Capital Drain

Rick's investment opinion newsletter February 2012 v.8 no.1

Before printing, think about the environment

Hi Readers,

I try not to write a boring newsletter, but lately the more things changed the more they stayed the same. Despite all the headlines and deadlines, the economy is still improving slowly, and solid old-fashioned dividend stocks are doing fine.

I'll see if I can find a few new tidbits to add to that.

In my opinion:

Executive Summary:

- Where we are: still improving slowly.
- What if the economy keeps going up? The stock rise will broaden.
- What if the economy turns down? Dividend stocks have support.
- A review of the dividend stocks: still OK.
- Housing is becoming more normal, but not a good investment.

> The recovery continues, and many US companies are doing well, but the prices reflect high continued growth expectations. If you're holding shares of any of the conspicuous high-fliers, especially the "hot" new tech IPOs, you might consider selling into this renewed bounce. Better to risk a little less gain rather than a lot more loss.
>
> 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 (or no E).

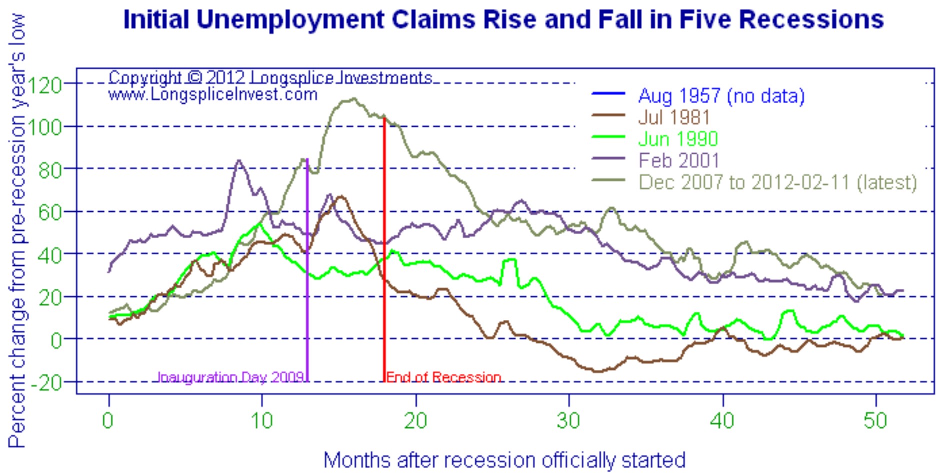
The Details:

"Annual income twenty pounds, annual expenditure nineteen pounds nineteen and six, result happiness. Annual income twenty pounds, annual expenditure twenty pounds ought and six, result misery."

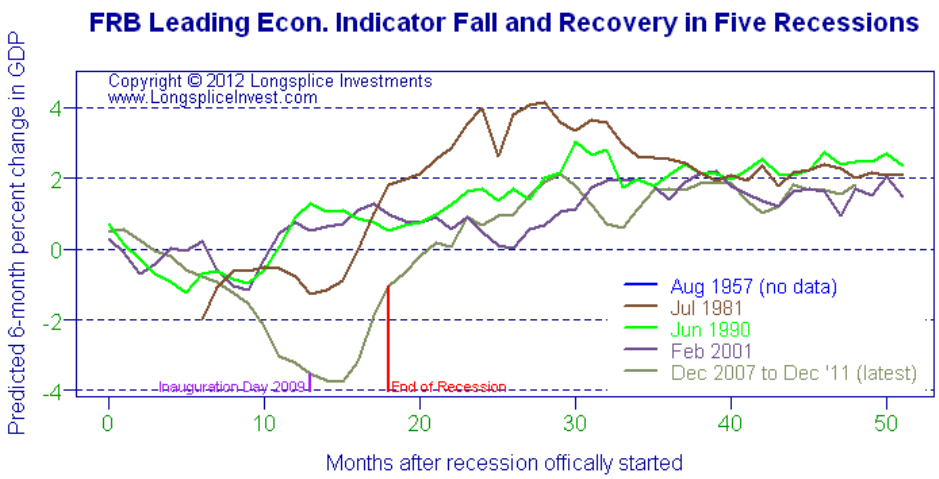
– Charles Dickens (as Wilkins Micawber in David Copperfield)

