Capital Drain

Rick's investment opinion newsletter May, 2013 v.9 no.2

Before printing, think about the environment

Hi Readers,

Memorial Day has passed so we're unofficially in summer, although there are still three weeks to go until the Solstice makes it official.

Overall, the world's economy is getting better, despite occasional "Crisis!" headlines. Slow and steady is winning the race, on average, most places.

In my opinion:

Executive Summary:

- The economy is still growing
- The Sequester is starting, but we haven't seen the big hit.
- Europe is the sickest of the big economies, but finally taking useful steps
- China is a puzzle, but probably OK
- Finance and bubbles: the downside of low rates
- The danger of rising rates

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 enthusiasm. Slow & steady for the long term will prevail.

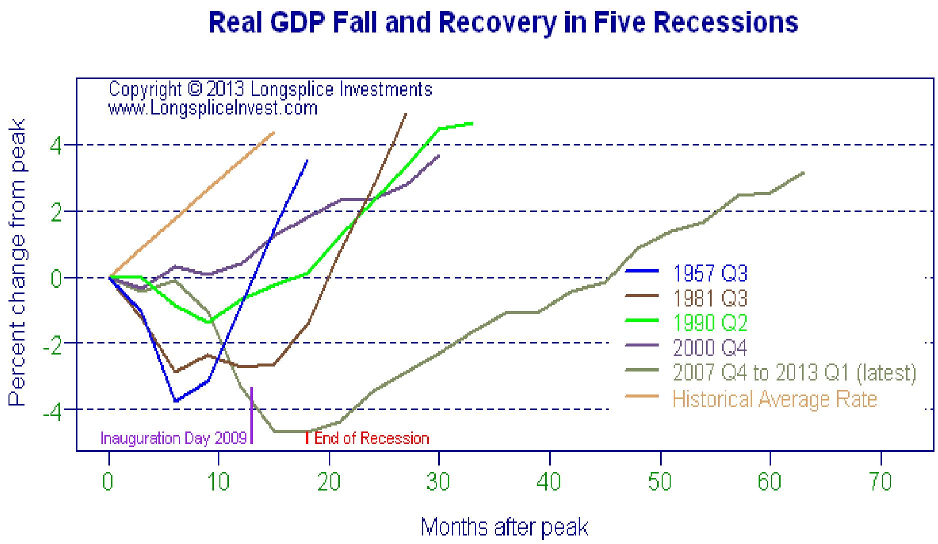
As confidence in the economy spreads, investing in all-market index funds becomes more attractive. We are likely reaching the phase where a rising tide will lift (almost) all boats.

If you're inclined to pick among individual stocks, be conservative and be in the best of securities: stick to value and well-run businesses, shift away from bonds, 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.

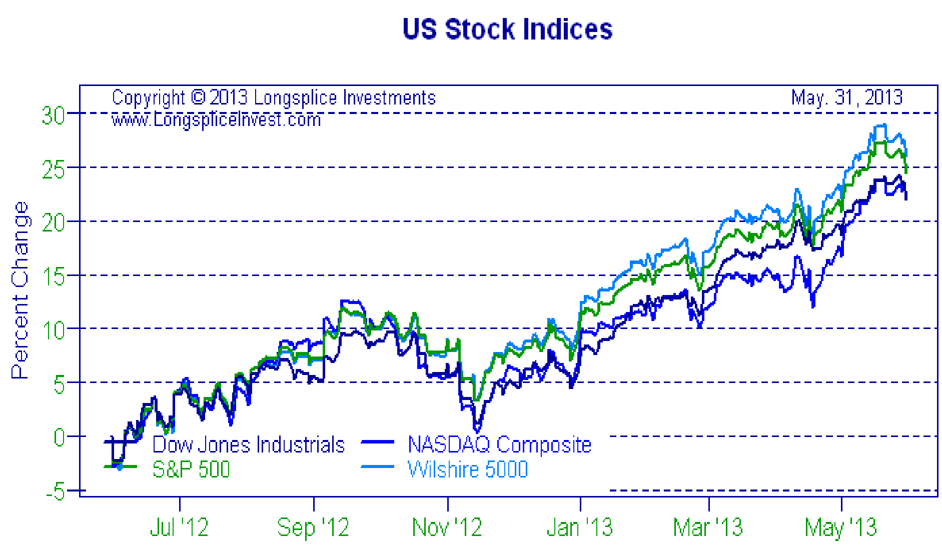
The Details:

One positive aspect of a very slow recovery is that it could also be a very long recovery. This applies both to improvements in the economy, jobs and GDP, and to rising stock markets. Simply put, even though we've been growing pretty steadily for more than four years, we are still nowhere near the level we'd have reached if the recession hadn't happened. That gap, growth we could have had but haven't had yet, gives us more years of improvement ahead without worrying about the usual cyclical limits to growth rates.



