Capital Drain

Rick's investment opinion newsletter April, 2008 v.4 no.3

Before printing, think about the environment

Hi Readers,

It may have been another quiet week on Lake Woebegon, but it was an unusually active month in the financial markets, all the way from the price of eggs in China to the price of mansions in the Hamptons. Which one do you think rose, and which fell? Correct. (It's delightful to have readers who are all above average .)

In other news, I've continued "moving in" to the new LongspliceInvestments.com web site. This month I moved the blog, making it much more appealing to resume adding to it.

I think this is the last month that the newsletter will include the detailed info for getting your Credit Report. In the future, I'll have the instructions posted as .pdf files on the website newsletter page, and just give you a link and a reminder every four months. Don't ignore the reminders, OK?

So, on with it, before I get any further past deadline. In my opinion:

Executive Summary:

- GDP is not really up 0.6%, it's down.
- It's not a recovery, it's a Dead Bull Bounce
- Housing prices have to go back to fundamentals to find a bottom
- Why gold is falling while [other] currencies rise
- Credit Check: TransUnion

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:

> "This is a man-made crisis and it's made by this false belief that markets correct their own excesses," Soros, 77, said. "It will take much longer for the full effect of the decline in the housing market to be felt."[1]

As I write this, the stock markets are having a big Yipee! of a rally. Why? Well...

Many people perceive recent news as good. No banks have blown up for a whole month. The Fed just lowered their target short-term interest rate. The Department of Commerce released a Gross Domestic Product (GDP) report that says we're not in a recession.

I'm not buying it.

Let's start with that last news item. The **GDP report** is nowhere near as encouraging as some are making it sound. First of all, it's the Advance Estimate of the first quarter (1Q) GDP. It could change; these estimates often do. A month from now they'll revise it, and that will still be called the Preliminary report. The accurate final report will be another month after that.

Second, the only reason it was positive rather than slightly negative was that retailers ordered more stuff than they actually sold. Does that sound like a good thing? That excess stuff is now sitting in swollen inventories. Retailers want to get rid of it, and they're not going to order more until they're sure they need it. So, technically the GDP increased because producers produced and sold to retailers, but the increase in GDP is really borrowed from next quarter. Producers will be asked to produce less as retailers refrain from ordering.

Third, GDP growth is quoted as 'real', i.e., adjusted for inflation. If, however, you adjust for too little inflation, it makes the GDP growth look bigger. The inflation estimate they use for GDP is a bit lower than most, and particularly lower than the current headline CPI-U. The difference is small, but would reduce real GDP growth by a few tenths of a percent.

Fourth, while "2 quarters of falling GDP" is the rule of thumb for a recession, it's not the real rule. The existence, start, and finish of recessions are determined by the National Bureau of Economic Research, based on more factors than just quarterly GDP. I still think they'll call the start of this recession as last December.

Finally, almost all economists are predicting that the second quarter will be worse than the first, and therefore likely negative GDP.

The point of all that discussion isn't just who's right or what the GDP really is. The point is, where to invest? Is the stock market a good place?

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1 Patricia Kuo and Bei Hu, "Soros Says Credit Crisis Will Worsen Before Improving (Update4)", Bloomberg.com, April 10 2008, Bloomberg, LP, April 10 2008, <http://www.bloomberg.com/apps/news?pid=20601087&sid=akh0d.rJSrUI&refer=worldwide>.

Despite today's 1.5%-ish rally, and a 5%-ish rise in April, I don't think stock investors will be very happy with the rest of the year.

Basically, I think we're seeing a Dead Bull Bounce.[2] There's more bad news to come over the next year. If the best news we have is the GDP, really, there is no good news. The bounce is noise. The drop will resume.

It's sad, but **house prices** have a long way to fall still. In the process, more ex-homeowners, investors, developers, and banks will be hurt.

Many remember the old days, before the bubble. The good reasons to buy a house were:

1) To rent it out profitably, or
2) To save money by paying a mortgage rather than paying rent.

