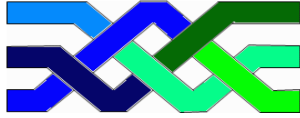


Capital Drain

Rick's investment opinion newsletter July, 2009 v.5 no.3

Before printing, think about the environment

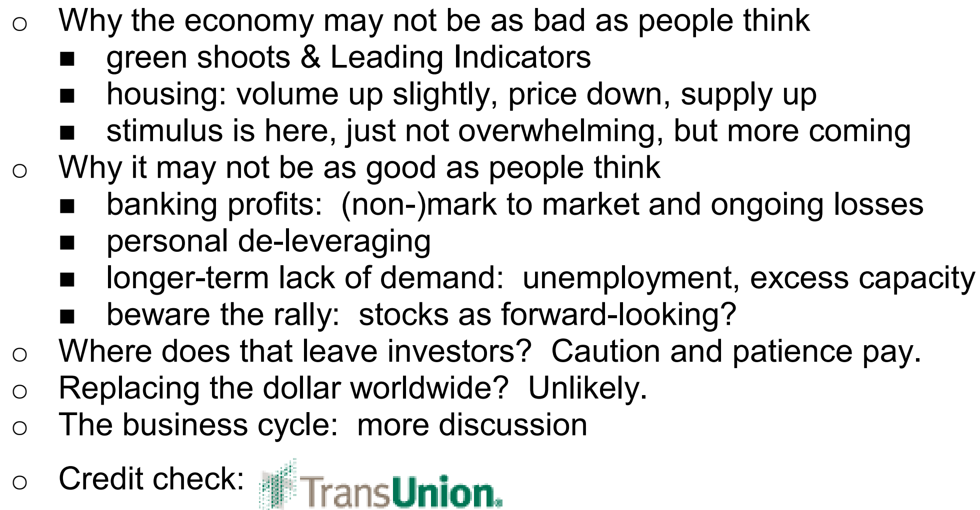
Hi Readers,

It's the end of July, and a full month into the third quarter of the year. That's the easy observation.

It's harder to say whether our so-called Great Recession is at the beginning of the end, or the end of the beginning. A lot has happened, and a lot still needs to happen for the economy to get back to comfortable levels of growth and employment.

Where, exactly, are we? In my opinion:

Executive Summary:



- Why the economy may not be as bad as people think
  - green shoots & Leading Indicators
  - housing: volume up slightly, price down, supply up
  - stimulus is here, just not overwhelming, but more coming
- Why it may not be as good as people think
  - banking profits: (non-)mark to market and ongoing losses
  - personal de-leveraging
  - longer-term lack of demand: unemployment, excess capacity
  - beware the rally: stocks as forward-looking?
- Where does that leave investors? Caution and patience pay.
- Replacing the dollar worldwide? Unlikely.
- The business cycle: more discussion
- Credit check: TransUnion

Stocks have had a pretty sprightly recovery. I think that's the result of too much optimism. If you're holding shares of any of the companies that are conspicuously in trouble, you might consider selling them into this bounce, even it that's at a loss. It is safer to risk gaining a little less rather than risking losing a lot more.

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 middle-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 know former Treasury Secretary Paulson had his critics, but I am not one of them. Did he do some things that in hindsight he might like to take a "mulligan" on? Sure. But he dealt with the problems in the best manner he could. The time to have taken action was when we were making liar and no-doc loans and calling then AAA, or allowing banks to go to 30:1 leverage. Paulson had to deal with eggs that were already broken. That the system did not crater is to his credit. Securitizing what he and everyone else should have known would be garbage while he was head of Goldman Sachs is not to his credit. But I digress." -John Mauldin[1]

Not so bad:

At long last, the optimists' comments are starting to sound credible. The shoot-from-the-hip emergency financial measures seem to have stopped the stampede. The odds of "Crash, phase II" are receding as more of the bad news has come out, been examined, and been factored into new projections. Some of the information arrives as good news/bad news pairs, but at least it's no longer all bad. I'll start by summarizing the positives.