Note the new line on the same old GDP chart here. If we had kept growing at the historical (mean since 1950) rate instead of suffering a financial meltdown, we would have passed our present GDP level in less than a year. We could have a GDP about 11% higher than it is now.

That growth gap is still growing, furthermore. You can see how the growth rate in the recovery from previous recessions was steeper (faster) than the average rate. Like the 'jobless recovery' from the tech bust, this recovery is still slower than the economy's average growth rate. There's plenty of room for more stimulus, if we get a Congress that can put economics ahead of politics.



Again, while that's bad news for how things are now, it's potential good news for how the future could unfold: a long, steady continued recovery.

That, in a nutshell, is why I'm confident that the stock market is nowhere near it's top. Certainly there will be corrections, and there could be some sort of big disastrous “hit by a comet” type of event, but in general the trend now is up.

What sort of metaphorical comets might we be hit by?

There's still some chance of another financial crisis. The post-crash Dodd-Frank Wall Street Reform and Consumer Protection Act, already weak before it could get out of Congress, is now being stalled on its way to specific regulations, and nibbled to death by ducks in the form of Wall Street lobbyists intent on weakening it. If it's weak enough, it won't be strong enough, right? So maybe we'll have another humongous crisis and another chance to really get the laws we need. Maybe next time some of the perpetrators will be arrested and tried, too.

Did you hear this one?

> Q: Why was Bernie Madoff the only recent financial criminal to go to jail?
> A: He was the only one who robbed the rich.

Funny, huh.

The Sequester has started, but its effects will be felt bit by bit. There was the shameless comedy, of course, of Congress finding money for the air traffic control system so they wouldn't have to have their flights home delayed. Seriously, as much as the private sector has been adding jobs, half of that growth has been taken away by government employees being laid off and furloughed. Longer-term effects of canceled projects, delayed repairs, reduced scientific innovation, etc., will become more noticeable. (The cost of thousands of kids going malnourished and being poorly educated by program cuts won't show up for decades, so while it's a huge public policy issue it is not a short-term investment consideration.)

We can hope that the pain points will reach enough people to pressure Congress' obstructionists to get serious, but we may have to wait until the '14 election. Meanwhile, the effects aren't likely to be catastrophic, but they will be a festering self-inflicted economic wound.

Europe's self-foot-shooting is much more serious. Their austerity programs have forced crippling recessions on at least two countries, and severe recessions on others. Even Germany is starting to see its economy slip, as all its regular regional customers stop buying. Fortunately the hard-core austerity ideology is being pushed aside by more reasonable thinkers. It's still possible that Europe could go over a precipice into a deep regional recession; that would be bad for everyone and might drag us down too. Maybe not, though, maybe Europe will just be a limping economy that won't help drive a world recovery.

China has perhaps the most uncertain outlook. They have serious problems with overbuilt factory and residential sectors, lots of loans that likely won't be repaid, and lots of banks that will be insolvent if the loans go bad. On the other hand, the Chinese government certainly knows about the problems, and for two decades they've been quite adept at making big changes when needed. Any big unpleasant surprises for China will be extremely unpleasant for the entire world's economy, but they may keep it under control.

Perhaps this would be a good time to remind you of the old adage “Bull markets climb a wall of worry.” Yes, there are lots of things that could go wrong now, and to a greater or lesser extent there always are. Long stock market rises happen when the dangers are known, worried about, and prevented or mitigated. Economic danger, in normal doses, is not enough to stop a bull market.

Since Congress is being hamstrung by zealots, it has fallen to the Federal Reserve Bank system to do most of the work of helping the economy recover. The Fed's only tool, though, is the money supply: basically they want to make sure that if anyone anywhere has a good idea for creating jobs and income, that borrowing money to implement the idea won't be too difficult. The Fed has been very creative lately in trying to get the money into the economy in new and different ways.

