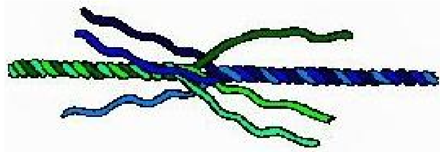
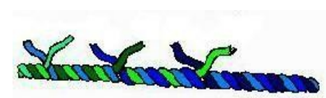


Capital Drain



Rick's investment opinion newsletter March, 2008 v.4 no.2

Before printing, think about the environment

Hi Readers,

It's too much of an understatement to say this has been a busy few weeks. For the markets, this has has been an historic few weeks.

Day by day I've been putting off sending this letter, thinking that I can include one more bit of current events. I don't think things will slow down, though, so I'm going to write this and send it, and I'll send updates if needed.

So, get comfortable. In my opinion:

Executive Summary:

- It's not the end of the world
- nor the bottom of the fall
- It can be dangerous to be too early: Peloton's tale
- Reflexivity: the Emperor's new clothes
- Rates are not the issue for the debt problems
- Rates are, however, the issue for the dollar and inflation
- leverage: the effect of losses on a bank or on a broker like Bear
- Holding European bonds, dumping gold

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:

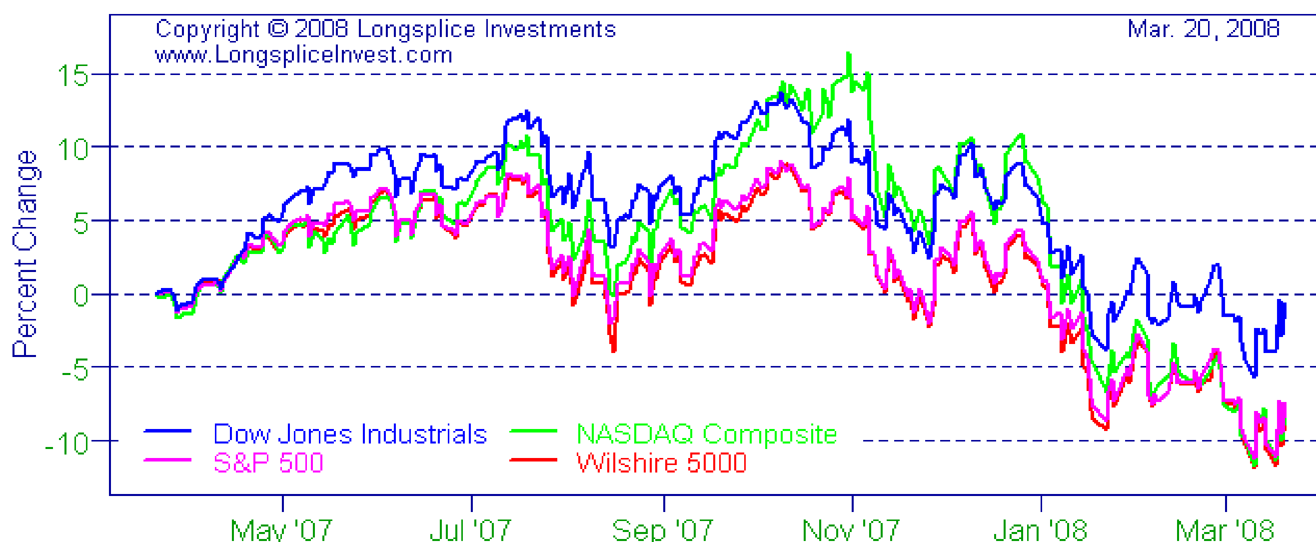
> In another sign of the times, Warren Buffett, who has long prophesied the dollar's decline, was at the center of a dollar kerfuffle recently when CNBC, the business network, quoted him as saying the dollar was destined to become "worthless." He quickly called the network to correct the report: What he'd actually said was that it would become "worth less." [1]

Lest we forget, just over a week ago doom was on everyone's lips. The stock market was falling, gold and oil were flying upwards, the dollar was plunging, and on and on.

At the time, I was going to write “Don't over-react. It's not the end of the world.” Regardless of the poor polices and resulting troubles, the country is, by world standards, richer than most Americans can imagine. Our various government institutions are strong and have stood through crises before. Some of the people in charge are pretty smart.

Then last Monday we learned that a $30 billion backup loan was not sufficient, and *poof* Bear Stearns, the country's fifth-largest brokerage, was gone. It was declared by its Board and top executives to be essentially worthless and subsumed into JPMorgan Chase bank.