> Job openings in the U.S. increased in December by the most in almost a year, showing employers are gaining confidence the economy will keep growing in 2012.
>
> The number of positions waiting to be filled climbed by 258,000, the biggest gain since February 2011, to 3.38 million... Payrolls increased by 243,000 workers last month after a 203,000 gain in December, and the jobless rate fell to 8.3 percent, a three-year low...
>
> "The labor market is gaining traction," said Henry Mo, an economist at Credit Suisse in New York. "The overall economy is doing well considering we have had a lot of drawbacks from overseas, including the European debt crisis."[1]

I see that more more news outlets are talking about the recovery, so I won't belabor the point. There are still risks, but recovery is happening.

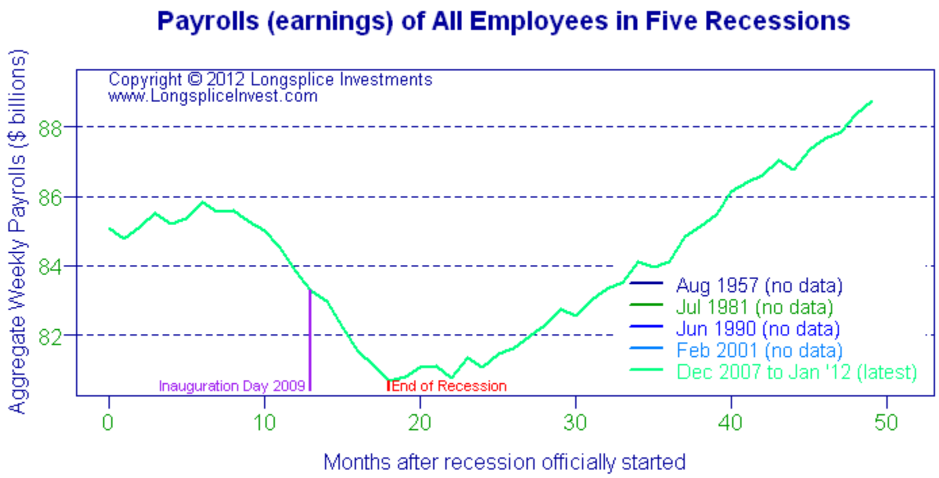


New unemployment claims keep falling, so the job market is returning to a more normal level of new layoffs. It's not yet at a normal level of hiring; there are roughly four job seekers per available job.

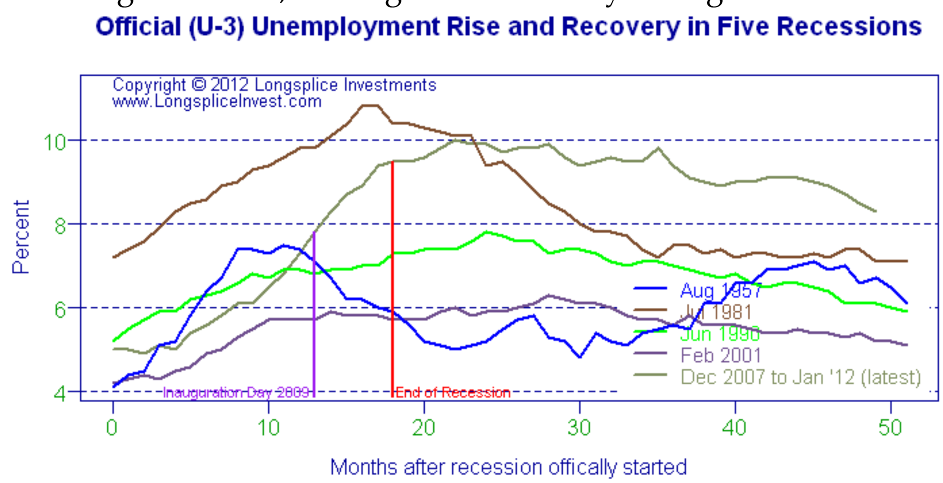


Both the proprietary Conference Board's and the Philadelphia Fed's public Leading Economic Indicator indices are rising steadily. These look at more factors, and their strength is very encouraging.

