Capital Drain

Rick's investment opinion newsletter November, 2010 v.6 no.4

Before printing, think about the environment

Hi Readers,

I hope you all had a delightful Thanksgiving, and are well on the way to recovery, and building your strength for the December holidays.

Without further ado, in my opinion:

Executive Summary:

- Avoid the crowd
- I still like last month's investment selection, and I'm sticking with it.
- Slow recovery, tough for the working and middle classes
- QE II folly
- The difference between inflation and a bubble
- No inflation coming
- Un-printing money

US stocks have had a pretty sprightly recovery. Most of those are nice companies, but the prices reflect high continued growth expectations. If you're holding shares of any of the conspicuous high-fliers, you might consider selling them into this bounce. It is safer to risk gaining a little less rather than risking losing a lot more.

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:

No one goes there anymore, because it's too crowded.
--Yogi Bera

A few days ago a friend earnestly told me that "everyone's buying gold." Or maybe it was developing country junk bonds, or... no, really, I don't remember what. My response to the comment was, "And? And what does that mean for us?"

"Well, we should buy it too, because look how much it's gone up!

No, and no.

When everyone is buying something and the price is way up, it is the worst time to join the rush. If everyone has bought <<whatever>>, what is left to drive it up? It's already so high, so why should it be higher still?

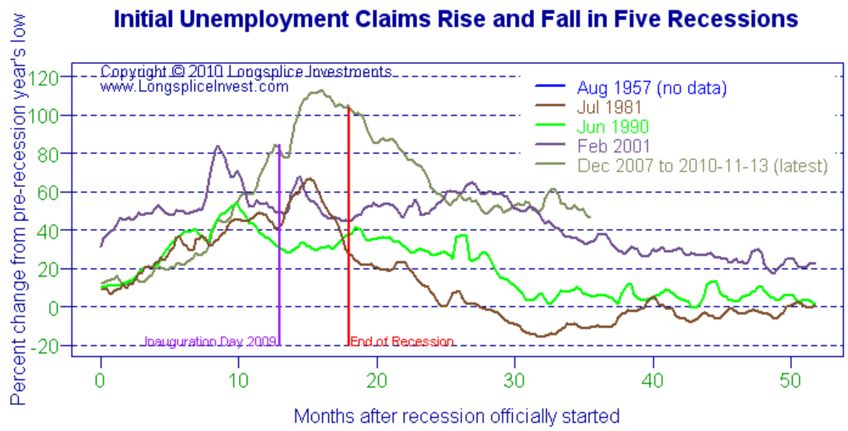
You want to make your investments before prices go way up, not after. Simple, right? But I keep hearing the opposite. You want to move to a good investment before the bulk of the crowd, not after. You don't have to be one of the first to get a good investment idea, but you definitely don't want to be one of the last.

For every bubble there is someone who followed the crowd and the rising price--and bought at the very top. When you chase the crowd, you risk being that person, and have a high chance of losing almost as much as that person will.

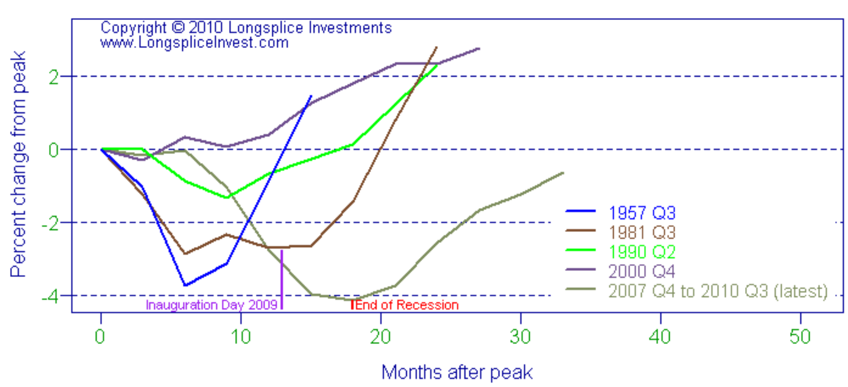
I wouldn't even bother writing this, it seems so obvious, but I keep hearing the same crowd-chasing talk from people who I know are otherwise quite smart. Don't do it.

Very briefly, I still liked the investment approach I described last month (starting page 3, specifics at the bottom of page 4.) The two-penny summary is: dollar is safe, gold is overvalued, bonds' best days are over, and the best idea standing is the stock of strong companies with attractive dividend yields.