So how does a rational stock market react to the sudden death of a major financial institution? It rallied.



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1 Craig Karmin and Joanna Slater, “Dollar's Dive Deepens as Oil Soars: Power of Greenback Faces Severe Test, But No Rivals Loom”, The Wall Street Journal, February 29, 2008, Dow Jones & Company, Feb 29, 2008 <http://online.wsj.com/article/SB120423483765800801.html?mod=hps_us_whats_news>

What are investors thinking? Perhaps that now that one company has died the others will all be safe? Or perhaps people think that the Federal Reserve's new activism will be expanded to rescue more companies, but next time well short of death.

By all accounts, if Bear had been allowed to simply fail, last week would have been a financial maelstrom that we'd have talked about for the rest of our lives.

Just as the previous week was not the end of the world, this past week's rally was certainly not the end of the crisis.

Mortgage holders are still defaulting, house prices falling, home builders stumbling toward their own bankruptcies, oil near all-time highs, dollar near post-war lows, inflation too high and rising-- you get the picture. There is plenty of trouble left with the potential to get worse, even if some areas are not as bad as the very worst fears.

There are some-- many-- who recommend buying back into the market now. After all, prices are down, and what could be the harm in buying back too early?

One word: “Peloton.” Peloton was a hedge fund, until recently. It actually did quite well for its investors last year: they saw the housing downturn and astutely shorted (bet against) homebuilder and mortgage-maker stocks, and returned, if I recall correctly, 83% last year.

If only they'd quit then. This year, they decided that the worst was over, and jumped in to buy the healthiest stocks from the sectors they had formerly shorted. They bought aggressively, borrowing a lot of money to increase their positions.

Sadly for them, those sectors still had bad news coming, often and regularly. By February, the value of the shares Peloton held was less than their outstanding debt. They were bankrupt. Their investors were wiped out. 100% loss. *poof*

Bear Stearn's investors fared just slightly better, taking a 98% loss in a year, but keeping the hope that their new (tiny) stake in JPMorgan can grow someday.

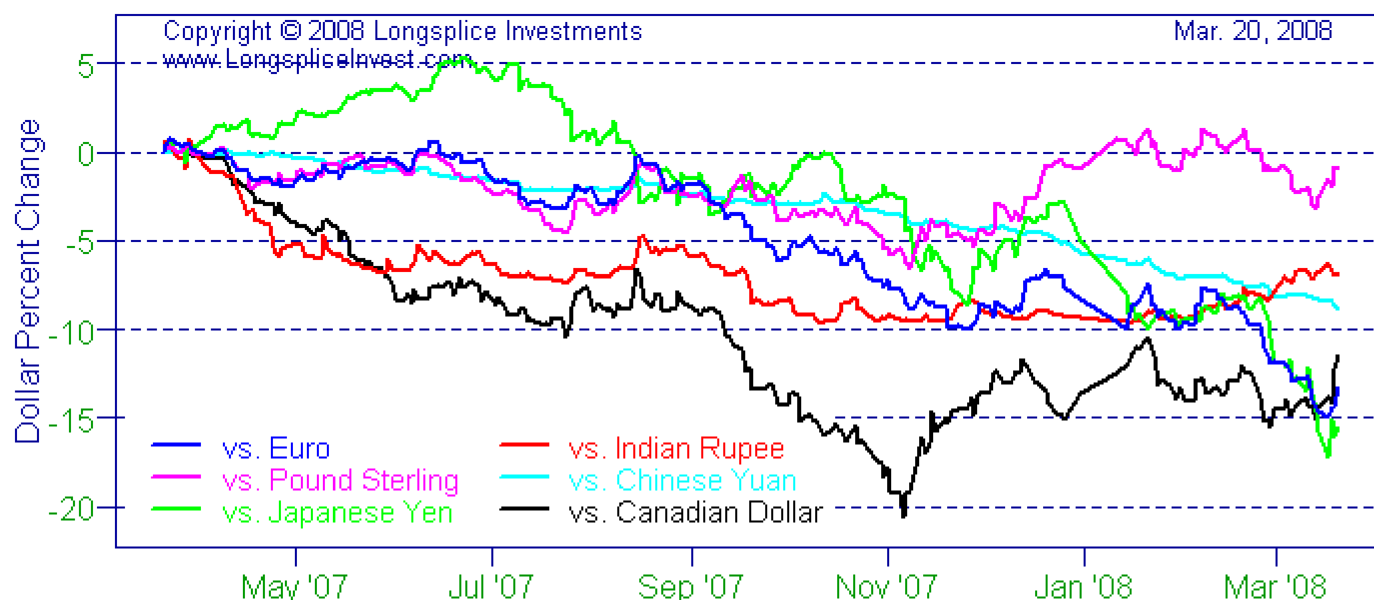
> "Boom-bust processes usually revolve around credit and always involve a bias or misconception. This is usually a failure to recognize a reflexive, circular connection between the willingness to lend and the value of the collateral. Ease of credit generates demand that pushes up the value of property, which in turn increases the amount of credit available."
>
> - George Soros, Financial Times, January 23, 2008