There are in fact some green shoots, even if many of them are still as small and vulnerable as the grass growing in the cracks of the freeway. (The next time you're in a 0 mph jam, get out and look down! I was surprised how much life is there.) People are imaginative and adaptable, and new businesses are forming to exploit the new conditions.

Furthermore, the Conference Board Index of Leading Indicators has risen for three months in a row. That sort of consistent rise usually-- not always-- precedes an economic pickup by about six months. Most of the Index components show improvements, albeit from a low level. New unemployment claims, for one example, are dropping, but they're still quite high; it's a measure of less-badness. Similarly less-bad are increases in new residential building permits and manufacturing hours worked.[2]

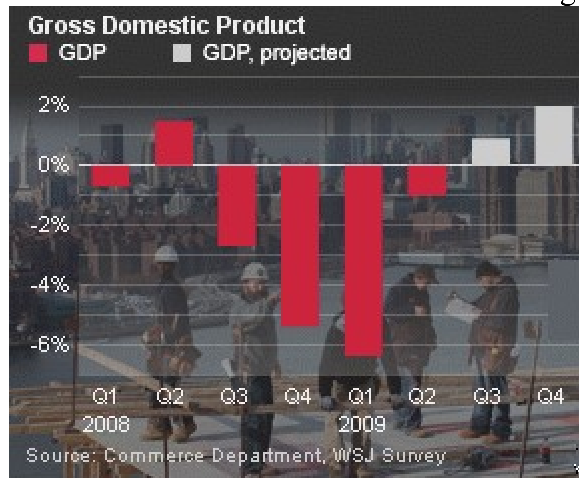
While we're not yet at the housing bottom, I think we can see it from here, and can get a sense of how low the bottom will-- and won't-- be. New and used sales volumes are rising, and the rate of decline of the prices is slowing. Buyers are now showing up at the foreclosure auction sales in large numbers. To be sure, those are buyers who are very choosy about good houses and low prices. Still, re-establishing a functioning market has to start by forming a bottom. When the bottom-fishers begin to outnumber the distressed houses, the market will be ready to slowly advance.

---

1 John Mauldin, "Europe on the Brink," Thoughts From The Frontline, 17 July 2009, InvestorsInsight.com, 17 July 2009 <http://investorsinsight.com/blogs/thoughts_from_the_frontline/archive/2009/07/17/europe-on-the-brink.aspx>.

2 "Global Business Cycle Indicators," 20 July 2009, The Conference Board, 30 July 2009 <http://www.conference-board.org/economics/bci/pressRelease_output.cfm?cid=1>.

The stimulus program was passed, and it has begun, and it seems to be working. In particular, the Cash for Clunkers program has been a huge success, or at least it sold a lot of cars. I'm not sure that it did a whole lot of good for the economy overall, but we'll see.



[3] Lest we forget, this is our second stimulus plan. The first one, under the Bush administration, was much smaller than the new one but nonetheless is credited with boosting the GDP to an intra-recession positive 1.5% (annualized) during the second (Spring) quarter of 2008. In English, it helped.

Similarly, the Obama administration stimulus plan has commenced, and it appears to have boosted GDP in the Spring (Q2) of 2009 by a few percent to a smaller loss. Of the roughly $700 billion authorized, only about a third has actually been spent so far. That has blunted the immediate effect, but it also means that the current quarter and possibly the next one will also benefit. If it succeeds, as predicted, in arresting the GDP decline and creating some growth, it will have done its job. The self-reinforcing feedback of the economy will have been flipped to reinforce growth.

Not out of the woods yet:

On the other hand, there is still plenty of bad news, starting where the collapse began: reckless lending.

There's a joke that in addition to CDO, RMBS, SIV, etc., there are three new initialisms in the banking crisis: DOA, ER, and ICU. Northern Rock, Countrywide, and Lehman Brothers were declared dead when the ambulances arrived, so they're no longer part of the problem. AIG and Citigroup, however, are on the operating tables on life support, being sliced and slimmed with no certainty that what's left can be stitched together into live, self-sufficient organisms.

