of world economic activity.

This is a good time for investors to be conservative, 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 with high P/E ratios.

The Details:

I don't watch TV much, so it makes an impression on me when I do see a show.

At the gym, not only are there TVs in the cardio room (the bicycles, treadmills, Stairmasters, etc. Understandable to have TVs there, it's boring on those machines) but there's also one in the locker room. There in the locker room, I can hear the sound. At lunch time, it's usually tuned to CNBC, and some of the commentators give me a second cardio-vascular workout.

How do some of these people manage to keep coming on the tube as guest 'analysts,' saying the same old stuff and so often being wrong? OK, they're entertaining personalities, but isn't anyone tracking what they say to see if it's good analysis? No, because that's not really their job; they're entertaining.

Most of them say the usual conventional stuff, and if anyone did challenge their predictive record they'd likely say "everyone else [all the other conventional voices] was wrong too!" Well, yes, yes they were.

Most of them do at least modify their pitch when events have proved them wrong, but they don't modify the biases that made them wrong in the first place.

I've been saying for ages (since the Feb. 2006 letter, at least) that the housing market was in for a correction. It's definitely correcting now, and even the TV talking heads see and say that. They, however, think the worst is past, that recovery will come quickly. I think housing will continue falling for a while, either a slow bleed for a year or a sharp drop if everyone decides "I want to get this house sold before the summer ends."

Fewer houses will get built, fewer new appliances will be bought, fewer kitchens will be remodeled, far fewer cash-out refinancings will be done, and the net effect is a big drag on the growth of the economy. Decreases in any segment ripple outward, reducing demand elsewhere, in a negative-feedback cycle until a new, lower, economic equilibrium is reached.

With a barely-growing US economy, one would think that inflation would be falling, wouldn't one? But it's not. Within the usual month-to-month noise, the inflation that the Federal Reserve watches is staying uncomfortably high, and has been too high for two years (see the May 2005 letter.) The Fed is NOT going to lower interest rates any time soon, because they're not at all convinced inflation is going to fade away. Lower rates are not going to ride to the rescue of the housing market or the overall economy.

In fact, long-term rates (which determine mortgage rates) have been rising. Compared to the inverted yield curve that I've discussed starting about a year ago February, the curve is approaching flat again, as it was in December 2005.

