Capital Drain

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Before printing, think about the environment

Hi Readers,

Autumn is here. (In the investment business, people get nervous if you say anything like "now the Fall begins.")

Each of us may like or dislike any particular season, but we all have to go through them in sequence, in their own good time. You can't force a change just by wanting it.

It's similar with the economy, and the financial markets. Almost everyone would love an endless summer of growth, prosperity, profits, and investment gains, but that's not what happens: the economy has its cycles, and the markets have their cycles. It's important to recognize which season you're in.

Where are we? In my opinion:

Executive Summary:

- Is the recession over? Depends on definitions.
- The stimulus package is a parachute, not an airplane
- Profit surprises were from cost-cutting, not improved sales.
- Housing: layoffs -> foreclosures -> bank stress -> less lending
- Market up or down?
- Surprises: flint-eyed or dreamy-eyed? What's known, vs. what some expect
- Gold? I'm skeptical.
- It's credit-check time again -- EQUIFAX

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:

> As Jeremy Grantham said when asked what investors would learn from this crisis: "In the short term, a lot. In the medium term, a little. In the long term, nothing at all. That is the historical precedent". Or as JK Galbraith put it, markets are characterised by "Extreme brevity of financial memory... There can be few fields of human endeavour in which history counts for so little as in the world of finance".[1]

Is the recession over? Maybe. By the simplest rule of thumb, two consecutive quarters of GDP decrease, very possibly. Certainly the third quarter (3Q) GDP growth will be much better than 2Q's, but it will probably be near zero, maybe more, maybe less.

Officially, recessions' start and finish are defined by the Conference Board, a private research group that looks for a sustained decrease in production, spending, and employment. That's as specific as they get. One writer (sorry, I forget who) said that the Board appears to start the recession when the GDP starts to fall, but doesn't declare it to have ended until employment starts to rise. Rising employment lags behind the GDP growth even in a "simple" recession. In this one, employment could be low, or even still falling, well after GDP bottoms.

The Board waits until the data is all in and confirmed before they declare an end, so that could take a while even after the economy and employment get better.

The data do seem, on balance, to be getting better-- with caveats. The Conference Board's Leading Economic Indicators (LEI) have risen steadily for five months, indicating that the basis of a future recovery is being built. The Coincident indicator (CEI) has been flat, no longer falling, for two months, so things are no longer getting worse.

Some of the data that feed those indicators are not so firm, though. Stock markets are up dramatically, which lifts the LEI, but many market analysts are shaking their heads in disbelief at the speed of the stock rebound. Stocks may yet fall, which would trim the LEI somewhat. Everyone is breathing a sigh of relief that the world didn't end, so consumer sentiment polls are more positive, also lifting LEI. Consumer sentiment is fickle.

The CEI is a little more solid, rising based on increased industrial production. Simple enough, except that production has definitely been boosted by Cash for Clunkers and other government stimulus programs.