Most importantly, there's a huge wing on the Fed/Treasury hospital full of badly damaged banks being (for the most part-- some will die) nursed back toward health. Some of these banks are actually reporting good earnings, but the appearance is deceiving: since the mark-to-market regulations were eviscerated, banks have been able to choose the timing of their still-to-be-reported losses, so that if they wish, their loss each quarter will be less than their current profit.

This scenario played once before after the Latin American debt crisis. Most of the big US and multi-national banks were technically insolvent because of bad loans. The authorities allowed them to a) pretend some of the loans were still good, and b) earn some easy money borrowing short-term for peanuts (low Fed Funds target rate) and lending carefully for a good rate spread. Then as now, over years the banks dribbled out their unrecognized losses into the stream of new profits. The ploy worked then, at a cost of reduced and more cautious lending by the banks. It may work again, if there are no big surprises, but thus far this crisis has been deeper and broader than the Latin Debt episode.

3 "Gross Domestic Product," The Wall Street Journal, 2 Aug 2009, Dow Jones & Co., 2 Aug 2009 <http://online.wsj.com/public/page/news-economy.html>.

For the recession to end, someone has to start spending more money. It really is that simple. The question is, who? Consumers aren't earning any more, and they've been scared out of the habit, at least for now, of borrowing more and living beyond their incomes. No increased spending there. Similarly, businesses have unused capacity, meaning that they could handle more orders from more customers without having to invest any more money in machines or buildings, etc. No increased spending there. Further, businesses know full well that their potential customers, whether consumers or other businesses, are in the same bind. There is no incentive to invest for new opportunities yet.

If that sounds like a chicken-and-egg problem, it is. That's the reasoning for the Keynesian prescription of government stimulus. In a bad recession, only the government can decide to take the first big spending step.

Wall Street loves rules of thumb. One of the perennial favorites is that "Stocks are forward-looking and will start to rise about half a year before a recovery." Well, yes and no. Investors do in fact try to look ahead, and try to position themselves for the future as they predict it. The only problem is that sometimes the predictions are wrong, and usually on the over-optimistic side. The current stock rally seems to me to be awfully quick and strong given the unprecedented size of the economic problems.

What's an investor to do?

I am suspicious of the US stock market's rally. I certainly am not thinking of jumping in to catch it "before it gets away." In the rest of the world, the best deals seem to be in the relatively well-established countries that are not overly dependent on exports to the US: Brazil, Chile, India, and Korea are a few of the likelier choices. Overall, though, I hate the idea of buying something just because it's rising. If I don't understand or believe in the rise, I'd rather wait and think.

In the bond market, there has also been a wave of optimism as the prices of junk bonds have risen. Even more than in the stock market, I think this optimism is premature at best. Many of these junk bonds need to be re-financed in the next few years. It does not appear that the debtors will be in promising financial health, or that the lenders will be ready to take big new risks. Eventually junk bond rates will fall, but they'll be too risky for me for a while yet.

Treasury Bonds are a traditional place to put money in uncertain times. The problem with Treasuries right now is that interest rates have almost nowhere to go but up, whether due to renewed expansion or inflation. Rising bond rates would mean a capital loss for the bond holders, on top of the already low interest rates.

A better deal could come from the highest-rated bonds of the most robust companies. The interest premium they pay above Treasury yields could fall, giving a net capital gain even if Treasury yields rise a bit. US municipal bonds, despite the struggles of the state and city budgets, are still a decent bet: the interest rates are good, and the likelihood of an actual default is quite small.

