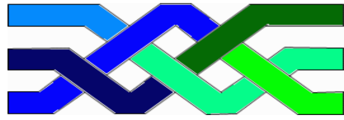


Capital Drain

Rick's investment opinion newsletter April, 2009 v.5 no.2

Before printing, think about the environment

Hi Readers,

Scratch one car maker. Chrysler is dead; long live Chrysler. GM is probably actually more dead, less likely to live on as a unified company after bankruptcy, but their management is so ineffectual that they can't even deliver their own death quickly, so Chrysler went first.

Scratch more banks. Eight more were closed by the FDIC in the month since I last wrote. So far 29 have been closed in 2009, or an average of more than one and a half per week. A few more are likely tomorrow, Friday, when the FDIC usually pounces.

H1N1 Swine flu could be something, or nothing. Informative, ya? I wrote last month about ignoring "eyewitness noise," the tele-media rush to broadcast half-true "facts" and half-baked analysis. Let's practice this together: we don't know yet. No one does. OK, just to be safe we could postpone the pleasure trip to Veracruz, but concerning our investments, we'll just wait until the picture clears.

In my opinion:

Executive Summary:

- It's still a worldwide recession, and still getting worse.
- Behavioral Finance: loss begets risk-taking.
- What does "doubling the Fed's balance sheet" really mean? An example.
- Does the stimulus necessarily cause inflation? No, not necessarily.
- inflation: borrowers win; deflation: lenders/savers win
- The Business Cycle: an introduction

Stocks are generally low enough that it's not urgent to sell now if you haven't already. The exceptions are stocks of homebuilders, automotive, and financial companies; those are still in for hard times. If you still have any money left in high-yield (junk) bonds, dump those, as fast as you can. 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:

> "What everybody is hanging their fundamental hopes on at the moment is the compilation of less-worse information," said Linda Duessel, equity-market strategist at Federated Investors. "We want to hear that we fell off a cliff, and we're done falling, maybe."[1]

Despite the past month's stock rally, there is every reason to remain cautious. Some forward-looking economic indicators are starting to hint that things are getting worse-- more slowly. That's the sum of the good news: worse more slowly. Meanwhile, we know a lot of bad news is coming: more layoffs, further reducing demand, killing some companies outright, producing more layoffs, etc. Add to that the possibility that there's at least one joker still in the deck, one out-of-the-blue negative surprise, and optimism seems premature.

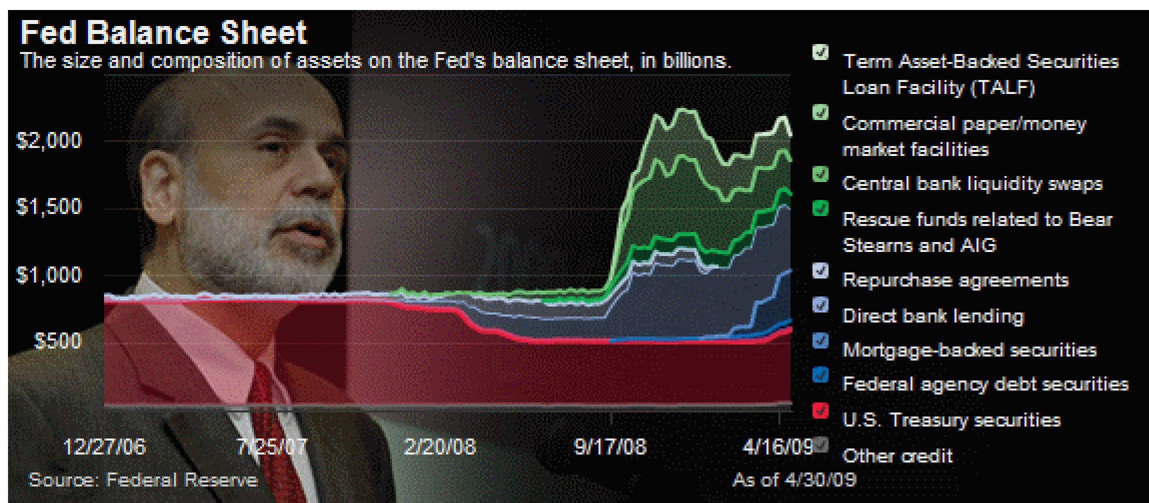
We're in an interesting period here: the stimulus is coming, but little has actually arrived. All of our trading partners are also in scary recessions, but most are applying stimulus to some extent, as we are. Banks are getting support, but more will still die. Some big key (supposedly key) industrial companies are being helped to restructure, but that restructuring will be a strategic retreat at best. Things will get worse, but then better, but when?

I repeat my summary opinion from last month: fold your money neatly, put it in your pocket, and sit on it. The time to reinvest is surely coming, and it's closer than it was a month ago, but it's not yet. I suspect that there will be at least one more plunge in the stock markets before a longer, profit-fed rally can begin.

Further, if you've lost some money in the drop thus far, **Behavioral Finance** offers a cautionary finding: when people have suffered a loss, they tend to take bigger risks than they otherwise would. Subconsciously, we feel cheated by luck. We feel the loss sharply, and we want that bad feeling to go away, ASAP. We deny the fact of the loss by imagining that it will be recovered on the next toss of the dice.

Sadly, our subconscious is predictably poor council in this case. Luck will not return to favor us; only market fundamentals can do that. The loss is lost. Sit, observe, reflect, and wait. Avoid the temptation to double and re-double your bets until the odds return to your favor.