A counterpoint to the reflexive increase in perceptions and valuations comes when the values start to fall. Some of the same market commentators who pooh-poohed the idea that hype caused the boom are now arguing that negative talk is the primary cause of the bust. Seriously. It's as if they were claiming that “If that loudmouth kid would just shut up, then the Emperor would have his beautiful new clothes again!”

It's not just negative talk and misunderstood appearances. There really are some problems.

The Federal Reserve's most recent cut in interest rates is more of a psychological crutch than a real economic boost. The problem in the market recently was not that money was too expensive (rates too high) but rather than some debtors couldn't repay anywhere near what they owed, and many people and companies couldn't get a loan at any price. The Fed Funds rate is not the stumbling block for debt problems, nor is lowering it the solution.

What a lower Fed Funds rate will do, however, is drive down the dollar's exchange rate, and heat up inflation. Both have been happening already based on previous rate cuts, but they will continue.

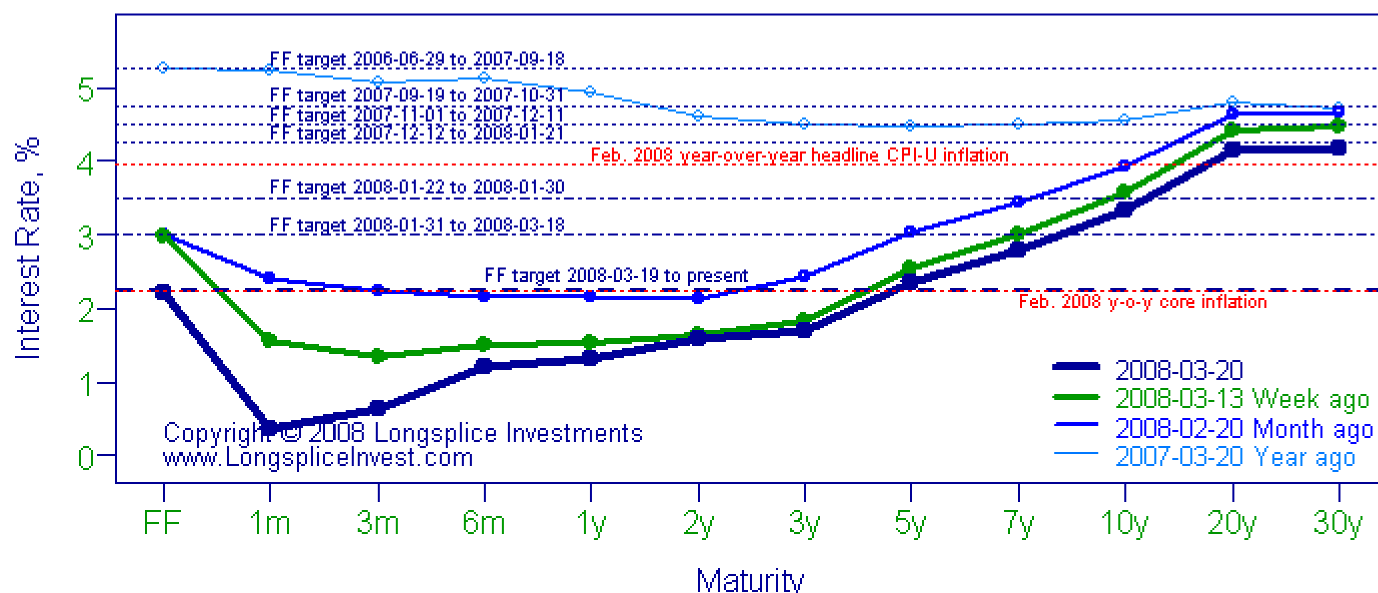


Notice above how the dollar value versus the Yuan just keeps sliding down (China controls the rate) but that versus the market-determined Yen and the Euro the dollar is still falling erratically too.