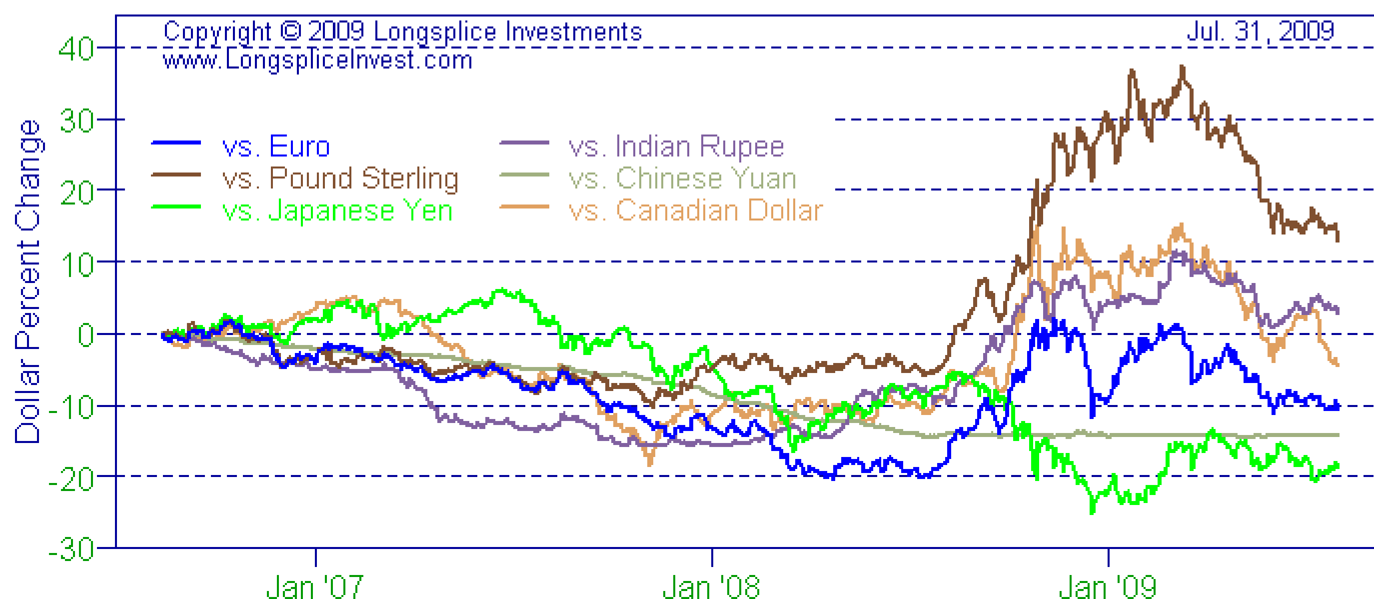
China's frustration with dollars

For a while the US dollar rose compared to most world currencies as the financial uncertainty made dollars appear to be the safest haven in an unsafe world. World investors parked their liquid assets in dollars, particularly in short-term Treasury bills.

Since March that trend has been reversing, as investors move their money back to their usual target markets. The new decline of the dollar, on top of the culpability of the US financial

sector for last year's turmoil, has prompted China to resume calling for an alternative to dollars as an international reserve currency. Some have even suggested that the Chinese Yuan (or Ren Min Bi) could be a substitute. At the very least, they suggest that the dollar could be replaced by a basket of other world currencies.

I think the Chinese anti-dollar faction are over-stating their case. Take a look at this chart of the value of the dollar relative to other world currencies over the past three years. Which of these currencies is not like the others?



The Yuan spent two years in a managed float, a slow steady rise against the dollar. For the last year it's been pegged against the dollar, with negligible change. You can see how much variation in exchange rates there is between the dollar and genuinely floating currencies.

So what?

So if the Chinese had wanted to store their wealth in a basket of currencies, they could have. All they had to do was to exchange the dollars they got from trading with us, and save the money in government bonds in Euros or Pounds or Yen or Loonies (the 1$ Canadian coin has a Loon, a type of bird, on the face) or whatever. But they didn't.

Why didn't they?

In short, the Chinese were preventing their currency from rising more against the dollar. Chinese merchants were receiving tons of dollars from their sales to us. In a floating exchange, that would have made the Yuan rise, the dollar fall, Chinese imports in the US more expensive, and US imports in China less expensive. The only way to prevent that exchange rate shift was for the Chinese government to buy the dollars from their merchants, for Yuan, and hold the dollars as dollars, for example by buying US Treasury bonds. By doing this, the Chinese government accumulated $2Trillion of Treasuries, and they're now concerned when the value of those dollars decreases.