1 David Gaffen, "Time to Brace for Trouble as Profits Debacle Starts," The Wall Street Journal, 6 April 2009, Dow Jones & Co., 6 April 2009, <http://online.wsj.com/article/SB123896411461990545.html>.



[2]

Not long ago, a friend asked, "What does it really mean when they say that the **Fed doubled its balance sheet**?" I thought I knew the answer, but I quickly realized I was fudging and flailing. I've thought it through, so here's an answer:

First some definitions:

Assets: What you hold: IOUs people owe you, as well as cash you're holding.

Liabilities: What you owe other people.

Balance Sheet: A detailed list of assets, liabilities, and the difference between them.

In the case of an individual, that difference is "net worth." If you hold more than you owe, the difference is your positive net worth.

In the case of a corporation, net worth is called "shareholders' equity."

The Balance Sheet follows the fundamental equality:

Assets = Liabilities + Shareholders' Equity

The two sides are equal and opposite. The sum is zero; the sides balance.

Picture the day the Fed was created. We the People set them up with some cash to do their job:

Assets		Liabilities	
cash	100	USA Citizens' Equity	100
Total	100	Total	100

Back in the August 2007 CapDrain I described how the Fed does its daily job adjusting the money supply to maintain its target rate. (Could this crisis really be that old already? Yes.) You may review or ignore that, as you wish.

A normal pre-crisis day, then, would involve either buying or selling some Treasury Bills in the open market, to increase or decrease the cash in the market, respectively.

2 Phil Izzo, "A Look Inside Fed's Balance Sheet — 4/30/09 Update," The Wall Street Journal, 30 April 2009, Dow Jones & Co., 30 April 2009, <http://blogs.wsj.com/economics/2009/04/30/a-look-inside-feds-balance-sheet-43009-update/>.

Increasing the money supply by 50: buy T-bills with cash, leaving:

Assets		Liabilities	
cash	50	USA Citizens' Equity	100
Treasury Bills	50		
Total	100	Total	100

Decreasing the money supply (from above) by 25: sell T-bills for cash, leaving

Assets		Liabilities	
cash	75	USA Citizens' Equity	100
Treasury Bills	25		
Total	100	Total	100

So now a crisis hits, they've already traded all their cash for T-Bills, and they need to get more cash into the system. Starting from the maxed-out Balance Sheet:

Assets		Liabilities	
cash	0	USA Citizens' Equity	100
T-Bills	100		
Total	100	Total	100

Step one: print money (borrow it from We the People)

Assets		Liabilities	
cash	100	USA Citizens' Equity	200
T-Bills	100		
Total	200	Total	200

At this point, the balance sheet has been doubled (previously Totals equaled 100, now Totals equal 200), but they haven't done anything with it. Their purpose was to provide more cash, for example by purchasing Fannie Mae (Federal National Mortgage Association) mortgage bonds:

Assets		Liabilities	
cash	0	USA Citizens' Equity	200
T-Bills	100		
FNMA bonds	100		
Total	200	Total	200

And there you have it: the Fed Balance Sheet, doubled, and put to work.

The first thing many people think when they see all that cash created and pushed into the economy is “That's more money chasing the same amount of goods... isn't that what causes inflation?”

It depends. If the economy and the banking system were normal and healthy, then the extraordinary stimulus might very well cause inflation. In the present,

however, we've got an economy teetering because of bad debts and decreased consumption, and a banking system bled white by its own losses. If we're lucky, if the government is gauging this right, then the stimulus will be enough to prevent deflation, but not so much as to cause inflation.

If deflation still threatens, they'll print more money. When the printed money is no longer needed, the Fed wants to prevent inflation by selling some of its bonds and T-Bills back into the market, and un-printing some of the cash, decreasing the liability owed to the citizens. For example, selling back some Fannie Mae bonds:

Assets		Liabilities	
cash	0	USA Citizens' Equity	150
T-Bills	100		
FNMA bonds	50		
Total	150	Total	150

Withdrawing the stimulus will be a delicate balancing act. If the Fed withdraws too slowly, causing inflation, then borrowers will win, and lenders lose. That's because inflation will decrease the purchasing power of money, so the borrowers will pay back money which has less actual value.

By contrast, if the withdrawal is too quick, there could be deflation, in which case lenders would win and borrowers would lose: debts would have to be repaid in dollars whose purchasing power had increased. In extreme cases, this can be catastrophic for the borrowers: they simply can't increase their current earnings fast enough to pay back their pre-deflation debts. Obviously catastrophe for the borrowers can't be good for the lenders either.

I'm inclined to think that the continued collapse in housing prices and global consumer demand will create some deflation, but not catastrophic levels. If that's true, then buying bonds could be very attractive. Treasury bonds would pay almost nothing, but carefully selected bonds of healthy high-quality companies could be the best deal in a difficult market. Their high yields would pay well, but would also likely fall to yields closer to Treasury Bonds over time as the crisis passes, creating capital gains.

Next month I'll give a bigger, better description of the typical business cycle and the accompanying typical cycle of most-attractive investments. Here's a taste:

In the typical cycle, bond yields would have fallen as the GDP fell, and would rise (causing bond prices to fall, causing capital losses) in the recovery when GDP resumed rising. This time has been different so far: because of the credit market troubles, bond prices have fallen as everyone's interest rates rose. The unwinding should be different as well: a comfortable stability, albeit at a lower level of GDP, will decrease bond yields, increasing prices, creating capital gains. Eventually, actual growth will return, and stocks will be favored as in a normal post-recession recovery.

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..

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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