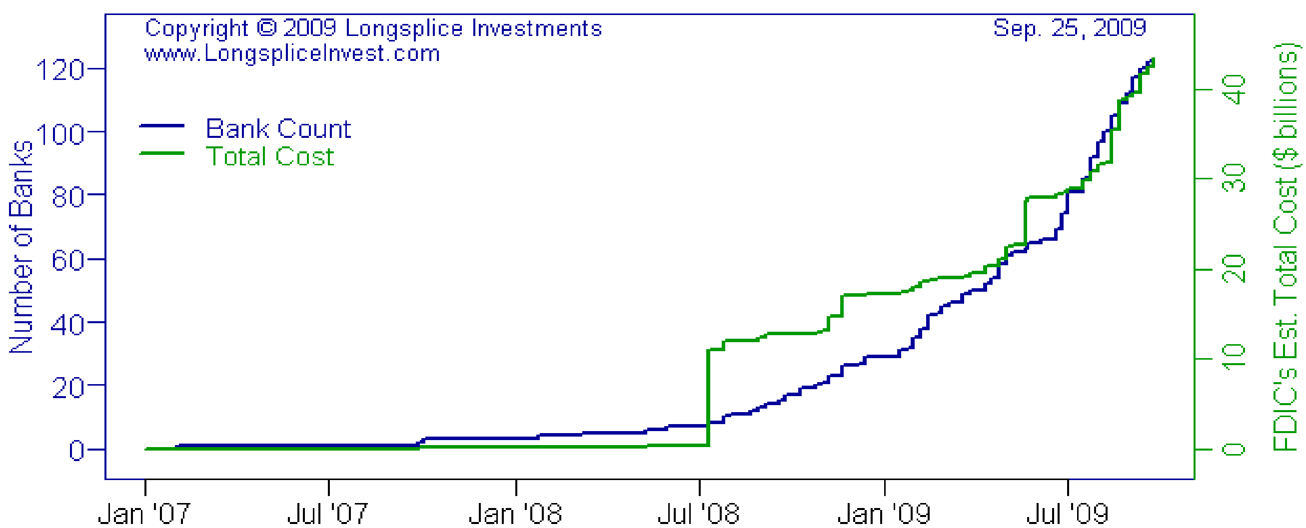
1 James Montier, "Six impossible things before breakfast, or how EMH has damaged our industry," Thoughts From The Frontline, ed. John Mauldin, 7 Aug 2009, Investor's Insight.com, 8 Aug 2009 <http://investorsinsight.com/blogs/thoughts_from_the_frontline/archive/2009/08/07/six-impossible-things-before-breakfast.aspx>.

The apparent success of the stimulus is making many investors optimistic. It's worth remembering two things, though:

- The stimulus is a parachute, not an airplane. Its job, the resources given to it, and the effects of diminishing returns (less bang for each additional buck) mean that the stimulus alone will not create a recovery. All it creates is a pause for the economy to evaluate and re-group.
- The surprise profits being announced by many companies are the result of rapid cost-cutting more than renewed growth. You can't cut your way to prosperity.

Meanwhile, there is still real trouble. The number of jobs in the economy is shrinking, steadily. Fewer jobs means less income means less spending means less production means fewer jobs. It's that simple. Also, many banks are only part way through their troubles. Not only does fewer jobs mean more foreclosures, but also commercial real estate loans are starting to default, as are the loans to some struggling companies. Evaluating and regrouping have let banks and regulators gather the data to predict how this will develop, but can't change the fact that a bank that loses too much money is dead. Dead banks shed employees, and cease to be very active making loans, stifling whatever pockets of growth the green shoots may be producing.

FDIC Bank Closures



The FDIC has been doing its job heroically, rescuing the insured depositors at 123 banks since the troubles began (99 this year so far) at a cost of $43Billion. With a capital B. That's paid for not directly by taxpayers, but by deposit insurance premiums paid by the banks in the past. Sadly the FDIC's saved-up surplus is just about gone. The FDIC has ways to borrow cash to continue its work, but its borrowing against the premiums that the surviving banks will pay in the future.

The FDIC arranges for a live bank to take over the useable remnant of each dead bank. The cost to the FDIC amounts to the cost of making the old bank's carcass solvent, plus a little sweetener for the rescuing bank's troubles, minus a little arm-twisting by the FDIC.

The FDIC is not giving money away, and as I said dead banks don't make loans. Even the dead portion of the new combined bank is a drag on the rescuing bank's ability to make loans.

Yeah, OK, fine, but is the market going to go up or down?

First: I'd love to know, but I don't. Second: It depends.

Market sentiment depends on many things, but especially surprises. The recent rally has come partly from the relief of waking up still alive, and partly from the better-than-expected results from some companies, even from some banks, car makers, house builders, and other objects of concern.

There's dangerous self-reinforcing feedback here. The pleasant surprises make the stock market go up. Because many people believe that the stock market predicts the economy, that makes people expect more pleasant surprises to come, and they bid the prices up to match.