In the neutral tones of financial science: too bad. Foreign exchange doesn't work that way. The US consumers' willingness to save rather than borrow and spend would have been higher if Chinese purchases of Treasuries hadn't held US interest rates down. Chinese

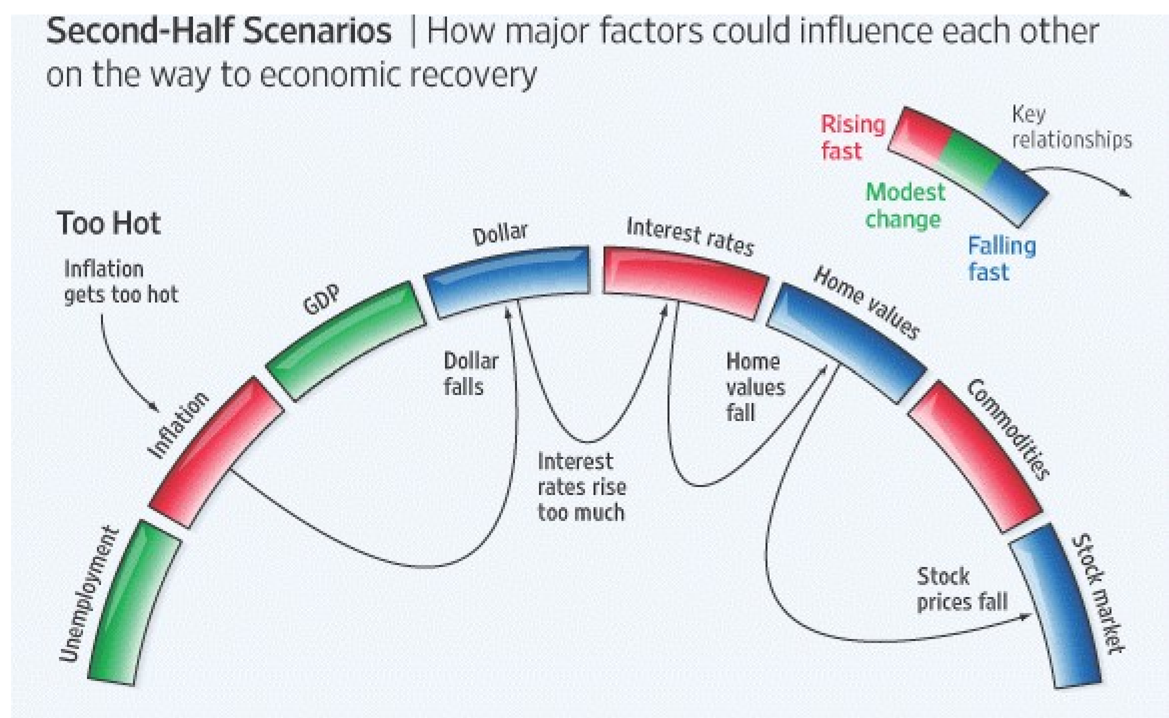
consumers' willingness to spend, and perhaps to borrow, instead of saving would have been higher if US imports had been more attractive.

Further, any discussion of an alternative to the dollar as a store of value raises the question of what to use instead. Gold? It's been tried, it's available now, but it's not perfect and it hasn't been used much in the past half-century. The Euro? Half a year ago, during the financial meltdown, many financial thinkers were speculating that the Euro wouldn't even survive, that macroeconomic differences between the Euro-zone countries would cause some to withdraw from the system. The Yuan itself? Other countries won't be interested in that until the Yuan floats at a market rate. A basket? It's available, if *á la carte*. Some countries are diversifying somewhat, but there's no international consistency.

Whither the business cycle?

