Capital Drain

Rick's investment opinion newsletter October, 2008 v.4 no.7

Before printing, think about the environment

Hi Readers,

Here in California we're allowed to vote early, in fact encouraged to vote by mail (what we used to call "absentee" ballots) or in a steady flow of voting at county offices. I've already voted. I hope that you have too, or will as soon as you can.

One of the virtues of Democracy is that it's good at correcting its own mistakes, at least eventually. One bunch of leaders ran things according to their theories. If you like the results, elect them again; if not, get a new group in who can fix things and move on.

That's the last I'll say about how we got here. From now on, the question is "what do we do next?"

Ready? In my opinion:

Executive Summary:

- Another week, another dead bank
- The dollar smile: dollars are "in" again
- Muni bonds look good; stocks do not
- The election
- A few could benefit from house arbitrage

This is different from my previous few years of summary:

To the extent that you feel comfortable not "buy and hold"-ing, take some of the profits you've got in stocks. If you still have any money in high-yield (junk) bonds, sell those, as fast as you can, even if it's a loss. For a while to come cash will be king. Almost everything else is reasonably likely to suffer losses.

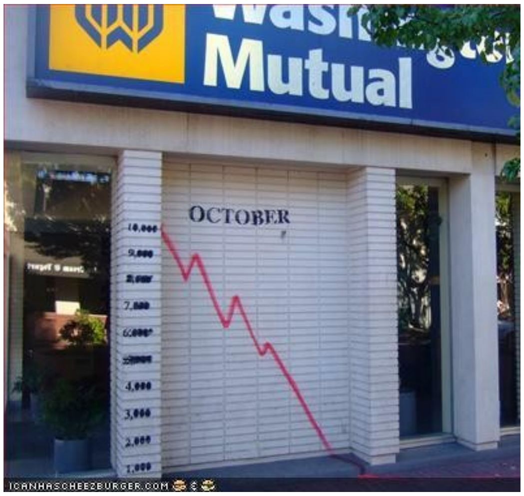
Short of that, this is a good time for investors to be conservative, to be in the best of securities: stick to value, to safety, to short maturities (for debt), and call me to chat if you're concerned about anything you're holding.

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:

Yesterday, another bank was put out of its misery, taken over by the FDIC to protect the depositors. This was number 17 for the year, and you probably didn't hear anything about it unless you live near Bradenton, Florida. It just wasn't newsworthy. There will be more.

At least the public still has a sense of humor.



During the summer and early fall I recommended first-world bonds, such as through BWX, PSAFX, or PFBDX. I was wrong, or at least too slow to react to an adverse change.

Even though the US economy is a big mess, the rest of the world's economy is being dragged in. That means that investors are fleeing back to the-- relative-- safety of the dollar.

The dollar is rising, so it's time to bring our money home for a while.

The rival financial firm Morgan Stanley ;-) has described what they call “the dollar smile.” When times are really good, the dollar rises because the US has the best mix of a dynamic economy and convenient capital markets to invest in. Investors selling their overseas currencies to buy dollars to invest cause the dollar to rise, one raised corner of the “smile.” When things are only OK here, then overseas (particularly developing world) investments are more attractive, so money flows out to them, pushing the dollar down. When things are really bad (as now,) then investors flee smaller and more vulnerable economies, pushing up the dollar as the other side of the smile. Right now, however bad our problems look, the other countries' problems are more uncertain and could be worse. Flight to relatively safe US investments means the dollar is fashionable again.

Stocks are still a bad bet. We just had one of the biggest single-day rallies ever, and one of the best weeks of stock appreciation ever, up roughly 14%. Can you suggest that that's because the economy looks good? Fourteen percent better? No, it looks terrible.

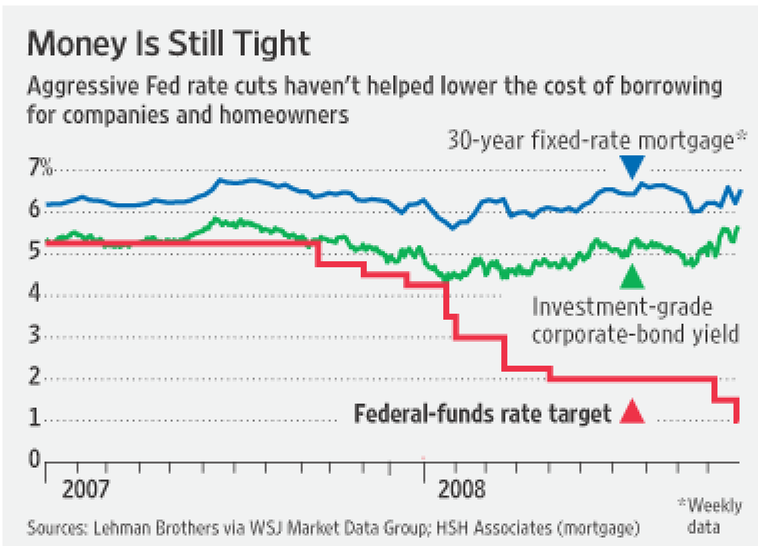
No one disputes any longer that we're in a recession, and the debate is whether we'll emerge from it the middle of next year or later. New bad news is still arriving, even if the Treasury and the Fed (and other governments and central banks around the world) appear to have figured out the control rods[1] before the runaway chain reaction culminated in an explosion. This is a relief rally, as investors are happy to wake up alive. The current rally may even run up for more weeks or more percent gained, but I believe the giddiness will pass and the stock markets will follow the economy down.