If there's a cluster of alarming surprises, the mood will be broken and the cycle will turn to self-reinforce downward.

> A key to investing well is a willingness to look stupid, Buffett says. "Most managers have very little incentive to make the intelligent-but-with-some-chance-of-looking-like-an-idiot decision," Buffett wrote in 1984. Most would prefer "failing conventionally." He added: "Lemmings may have a rotten image, but no individual lemming has ever received bad press."[2]

The question then is, are there enough rational investors out there making hard-nosed, flint-eyed, no-punches-pulled estimates of future business results? Is all the remaining bad news of foreclosures and bank failures and production and consumption decreases known, and realistically factored into stock prices?

Or are some investors allowing themselves just a bit of rose-colored vision? We want the economy and markets to go up. Only pessimists and spoilsports insist on allowing for unknown problems and disappointed hopes.

I have no proof, but as a card-carrying spoilsport I'm concerned that the world economy is still too fragile to allow a rosy view of stock prices. Hey, it could happen, but I'm not eager to bet my money on it.

The disaster phase of the financial meltdown is almost certainly over, but the good times are not yet ready to roll.

2 Ben Steverman, "How Buffett Bounces Back: The ability of the 'Oracle of Omaha' to recognize and learn from his missteps is one of his greatest strengths as an investor," BusinessWeek, 8 July 2007, The McGraw-Hill Companies, 2 July 2007 <http://www.businessweek.com/investor/content/jun2007/pi20070629_065445.htm>.

I've been asked by several friends about gold as an investment, whether via the stocks of the mining companies, or via the Exchange Traded Funds (ETFs) which offer a collective way for investors to hold gold bullion and reduce the cost.

Arguments for:

- If the dollar falls, the dollar price of gold rises.
- Gold is viewed as a hedge against inflation.
- Gold (along with ammunition and beer) is viewed as the ultimate portfolio for the end of the world as we know it (EOTWAWKI.)

Arguments against:

- Gold does not pay a dividend. It's a pure play on price appreciation.
- It's a very thin market. It may sound impressive that central banks hold thousands of tons of gold, but the total value is very small compared to the stock or bond markets. A modest surge of buying interest can drive the price up very fast, but a similar modest decrease can pound the price down at least as fast.
- If there's deflation, or even very very low inflation, then after a possible EOTWAWKI bounce the price of gold will likely fall.

Longer-term readers may recall that I liked gold off and on, mostly on, for years leading up to the crisis, but right now I don't see the balance of risk and returns, knowns and unknowns, as attractive. I can always be wrong, but that's my opinion.

What to do then? Other parts of the world were less hurt by the financial bust, and are already growing again: Brazil, India (despite a very bad year for farmers), Europe, Chile, Korea, and Taiwan to name a few. Any ETF or mutual fund that's heavy in stocks from those areas could be very good.

High-quality corporate bonds in those countries (for example in a fund such as BEGBX) yield a decent premium interest rate over the modest returns on Treasury bonds. As the economy improves, the rate premium should decrease, yielding a capital gain on the bond price. Any fall of the dollar will increase the gain. If there's a big increase in inflation, though, bonds would be hurt. I don't expect increasing inflation for quite a while.

This is important.

Lucky you, it's **Credit Check** time again! Once per year per Credit Agency you're allowed to get a free copy of your Credit Report, quickly, online. Honest, it's quick and free. Do it now!

If you've been following along with my every-four-months pace, you're ready to go to Equifax (again.)

It's easy, and to make it even easier I've taken notes from my own recent visit. You can follow the instructions at http://www.longspliceinvest.com/CapDrain/Equifax.pdf .

If you have trouble with the online process, you can fall back to printing and mailing the request form.

It's time to re-re-check everything and send 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 (sporadically, I admit) the process and progress of starting the mutual fund, along with occasional economic or investing thoughts.

Please forward this to any friends who are interested. Thanks!

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