The two reasons were complementary, and could exist together. Not everyone could afford a big down payment, so some had to rent. Others had cash to invest, and could earn positive cash flow after interest and taxes.

One seldom heard then about the reason everyone thinks of now:

3) To sell at a profit. (The Ponzi option.)

Before the inflation of the '70s and '80s, that was not assumed to be reliable.

In the housing bubble, home-buyers relied solely on reason 3. Reasons 1 and 2 weren't even true. Investors couldn't charge enough rent to earn a profit after taxes and interest, and homeowners could have saved money by renting and banking the difference.

Now that's unwinding. The magic spell of belief in levitating housing prices is broken, and investors and new home-buyers aren't going to jump in in large numbers until reasons 1 and 2 are true again.

The foreclosures related to sub-prime loans are nearly finishing, but the foreclosures due to negative-amortization loans (a.k.a. payment-optional or option-ARMs) made to good, even "prime" lenders are falling apart now. Add to that forced sales due to job losses or illness. Everyone's trying-- needing-- to sell into a market where prices are dropping at record rates and nearly a year's worth of normal sales volume is sitting empty.

I haven't heard a plan yet from Bush, Paulson, Frank, Pelosi, or even investors like Bill Gross or economists like Robert Reich or Paul Krugman-- haven't heard a plan yet that accepts the point: House prices HAVE to fall to reach equilibrium with demand, that is, to begin to create real financial demand from reasons 1 and 2. Supporting house prices can't work, not even having someone buy up houses and destroy them. (Yes, it has been proposed.)

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2 Traditionally called a 'Dead Cat Bounce,' from the observation that even a dead cat will bounce when dropped from high enough. I prefer to not alarm the local cats, and wish especially to point out more clearly what it is that's really dead and bouncing. It's the Bull.

Rents have to be reasonable for people's incomes. Purchase prices have to be rational compared to renting. Rents are near historical norms relative to incomes, so it is prices that will change.

A year or so ago I explained how gold acts like an extra-national currency. For a year, that was apparent: the dollar was falling against all major currencies and against gold, i.e. gold was rising along with the Euro, Yuan, etc.

Why, lately, are **currencies** still **rising, but gold falling**?

Basically, because gold rose more than any of the other currencies did, and now it's falling back in line with the pack.

To use a simple example: The dollar fell vs. the Euro, and it fell a lot vs. gold. Arithmetically and in fact, that meant that the Euro fell vs. gold. Well, the Euro is pretty healthy so there's no good reason it should have fallen vs. gold, i.e., that the Euro price for gold should have risen so much. Now gold is falling relative to the Euro, at an even greater rate than the dollar is falling relative to the Euro. Again, do the sums: that means that in dollar terms the Euro rises more but gold falls.

Does that make sense? If not, next month I'll make a diagram to clarify.

One last topic and then I can send this off.

This month we finish another cycle of **credit check**ing, this time at the third agency, TransUnion. I don't want to be mean about it, but of all the agencies, only TransUnion have been difficult to deal with, and they've been difficult EVERY TIME, three years in a row.

It's worth it to try anyway, of course. Identity theft is accelerating, and spotting something fishy in your Credit Report may allow you to nip a problem in the bud.

I hope these directions will guide you through the process. I've had to extrapolate from my notes from the other two agencies, although the script has been checked and confirmed to work by one reader.

- Open your favorite browser and go to https://www.annualCreditReport.com
- select your State and click "Request Report"

- Fill in the form with your personal information.
  - Click the little box that says "show only last 4 of Social Security Number in report"
  - Enter the security code (this prevents automated logins)
  - Press "Continue"

- Click the little box next to TransUnion
  - Click "Next"

- Click "Next" again

This is where TransUnion stops co-operating with me. If they don't co-operate with you either, here's how the process goes:

- They say I already have an account.
  - I snuffle and root around through papers for a while, dig out my account number and password, and enter them.
  - Click “Enter”
- They ask me to select a new Secret Question and answer. OK.
  - Click “Enter”
- Back to the main script:
  - Don't click on any of the added-cost items.
  - Do read the Service Agreement
  - Click “Accept”
- Would you like to be automatically reminded to check TransUnion annually?
  - Click “Yes” or “No”

