Capital Drain

Rick's investment opinion newsletter January, 2010 v.6 no.1

Before printing, think about the environment

Hi Readers,

I've been distracted by other projects, so I've neglected this newsletter terribly. I'm going to make this short and sharp, and fill in some points next letter.

By the way, it's anniversary time. It's now been (just over) five years since I wrote and shared my first newsletter.

So, here we go. In my opinion:

Executive Summary:

- Economic growth GDP is good
- Leading Economic Indicators index LEI is good
- Very dependent on stimulus, of which about 1/3 has been used.
- Many other parts of the world are recovering nicely
- Money is in the banks, but not being lent to small business or consumers
- Excess liquidity → bubble in speculative assets (financials, commodities.)
- Gold, commodities, stocks, junk bonds overpriced
- Long-term treasuries? Maybe attractive.
- The key: inflation? Unlikely.

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 still conspicuously losing money, you might consider selling them into this bounce. 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 diversification, value, safety, and call me to chat if you're concerned about anything you're holding.

Above all, as ever, avoid the investments that are at all-time extreme valuations: junk bonds, developing-country bonds, and headline-grabbing stocks with "can't lose" stories and high P/E ratios.

The Details:

The strength of the rise in the economy as measured by GDP has been surprising. The third quarter (3Q) GDP was better than I expected, and 4Q was better than almost anyone expected. Clearly the stimulus is doing something good. Whether the good effect will continue without a dip is hard to say.

Further, the Conference Board's Leading Economic Indicators continue to rise steadily, now for the tenth consecutive month. That's excellent news. The coincident indicators, which reflect current business activity, have been rising for six months, consistent with the quarterly GDP measures. Even the Lagging Indicators, which are useful because they confirm that the trends have reached even the slowest-reacting parts of the economy, are slowing their fall to almost flat.

To be sure, the good news is coming from the Federal stimulus, which won't last forever. So far, only about one-third of the stimulus money has been spent. There's more to come. Further, part of the point of stimulus spending is that creating jobs doesn't just employ people to do something useful: it also gives them money to spend. That spending wends its way through the economy, helping (eventually) almost everyone.

With the recent release of the 4Q GDP, there was some grousing that a big part of the increase was not from final sales to consumers, but from retailers restocking their shelves. Some were spinning that as "not a real recovery," but they miss two essential points:

- Retailers are restocking because they see that consumer buying is picking up, so their depleted inventories are too small.
- Increased goods production to restock inventories requires more workers, creating more take-home pay, and more spending.

The self-reinforcing decline appears to be becoming a self-reinforcing expansion. By the time the stimulus money runs out, the expansion may (should) have enough strength to continue building on its own.

Furthermore, this bank-crisis-precipitated recession hit other countries in proportion to their own bank excesses. That means that most of the world, having been less exposed, was less damaged and is recovering sooner. Most developing countries are already expanding again. Even England and the most of the EU developed countries are expanding. Their expansion creates more demand for imports from us, further reinforcing our recovery.

Broadly, then, the 'real' goods-producing economy is getting better. What about the banking part of the economy?

Not so good, and not very helpful. First of all, the FDIC is still having to close and take over an average of nearly a bank per business day. As I wrote in September, dead banks don't do much lending. The rate and cost of bank closures is clearly not leveling off. This is particularly unhelpful for the economy because these small (relatively) banks are the ones that lend most to individuals and small local companies. With those banks ailing, they are not able to support the many individuals and companies which are doing well enough that they could use-- and repay-- new loans.

If all the bank-bailout money we've heard about isn't being lent to Main Street, where is it going?

First of all, it's helping keep many other banks alive. They'll lend more as soon as they can, but for the moment they're having to repair the damage of big losses on bad loans.

Second, most of the money went to banks bigger than the ones the FDIC is rescuing. Those bigger banks have different customers and profit mechanisms. Specifically, through lending to speculative investors (for example, hedge funds) or through their own proprietary trading, they are interested in using their money for investment capital gains rather than just earning interest. They're taking greater risks, generally, and they're helping fuel the price rises of investable assets;

The economy is recovering a bit, but stock prices have run up a lot. Too much, I think. Companies' profits will improve, but not soon enough or high enough to justify the current prices. Higher-yielding (riskier) bonds have been bid up as well. Similarly, oil and other consumable commodities will see increasing demand, but not such dramatic increases as are already expected as justification for their higher prices.

If corporate profits continue to grow slower than would justify their current high prices, then there may be a renewed sell-off until prices reflect lower expectations. Personally, I would not buy stocks or commodities at this point. It may even be time to sell some, just to lock in the past nine months' gains.

Inflation, gold, the dollar, and bonds are particularly tied to one another by uncertainty.

Some analysts expect inflation to rise, caused by the money-creation of the bank bailout and the stimulus. They recommend buying gold, an anti-inflation stalwart, and selling or avoiding the dollar and bonds.

Other analysts point out that inflation doesn't come from the money supply itself, but from too much buying chasing too few goods. With the current high levels of unemployment and idle factory capacity, companies and people paying down their (on average, high) debts, and the relatively low levels of spending, rising inflation seems highly unlikely. Moderate levels of deflation are still possible.

I agree more with the no-inflation group. I would not want to own gold, or high-PE (or money-losing) stocks. There's essentially no incentive to own short-term treasuries; your mattress pays almost as much interest.

What does that leave? Carefully picking through overseas countries or stocks could find some areas that have not been over-hyped and overpriced. I'll get back to you on that in the next letter.

The real dilemma for me is whether long-term US bonds are a good deal.

Some assume that when the Fed starts raising short-term rates, that long-term rates will rise to follow, causing capital losses for long-term bond holders. However, the logic for their expectation is that the Fed would be reacting to inflation, and the raised inflation expectation would be the reason for longer bonds becoming unappealing. What would happen, though, if the Fed starting raising short rates back to normal levels before higher inflation was visible? I think that long-term bond yields may even fall, as the fear of renewed inflation was decreased by a timely Fed preemptive rise in the short rate.

If that happens, then bondholders could see a capital gain in addition to earning the current 4+ % dividends.

It's not certain, but I'm inclined to think that long-term Treasuries and selected very good AA corporate bonds could be the best available investment for the moment.

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 forward this to any and all friends who are interested. Thanks! If you got this as a forwarded copy, you can get on the list to get your own future copies directly by sending me your email address.

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