1 Used to control a nuclear reactor; see http://en.wikipedia.org/wiki/Control_rods for an explanation.

By the way, I missed it back in July, but the government revised the GDP for the fourth quarter of 2007, down to a decrease of 0.3%. As I wrote back in January[2], it's likely this recession will be pegged to have started last December.

Cash is still king.

Depending on the State you're in, short-to-medium term municipal bonds via a mutual fund could be a good opportunity. Muni bonds are not generally a bad risk, but the risk aversion (fear) of the markets overall now is causing them to have unusually high yields. If your State has an income tax, muni bonds from your State are tax-exempt, so they give the biggest benefit in taxable accounts. At current rates, though, they're at attractive yields even in tax-free counts. The mutual fund gives you professional bond selection and diversification; you'll get good yields now and a likelihood of capital gains when conditions calm down.



[3]

By the way, the recent decrease in the Federal Funds target rate is largely irrelevant. The cost of overnight deposits at the Fed is not in any way the cause of recent problems or an important part of the solution.

You may have noticed there's going to be an election on Tuesday. The traditional stereotype has been that Republicans were good for business and Democrats were bad. Thus, if a Democrat won, there would be a stock selloff, or a rally if Republicans won. Less often told but also true, within a few months the public would realize that the stereotype grossly exaggerates reality to put it mildly: the Democrats were unable to impose communism, and the Republicans were unable to make money grow on trees. The earlier rally/selloff would reverse itself. For what it's worth, the average stock market gain has been higher under Democratic administrations than under Republicans.

All that history is likely irrelevant this year, though. The outgoing Republican brain trust will not be missed, and the public predominately believes that Obama will be the better shepherd for the economy and will likely win. If there's no trouble with bitterly contested vote counts, there could well be a stock market rally after the election, simply out of relief to have that completed.

Personally, I would treat any big rally as a selling opportunity. The market typically starts to rise before the economy does, but it does so based on rational predictions of economic

2 http://www.longspliceinvest.com/CapDrain/CapDrain_v4n1.pdf , page 3

3 Hon Hilsenrath, Joellen Perry, and Liz Rappaport, “Fed Steps Up Assault on Slump,” The Wall Street Journal, 30 Oct 2008, Dow Jones & Company, 30 Oct 2008 <http://online.wsj.com/article/SB122528340048979949.html?mod=testMod>.

improvement. Stock market declines rarely (if ever, I'm not sure) end while the economy is still getting markedly worse.

There's been a lot of talk about "supporting house prices," as a way to end the cycle of price declines and foreclosures. As I wrote last April,[4] house prices are not arbitrary, and with the ponzi bubble burst they will probably fall back to be priced at their economic value: the price where buying is financially equal to or better than renting and saving the monthly difference.

If a future administration wants to succeed at supporting house prices, the way to attack that is to increase the affordability of houses nationwide. You can do that by lowering prices (not what anyone wants) or-- OR-- by raising typical working disposable incomes.

After some decades of belief in trickle-down economics, where government supports businesses (investors) and the workers supposedly benefit as an after-effect, we might consider trying trickle-up. Support the working class (good schools, health coverage, wage growth) and let's let the investing class benefit as an after-effect of the increased purchasing strength of the mass markets.

There is one hypothetically possible benefit of the housing price plunge for the adventurous and careful:

- If you own a house in an area where there's still good demand, so you could sell for a reasonably good price,
- and there are houses not too far away, in an area where you'd be comfortable living, where the prices have been driven far down,
- and you have good enough credit so that you could get a loan even though banks are belatedly cautious,
- then you could consider buying and moving into one of the "bargain price" houses and selling your current house.
- Invest the price difference.
- If the market never does improve, you keep the invested money and the gains from it.
- If the market does improve, after a few years you could take your capital gains from the new house, plus some of the invested money, and buy back into your old neighborhood.

I'm definitely not a real estate expert, so you should talk this idea over with someone who is. It's basically housing arbitrage: buy low, sell high, in an environment where some of the houses are priced far lower than other comparable houses.

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, the company web site has archived editions of this letter, lots of charts, and links to other interesting sites. There's also a web log where I discuss the process and progress of starting the mutual fund, along with occasional economic or investing thoughts..

4 http://www.longspliceinvest.com/CapDrain/CapDrain_v4n3.pdf , page.3

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