- They say “Unable to confirm your identity.” B@stards.
- Fallback position:
  - To Request your Credit Report by Mail:
    1. Download the request form
    2. Print and complete the form. Check the box for TransUnion.
    3. Mail the completed form to:
       Annual Credit Report Request Service
       P.O. Box 105281
       Atlanta, GA 30348-5281

       Your reports will be mailed to you within 15 days. Please, allow 2-3 weeks for delivery.
- You're done with them for another year, during which they may fix their system.

- Enter the last 4 digits of your SSN
  - Click "Submit>>"

- Answer the security questions
  - Click "Submit>>"

Probably at this point, although I could not confirm:

- Select a new Secret Question and answer.
  - Click “Enter”
- Don't select any of the added-cost items.
  - Do read the Service Agreement
  - Click “Accept”
- Would you like to be automatically reminded to check TransUnion annually?

- Click “Yes” or “No”

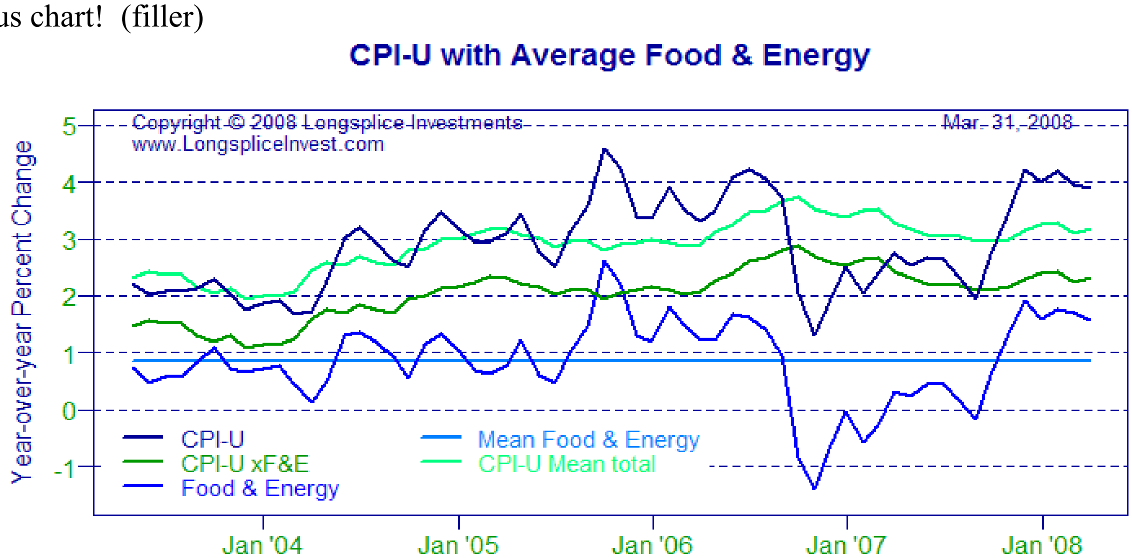
- You should see the Report Summary page and instructions to make a note of your report number.
  - Make a note of your report number.
  - Notice where it says the number of potentially negative items, number of accounts in good standing, etc. Do the totals seem right?
  - Click the little link that says "Print your report". (It's on the same line as your name)

- This pops open a new page (or tab) with your actual report.
  - Read through it
  - Click "Print Report"

- Assuming you haven't had any problems with these steps, you're done.

- Click "Close window" to close the print page/tab.
  - Click "Return to AnnualCreditReport.com" at the very top of the page. This logs you out from TransUnion.
  - Click "OK"
  - If you then get a message that your session has timed out, ignore it. You're done.
  - Close the browser window.

Bonus chart! (filler)



Notice that even when “volatile” Food and Energy are reduced to a 5-year average, it's still a big chunk of inflation that is not captured in Core inflation.

It's time to check the spelling and mail 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,

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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