Capital Drain

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Before printing, think about the environment

Hi Readers,

A lot has been happening in the world, but it hasn't changed my thinking about what investments have the best risk/reward ratio for the moment.

I realize, though, that just because I'm thinking “same old, same old” doesn't mean you're not wondering what's going on.

So, here's a very quick filler letter. I'll have a fuller letter in November. Promise.

In my opinion:

Executive Summary:

- The recovery continues despite all the noise and drama.
- A government shutdown or debt default is unlikely.
- Life gives us lemons, our lemonade is very low inflation.
- Will the end of QE cause withdrawal symptoms?

The recovery continues, many US companies are doing well, and the prices reflect continued growth expectations. The big picture is good, but there is some froth among hyped popular stocks. 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. Better to risk a little less gain rather than a lot more loss.

As confidence in the economy spreads, investing in all-market index funds becomes more attractive. We are likely approaching the phase when 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, to safety, to good solid dividend yields, and call me to chat if you’re concerned about anything you’re holding.

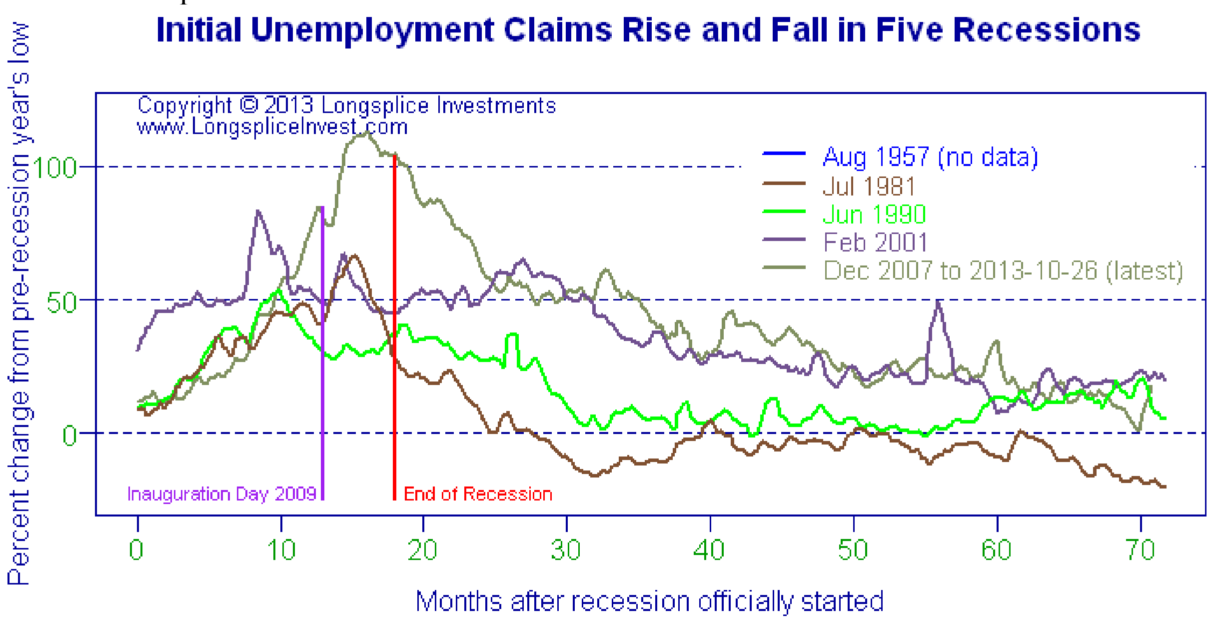
Above all, avoid the investments that are at all-time extreme valuations: junk bonds, developing-country bonds, and headline-grabbing stocks with high P/E ratios.

The Details:

Well, wasn't that interesting? We got a government shutdown, we threatened to default on debts, we watched one political faction demand the sun and the moon and then scale back to asking for, and getting, nothing.

Something good may yet come of this-- with luck it will mark the end of the Radical Right “Tea Party” reign of error. They fundamentally misunderstood their political strengths and weaknesses (not to mention Macroeconomics), and picked a fight they couldn't win. Next time, one may hope that they'll be told-- by the rest of the Right-- to please hush while the grownups are talking. Another government shutdown or an actual debt default is much less likely now that we've seen one up close.

The shut down did a bit of damage, in lost government wages, some lost greater-economy wages, delayed private investment, and so on. That's clear enough in the new unemployment claims. Our question to ponder is whether the bounce back from the economic fumble will be quick or slow. We'll see.



After having fallen to the same level as the low before the recession, the initial claims have quickly popped back up to about ten months ago's level. How quick will the re-recovery be?

By the way, in the next letter I'll have re-done all the charts to compare the five recoveries, not the entire recessions. The decline is clearly past, so we want to see what we can learn from the history of prior climbs, from the bottoms of the troughs of the recessions upwards.

The long, painfully slow recovery is at least giving us very low US consumer inflation. That in itself isn't a huge help to anyone, but at least it is no additional harm. The low interest rates that small savers (including many retirees) and pension funds earn is a problem, but at inflation would make that worse. Let's count that as a blessing.

The big question hanging over the economic future is whether the end of the Federal Reserve's Quantitative Easing injection of money into the financial system will cause withdrawal symptoms. QE has been a great pain killer, especially for the big banks.

Aside from keeping the bankers from panicking, it hasn't done much for the rest of us. That's why we don't have inflation: despite all that massive money supply in bank vaults, we do not have a lot of consumer demand, so there is nothing remotely resembling too much money chasing too few consumer goods. Until more of the money reaches workers, so they can become buyers, so producers will hire more, the QE money is having no effect on Main Street. The whole virtuous economic feedback system of growth is creeping rather than leaping forward.

When the economy starts to leap, the Fed will be pretty careful to first reduce QE, then actually to reduce the money supply. When the bankers' little heroin drip is cut off, will they simply return to normal, or perhaps have a headache-y hangover, or go into convulsions?

The answer comes from a different question. What has all that QE money been doing, really? It obviously hasn't been going out to US job-creating small and medium company loans. Those come from small and medium banks, which haven't been getting the hooch. The big (bigger than ever, and still too big to fail) banks have been making lots of bets around the world. They've bet on big and small developing countries' stocks, on commodities inflation, and lots of other big, bulk portfolio bets. It's easier to get in and out of that kind of bet.

Thus far, we've seen them get in. What we don't know, what I can't predict, and what we'll have to wait and see, is how disorderly it will be when the big banks try to get out of those bets. Keep in mind, they're betting with borrowed (from the Fed) QE money. If that money is withdrawn, the banks HAVE to sell something to return the money. Can the Fed get the balance right, necessarily avoiding inflation but also avoiding deflation? It depends. We'll see.

I'll definitely be watching for signs of the change's direction, and you'll be the first to learn what I see.

That's it, until next time.

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