I'd like to share these beautiful diagrams from Andrew Garcia Philips as published in The Wall Street Journal. They demonstrate the interplay of economic factors to produce very different results depending on whether the US fiscal and monetary stimulus is excessive, insufficient, or just right..

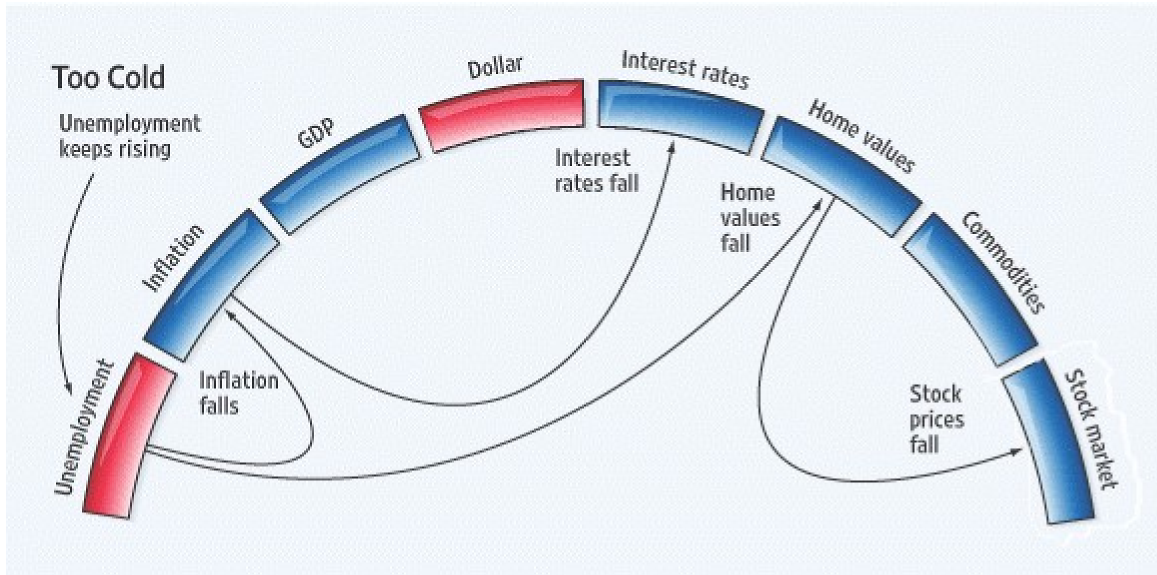
Excess stimulus, or "'too hot," would likely cause US inflation. Other, more stable currencies would draw investments out of dollars, lowering the exchange rates. The Fed would likely raise interest rates, which incidentally would raise mortgage rates and decrease the affordability of houses, driving down their prices. With all this turmoil and the departure of investors, the stock market would likely fall.



[4]