Initial Unemployment Claims Rise and Fall in Five Recessions



Real GDP Fall and Recovery in Five Recessions



As I mentioned starting in January (top of page 2,) the economy is improving steadily but still too slowly.

Happily, the pace of improvement is picking up.

First-time weekly unemployment claims

are falling, although still at a recession-like level. GDP has risen nearly back to the pre-bust level, although that's far below where it would be had the crash never happened. The pace of FDIC closures of failed banks, and the cost of closing them, have slowed to their lowest rates in years.

These little steps are important. Just as the recession was self-reinforcing on the way down, the recovery is self-reinforcing on the way up. Each person not laid off, each extra increment of GDP, and each newly hired worker help build the economy toward hiring more and recovery.

That said, unemployment is still very uncomfortably high. American workers and the middle class are still in trouble, and still in pain.

The Federal Reserve's new program of Quantitative Easing (QE II) is unlikely to help. It won't hurt much either, except for the illusion it creates that the government is doing something.

Quick review: what is QE anyway? Ordinarily, the Fed can speed up or slow down the pace of the overall economy by raising or lowering their overnight Federal Funds interest rate. In normal times, that works. Lower rates encourage businesses to borrow and invest in profitable new projects; higher rates make it more difficult to be assured that new projects would be profitable, so many are held back.

This is not a Wall Street phenomenon, it is Main Street, the commercial economy. Commerce PULLS money out from the Fed (borrows) when the interest rate looks attractive, and borrows less if the rate is too high.

In a deep recession like this, that system breaks down. The economy is down so low, and so many people are unemployed, and so many employed people are scared and paying down debts and not spending, and so many businesses see no need to expand anything, that the pull isn't there. Not even a very low interest rate can induce Main Street to borrow more, or induce Main Street banks to lend to customers that are in trouble. Not even a rate that's near 0%. With no pull, the Fed is left trying to "push on a string."

Quantitative easing tries to address that. On the assumption that more money in the financial system has to end up on Main Street somehow, the Fed is pushing more cash into the system, or "printing" money. I've got a more detailed discussion of the process below, but for now let's just accept this: the Fed can put more money into the biggest banks in the country. The Fed expects (hopes) that the money will help create more Main Street- level economic demand.

You can look at the headlines right now and see the problem. The cash is not making its way from the big Investment Banks (IB) to the smaller Main Street banks and commercial and individual loans. Instead, the IBs see more potential profit and less risk by loaning the money to private equity, hedge funds, and commodity speculation. Those are not activities that contribute to GDP or hiring. Those are, however, activities that can generate financial bubbles.

QE II can push money into the big banks, but as currently designed it can not push the money all the way to Main Street.

To actually put the $600B QE II money to work, the Fed would have to hire the unemployed as 'special assistants' and pay them to do something-- anything. Those new earners will spend more, GDP rises by definition, and the recovery takes off.

Next month (which will really be next week) I'll add a discussion of the other dimension of this, stimulative spending versus budget deficits.

Some people are afraid that the massive Fed actions increasing the money supply in the financial system will necessarily cause inflation. I am not.

First, a definition: The difference between inflation and a bubble is that inflation is an increase in the price of every-day goods and services, whereas a bubble is an increase in the price of some sort of investment asset (gold, houses, collectables (including rare tulips, for example,) oil futures, dot.com.fantasies, etc.) In either case, too much money is chasing too little of something; the only difference is whether the something chased is a Main Street thing or a Wall Street thing. One can happen without necessarily affecting the other.

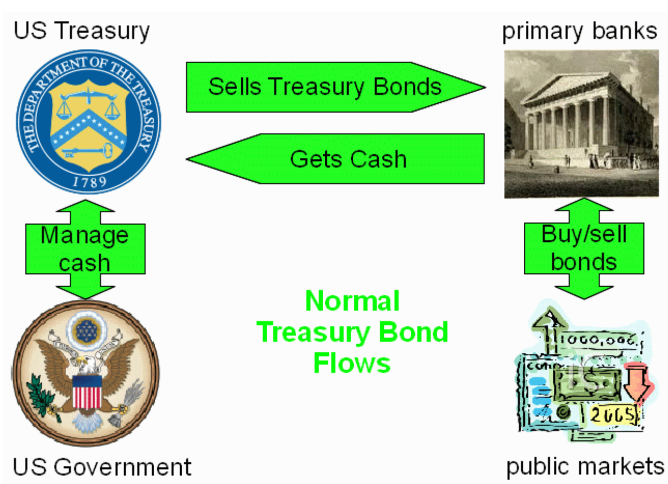
With the economy and job market as weak as they are, it is very hard to see too much consumer money chasing too few consumer goods, or even too much commercial money chasing too few production goods. I've gone over this topic before this past January (middle of page 3) and April 2009 (bottom of page 4.) When the facts change, I will change my mind.