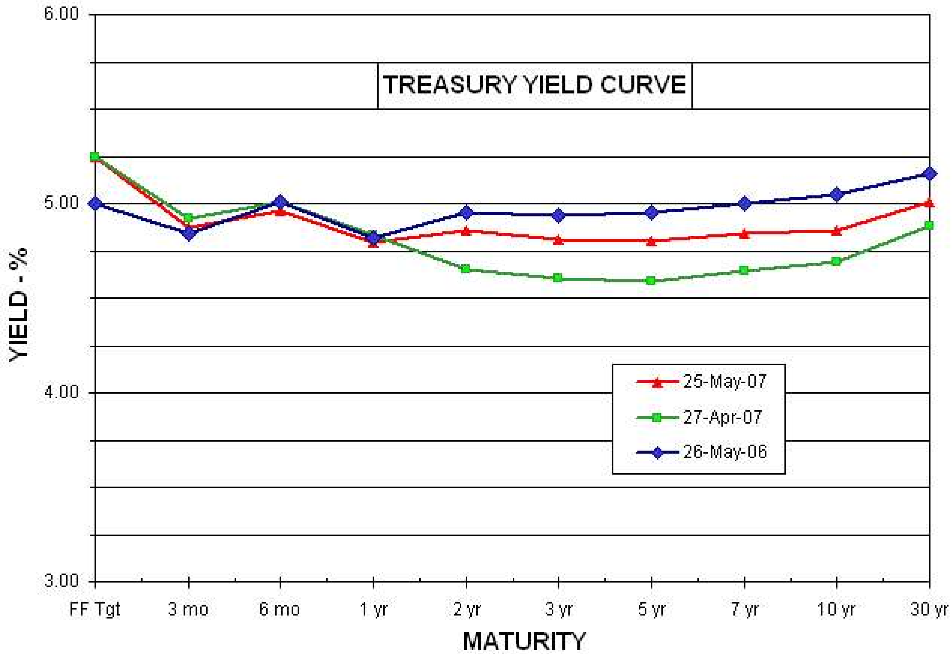

Chart courtesy of Martin Capital Advisors, LLP, www.martincapital.com

Oh, and the dollar continues falling, an average of 6% per year over the past five years. Since we import so much, that falling dollar will surely start to show up in higher costs for all imports (not just oil), which will further exacerbate both rising inflation (highly likely) and falling GDP (merely likely.) I first discussed the effects of the falling dollar in my first letter, December 2004, but it has been ongoing since January of 2002.

Why all these references to older newsletters? Because the current macroeconomic problems have been a long time coming, and they will likely be a long time going.

The question for this moment is, "What to do about it?"

The recent run of US stock-index record high closes makes no sense to me. Sure, I understand, earnings have been good. The stock market is supposed to look forward, though, not back at recent accomplishments. Also, the private-equity leveraged buy-out frenzy has raised people's expectations of what their companies could be worth in a buyout.

It all looks to me too much like 2000, but not concentrated in a single industry. Maybe it's only like 1999, and has some room left to run. I don't feel like being the last one standing when the music stops, so I'm sticking to more conservative investments.

I say more conservative, because they are investments which I think are much more likely to conserve my capital if the housing/inflation/slowdown/dollar mess takes the enthusiasm out of the stock market. To other people, like the folks at CNBC, my recommendations are not conservative but heretical or radical because they are unconventional. Oh, well.

As so often before, I suggest that you put a large fraction, ideally more than half, of your stock and bond investments in the stocks and bonds of the major economic powers (not the flashy upstarts) of Europe and Australasia. Remember that figure of the dollar falling 6% per year on average? To the holder of an overseas investment, that's a 6% annual return ***just from the currency adjustment***, without even considering the good economic performance of those regions and those securities markets.

If you're wavering about putting too much of your money "over there," here's a half-measure to consider: look for the big strong US companies that have the majority of their sales overseas. Again, there's the currency benefit: the dollar's fall alone has raised those companies' overseas profits 6% per year (a very loose broad average now) before even considering the companies' overseas successes.

A falling dollar is a run-away benefit to these companies. To the extent that their costs are incurred here in dollars, their costs translated abroad are falling, making their products more competitive. Sales rise, profits rise. Then every bit of profit gets magnified when it's converted back to dollars.

As a very general rule of thumb, the large capitalization companies are the ones with high overseas sales. Just for example, off the top of my head: GE, the major drug companies, Caterpillar, IBM, Proctor & Gamble, and so on. Of those, some are probably overpriced, but some could be attractive based on their overseas exposure.

It used to be said that "When the US economy sneezes, the world catches a cold." I think those days are ending. At the moment, among the traditional economic powers Europe and Japan enjoy higher GDP growth rates than the US does. Some of the high-growth countries like Brazil, India, Korea, Taiwan, etc., have established enough of a middle class that their own domestic demand can keep their industries busy even if their exports to the US falter. China is probably in that group, but they are awfully dependent on us for final demand. Mexico is definitely dependent on US demand, so our recessions will be their recessions for some years to come.

Yesterday's big drop in the Shanghai market, by the way, is not significant for US investors. When they had the previous drop a few months ago, it spooked people around the world, but now that everyone has had time to think about it, reactions will be calmer. The Shanghai market is meaningful for China, but not for the rest of the world.

That said, I think the US may soon end its string of record market highs, but for its own reasons. The factors that will harm the US economy are essential domestic (nothing is more domestic than housing!) and the harm to most of the rest of the world will be (perhaps after a few wild trading days) slight.

It's time to hit "send."

If you have any questions, please write or phone. If you want to read more, I've got a web site (see URL below) with archived editions of this letter and some links to other interesting sites. There's also a weblog where I discuss the process and progress of starting the mutual fund.

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

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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