On the chart on the next page, notice that the current Fed Funds target rate is as low as the “core” CPI-U inflation over the past year.

After inflation, the short-term interest rate is zero percent. Treasury bond yields from 30 days out to five years are actually yielding less than the current “core” inflation. The real (“headline”) inflation, which includes all the things you and I actually have to buy, is higher than the rates being paid on Treasury bonds all the way out to the 20-year bond. On the one hand, that could mean that bond investors are sure

that inflation will fall. But if money is free (zero after inflation) now, why should inflation fall?



Perhaps the bond market is thinking that the coming recession will drive down inflation enough that they'll get a positive return on their bonds. So, a recession is now the *good* news.

> "...leverage proves to be as toxic on the way down as it was intoxicating on the way up." [2]

You may have wondered: just how does leverage (use of borrowed money) kill a bank, or a broker like Bear?

Very briefly: let's say you start a bank. You have $1 billion in startup equity, which is the effectively the money you show everyone to demonstrate that you can afford to slip up without hurting your customers or killing your bank.

Based on that strength, you're able to borrow $10 billion. For a bank, that could be deposits. For Bear, that could be bonds, or short-term loans similar to deposits. The key characteristic of deposits or short-term loans is that the money can be withdrawn quickly if the depositors get spooked.

The ratio of borrowed money to capital is the leverage. In this example it's 10:1.

The bank or broker makes a profit from this setup by lending $10 billion out for higher rates (to more or less risky customers) than it (the trusted institution) is paying.

Then one day, a rumor starts. True or not, someone says that your bank is losing Tons o' Bucks ™, and the public can see that the rumor *could* conceivably be true.

2 Caroline Baum, "John Galt Plan Might Save U.S. Financial System", Bloomberg, Mar. 10, 2008, Mar. 10, 2008, <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=avFnuh9oWHVo>

Rational customers that your depositors are, they start pulling out their deposits (or not renewing their short-term loans) just to be safe. That's a run on the bank (or bank-like broker.)

There are $10 billion of depositors out there, but you're only holding $1 billion in cash, your initial capital. You can pay out what you have, and hope the run on the bank stops, while frantically trying to get money back from your borrowers and looking for other sources of deposits or loans for you.

If you run out of cash to give back to depositors, *poof*, you're an ex-bank. It can happen fast. Ask Bear Stearns.

Now this is a known problem, so the Federal Reserve Banks were set up years ago to provide emergency loans to banks. But only to real, regulated, public-deposit-taking banks. The problem today is that many of the big lending institutions aren't really banks; they're brokers like Bear, or mortgage lenders like Countrywide. They can not borrow from the Fed as simply as a bank (JPMorgan or BofA, for example) can. Thus when the pseudo-banks get in serious trouble, the situation can be de-fused by having a real bank take them over. That's happened.

Another danger point in the system comes if the relatively risky borrowers get in trouble and can't pay back the bank. In the previous example, if the bank lent $0.1 billion to Joe's Used Condos, which defaults, then what happens? The bank still owes its depositors $10 billion, but it now has to recognize that the most it will get paid back on its loans is $9.9 billion. The bank makes up the difference from its capital, so that's now reduced to $0.9 billion. If the bank wants to restore the 10:1 leverage that they had before, they need to a) find a source of $0.1 billion of new capital, or b) decrease their outstanding loans to $9 billion.

If new capital is scarce (as now) then they'll be squeezing their borrowers (as now) and will not be making new loans (as now.) In total, that initial $0.1 billion loss becomes $1 billion less credit that they want to extend to borrowers.

That crimps the economy, which pressures some companies, some of which default on loans, and the vicious circle is closed.

So, what do we, as investors, want to do about this? As I wrote in January, bonds of blue-chip European and Asian companies and big healthy countries give you the best chance of some gains, avoiding the falling dollar, and minimum likelihood of defaults. You can buy them easily via ETFs and mutual funds. I particularly like the ETF called BWX, and the mutual fund PFBDX.

Several times in the past few years I've spoken highly of owning gold (via GLD or BGEIX) as a way to escape the dollar. That's been especially profitable from May to the end of February, but I think the party is over; I sold my GLD when it started falling last week.

A small side note:

Yes, it really is basically compatible with-- and as good as-- the expensive proprietary office suite from that mega-software company. I'm using it to create this document.

And it really is free. Click here to get yours today.

It's time to check the spelling and ship this to you.

If you have any questions, please write or phone. If you want to read more, I've got a web site 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.

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

A collection of fine industrial Boilerplate, but true:

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