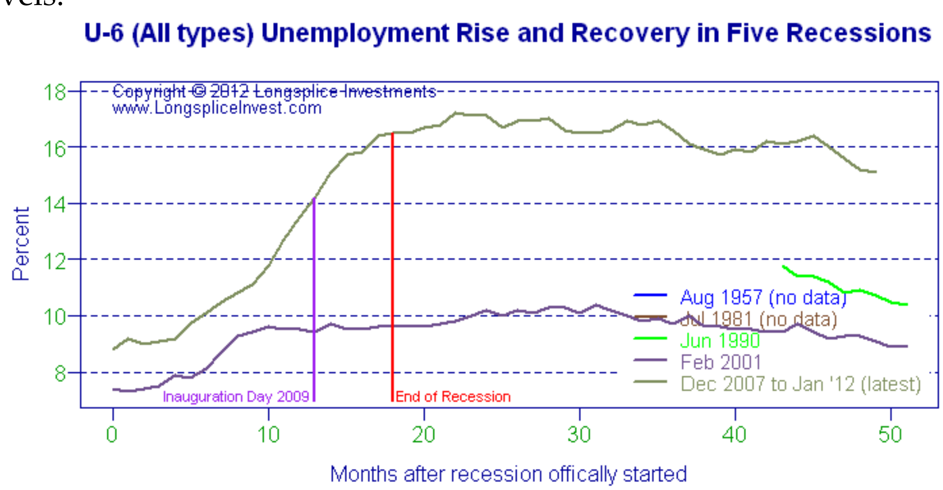
1 Bob Willis, "U.S. Job Openings Rise by Most in Almost a Year in Recovery Sign: Economy," Bloomberg.com, 7 Feb 2012, Bloomberg L.P., 15 Feb 2012 <http://www.bloomberg.com/news/2012-02-07/u-s-job-openings-rose-to-3-38-million-in-december-in-sign-of-confidence.html>.



Economic growth comes mostly from consumer spending, and consumer spending comes from consumer earnings. The aggregate earnings of the US workforce are back up to well above the pre-recession level, although population growth means that the per-capita earnings are still low but recovering. Still, more earnings are there, feeding the virtuous cycle of growth.



The official unemployment rate (people not working but actively looking) is starting to improve steadily. Note, however, that the absolute level is still higher than even the worst of the '57, '90, or 2001 recessions. We need a lot more job growth to get unemployment back down to "normal" post-recession recovery levels.



Counting all un- and under-employed workers, the picture is starker. About 15% of the workforce are unemployed, part-time but want to be full-time, or have stopped looking because there aren't jobs available. Don't judge the latter too harshly; employers can be and are being picky with new hires. Even a highly competent, skilled worker can be completely uninteresting to hiring managers if his or her skills aren't a perfect fit for an opening, and more perfect applicants are available.

That's where we are. Now what?

In particular, with the stock market back up to roughly pre-recession levels, are stock prices too high, too low, or already just right (meaning no significant rise still expected)?

I know that you know that I know that ***I don't know***. Right?

Still, I can look at the odds and form opinions.

One stock market saying is that "Bull markets climb a wall of worry." Analytically, there are always good reasons to be concerned, but usually most of the bad potential problems get sidestepped or solved gracefully. There are certainly good reasons to be concerned now. I think, though, that the Europeans will get through their debt crisis without a disaster (Greeks see that differently of course), and we will probably continue our recovery and reach a cyclically healthy level to deal with our own debt. The Fed is probably completely capable of preventing inflation once our recovery speeds up. (See the November 2010 newsletter, pages 3-5, for a detailed discussion.)