Inflation is still possible only if the Fed screws up. They've created all this money, but they need to un-create it quickly when the Main Street economy starts to run hot.

How does the Fed un-create money?

First let's review the normal processes of the two big government financial players, the U.S. Treasury and the Federal Reserve.

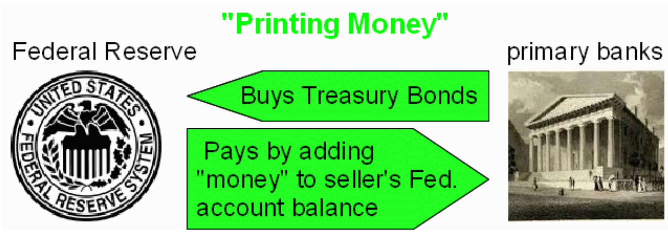
The Treasury is the every-day ATM for the U.S. Government. It keeps the money collected in taxes, and it pays out money to other government bodies according to the laws passed by Congress. They are not allowed to overdraw their account. If they need cash either 'til payday (the days big tax filings are due) or on a longer term, the Treasury sells bonds-- Treasury Bonds-- to the market via a handful of big banks.



Note that in this case the Fed is not involved. The bonds are sold to private investors in the public market. The money supply stays the same, some of it just changes hands.

(When there was a budget surplus the Treasury also sometimes bought bonds with surplus funds. For now, though, nevermind.)

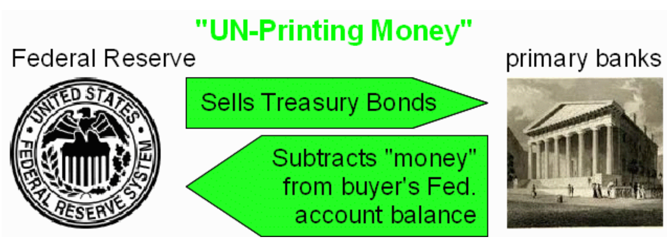
Quantitative Easing is when the Fed steps in to add more money to the money supply, colloquially called 'printing money.' I should point out that QE is not like the historical (and a few contemporary overseas) examples. The unambiguously bad type of printing money is one-way. The issuer prints money and uses it to pay for government functions.



QE, on the other hand, uses the new money to buy Treasury Bonds. It's a crucial difference because now the Fed holds something of value, bonds, which it can sell back to the market later.

No actual money is printed; it's all done electronically. The Fed places an order for some bonds with a big bank/bond dealer. The bank delivers, and the Fed-- rather than delivering actual cash back-- simply reaches into that bank's computerized account and increases the balance by the appropriate amount.

Quantitative Tightening (QT,) or "Un-printing money," reverses that flow. Here again, note that the actual money-printing disasters involved a government that had no intention of un-printing, ever. QT is the reason inflation need not be our destiny.



The Fed offers some of its collection of Treasury Bonds back to a big bank/dealer. At their agreed price, the Fed delivers the Treasuries, and then its computer reaches into the bank's account and decreases the balance by the agreed amount. ***Et voilá***, the 'money' no longer exists. It's that simple.

That's why the Fed can be confident of decreasing the money supply very quickly if inflation starts rising. The only remaining question is whether they will do the right thing at the right time. There may be an inflation problem if they're too late or too slow with the QT. We'll just keep an eye on them as things progress.

One last thing: the housing market in the US is a huge mess, and will stay that way for quite a while. With the backlog of foreclosures and high unemployment, more houses are going to come onto the distressed-housing market for several years.

Some local markets may start to rise, or may even be rising now. However, before investing your precious time or money into the real estate market, you need to ask yourself "Why is this [city | neighborhood| property] so much better than the national average?" If you can't come up with a solid quantifiable logical reason [high local employment | high local rental rates | very low local foreclosure rate], then wait. There are lots of other things you've "always wanted to do but didn't have the time." Do one or two of those. Three if they're small. Then, maybe, the housing market will be beginning to recover.

That's it for now.

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,

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