Unfortunately, all the Fed's channels to the economy run through big banks. The Fed can't even lend directly to state or city governments to fund, for example, infrastructure projects. Instead, the Fed must lend to big banks, and the invisible hand of pursuit of profit is supposed to tempt the banks to lend in economically useful ways.

Compounding the misfortune, the post-Glass-Steagall banks combine traditional loan-making with big-time deal-making and purely financial speculation. The Feds can't say "Hey, all this free money you're getting is for Main Street projects only." And the bankers realize that speculation is immensely more likely to give them big quick gains, the lifeblood of their option-and-bonus-based pay system. So, the invisible hand works fine, in that the banks pursue profit. Unfortunately the profit opportunities they pursue don't help the real economy, at least not in any proportion to the unprecedented enormous sums of money the Fed has given (OK, lent for a pittance) them to play with.

Way back in November 2010 (mid p.4) I wrote about why I'm not worried about inflation and how the Fed can undo all of its lending when the time comes. That discussion assumed that the Fed lending would be used the old-fashioned way, being re-lent into the real economy. There's one important difference now that so much of the QE money is in the financial speculation market: when the Fed starts tightening (calling back the lent money), and interest rates rise, many speculative trades will no longer be profitable-- so they'll be closed, meaning bought back or sold so the traders have no remaining bet. All that motivated buying and selling may turn out to be disruptive, particularly because a lot of traders herd together and are in the same or similar trades.

For the rest of us, especially retirees and savers, the end of the Fed's forced low-low rates will be welcome. Once the Fed stops giving money away, banks will once again have to start paying decent rates to savers to attract funds.

The Fed doesn't come to me for advice, but with all their clever maneuvering to use monetary policy to try to stimulate the economy, it would have been super-helpful if they'd found ways to force more money to main street. Subsidizing higher interest rates paid to small savers, for example, would have increased income and consumption and GDP far more than what actually happened. Lending not to big (investment) banks but to consumer and small-business banks would have encouraged more local job-creating re-lending

Next in our list of worries comes the downside of rising interest rates. I've been saying for a while now to get out of bonds because of capital losses to come. That may be too technical, so let me try a quick example. If this doesn't make sense, let me know and I'll re-work the explanation.

Bonds don't actually pay an interest rate, they pay a defined coupon or interest payment.

Just to keep the math simple, let's consider a 1-year bond that, when new, pays 1%. That really means it pays $1 per $100 of face value, no more and no less, no matter what. If 1% is the market rate, you'll take that deal and pay $100 to get $101 back in a year. You do it.

Suppose, though, that the market rate rises to 2%. This is an extreme rise in real life, but it makes the story obvious.

Now, you could buy a bond that pays $2 back per $100 of face value. You'd pay $100 to get back $102 in a year.

Suppose, though, that you have to pay the rent, so rather than buying more bonds you're selling one you own from before the rate rise. You're looking for a buyer.

Any buyer now could pay $100 to get $102, so you are not going to get anyone to pay you $100 to get $101. You have to reduce your selling price to make your old bond equivalent to new higher-coupon ones. In round, simple, numbers, you would have to sell your old bond for about $99 and a little change, so the buyer could get back the $102 per $100, by getting back $101 (the bond's original price and fixed $1 coupon) per roughly $99 paid.

You, having paid $100, end up with $99. You suffered a $1 (per $100, or 1%) capital loss because the interest rate rose.

Back to real life, this is about to happen to almost all bonds. Sooner or later the Fed will tighten, and interest rates will rise.

Long-maturity bonds are affected more than short, because the annual compounding accumulates. Imagine our example as a 30-year bond paying $1 coupons each year for 30 years (and the $100 principal at the end of the 30). What happens when buyers can get $2 back each year for 30 years? How much would that decrease the buyer's offer for your $1/year bond? Answer: a lot.

Adding to that, most small investors don't hold actual bonds but rather shares in a bond mutual fund. Funds buy and sell bonds frequently, so they take those capital losses right away, and pass them on as losses to the fund shareholders. That happens whether you need to sell your shares to pay the rent or not. That's important: in our first scenario, if you hadn't needed the cash, you could have held your 1% bond and gotten the $101, not the $99 you ended up with by selling. In a bond fund, the fund sells, and you get the loss, even if you had no need for the cash. Bond funds are really really bad when interest rates are rising.

That's enough jabber out of me 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..

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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