China seems able to handle their economic balancing act; Syria really does not affect us much economically; Iran is proud and stubborn but not stupid and probably won't create any long-term crisis; North Korea is relatively quiet.

In short, all the concerning things that you've already read about are probably not going to derail a recovery. Any real surprises might, but those are things we truly don't know about yet.

I tend to be pessimistic during Bull markets; they go up and I worry, just as the saying goes. In this case, I have enough confidence to stick with the dividend stocks that I've been with for the past 15 months, but not so much that I want to expand into the stocks that are more sensitive to the economy's ups and downs. Optimists may rush in now, and they may not be wrong. I'm happy being more conservative (in my investments).

Keep in mind, this is an election year. There is one faction which wants to paint the current administration as a failure, and to do so they've necessarily been pooh-poohing the apparent recovery. I do not agree with them.

If things go really well, the Federal Reserve will eventually start raising interest rates. Even if things go badly, someday they'll have to get better. When that happens, all bonds will start taking capital losses: as the interest rates rise, the prices of bonds fall to equalize old bonds with newly-issued ones. The risk/reward ratio right now in

Treasury bonds is horrible: almost no yield, insignificant chance of lower rates, and a guarantee of higher rates eventually. I'm not interested.

Corporate bonds yield more, but again they have the risk of rising Treasury rates, which tends to raise corporate rates as well. If the recovery is uneven or just slow, some of those companies could get into trouble and the bonds could be downgraded and lose value. It's complicated and I'm not interested.

Looking at the other side, if something tips the economy back into recession or negligible growth, then what? Again, bonds have little to offer. Adept market-timers may be able to catch the capital gains of falling rates, but it's tricky. Stocks that depend on earnings growth for share-price growth will also likely be hit hard.

We're back where I started: I'm sticking with strong companies with strong earnings even in the recession, which are paying attractive dividends from a fraction of those earnings. I think they have the least downside if there's an economic problem, they participate (if unexcitingly) in economic improvements, and they pay a better return than you can get anywhere else except high-yield bonds. They're a safe place to wait and watch.

Gold remains the favorite for people who expect runaway inflation or systemic collapse. I expect neither, and if neither happens then gold will probably continue its sporadic fall.

> 'Examining 250 properties around the U.S., and going through close to 40 client files to project the financial impact of owning real estate versus liquidating it, Arzaga, an adjunct professor in personal finance at the University of California at Berkeley, found that, "100 percent of the time it was better to rent, rather than own." '[2]

I still have no interest in housing as an investment.

It's true that some metrics are picking up: new construction is up, existing home sales volumes are up, in some areas the prices have stopped falling.

However, new construction is mostly apartment buildings for new renters. Sales are rising, but in most areas prices are dropping faster. The areas with stable prices are the areas with stable employment for professionals, like inside the DC Beltway, San Francisco, and core Silicon Valley. Even the fringes in good areas are still falling.

Meanwhile, the banks are still foreclosing on literally hundreds of thousands of houses. This can only be a drag on the market. The longer unemployment stays high, the more un- or under-employed homeowners will have to give up.

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2 Lou Carlozo, "Rich Arzaga owns a luxury home in San Ramon, California, but he's not betting on it as an investment," Reuters.com, 15 Feb 2012, Thomson Reuters, 16 Feb 2012 <http://www.reuters.com/article/2012/02/15/us-housing-americandream-idUSTRE81E1LG20120215>.

In economic theory, bad pricing leads to bad investment. The low mortgage rates and rising house prices of the early-to-mid 2000s led to excess investment in purchasing and building new homes. As we come out of the recession, there simply are not enough financially healthy buyers who do not already own homes. Supply will exceed demand until the economy gets back to roaring.

The housing bubble was an economic era all its own. Without the lure of rising prices, the only financial reason to own a home is if it is cheaper than renting. Since the 1980s at least, that has not been the case. The human urge to feel secure in a home that "is mine" is understandable, but it carries a price. The folklore that grew up around rising prices was simply a bubble, which we are unlikely to see again in our lifetimes.

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..

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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