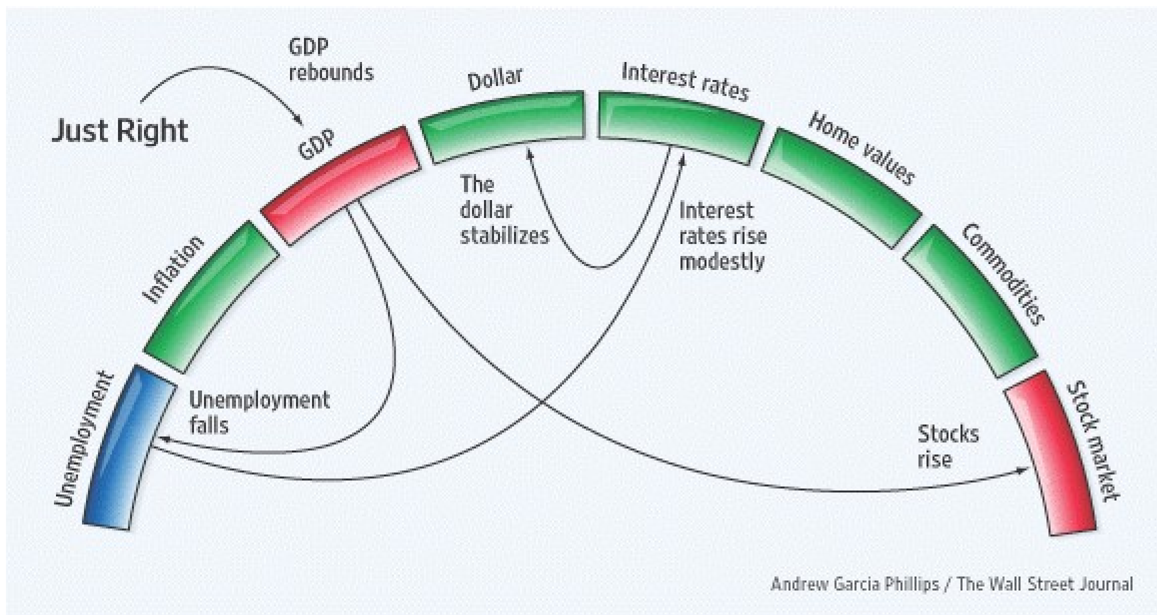
4 Andrew Garcia Philips, <http://s.wsj.net/public/resources/images/P1-AQ180_RECOVE_NS_20090607193751.gif> from Mark Gongloff, “Land Mines Pockmark Road to Recovery,” The Wall Street Journal, 8 Jun 2009, Dow Jones & Co., 31 July 2009 <http://online.wsj.com/article/SB124442326661992487.html>.

Insufficient stimulus, or "too cold," would be a continuation of the current crisis. The dollar would bounce back up as the safest bet. Inflation and interest rates would fall, but the dismal economy would cause more job losses, decreasing average home affordability. Companies' profit prospects would be uncertain but generally poor, so stock prices would likely fall.



[5]

If, through luck and cunning, the stimulus is just about right, then we get the happy picture: economic growth will be stimulated, but inflation will not. Employment will increase. Interest rates will return to more normal levels, and the dollar will stop its renewed fall. With good news in all other areas, the stock market would likely rise. We'll see.



[6]

5 ibid
6 ibid

This is important.

It's **Credit Check** time again. With all the ID theft and fraud happening today, checking your Credit Report is a free way to assure that nothing is being done to you. Once per year per Credit Agency, you're allowed to get a free copy of your Credit Report, quickly, online. Do it now!

If you've been following along with my every-four-months pace, you're ready to revisit TransUnion.

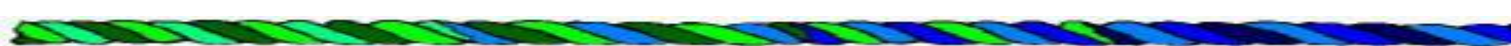
I've taken notes from my own recent visit, so you can follow the instructions at www.longspliceinvest.com/CapDrain/TransUnion.pdf . I sincerely wish I could say it's completely easy. Sadly, TransUnion has always been more difficult for me to work with than the other two Agencies. In each of three attempts so far I've had to abandon the online process and fall back to printing and mailing the request form. Still, the form is not so bad and TransUnion's response is prompt. Online may work for you.

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.

It's OK to forward this to friends who are interested. Thanks!

Take care,
Rick



Rick Drain
P.O. Box 5425
Redwood City CA 94063-0425

CapitalDrain@LongspliceInvest.com
www.LongspliceInvest.com

"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:

Nothing in this e-mail should be considered personalized investment advice.
Although I may answer your general questions, I am not licensed under securities laws to address your particular investment situation. No communication from me to you should be deemed as personalized investment advice.

Any investments recommended in this letter should be made only after consulting with your investment adviser and only after reviewing the prospectus or financial statements of the company.

The information and opinions herein are for general information use only. I do not guarantee their accuracy or completeness, nor do I assume any liability for any loss that may result from the reliance by any person upon any such information or opinions. Such information and opinions are subject to change without notice, are for general information only, and are not intended as an offer or solicitation with respect to the purchase or sales of any security or as personalized investment advice.
Copyright © 2009, Frederick L. Drain