Capital Drain

Rick's investment opinion newsletter December, 2013 v.9 no.6

Before printing, think about the environment

Hi Readers,

Oops, I promised a letter in November. My apologies, it's now mid-December. Sorry to have kept you waiting. On the other hand, the newly modified charts, showing progress since the recession ended, are ready now.

The charts show decent but slow progress.

Expect a long slow continuation. That could be better, but it is good.

In my opinion:

Executive Summary:

- Conditions are improving, but frustratingly slowly.
- The Fed's continued low rates are pushing bond investors into bigger risks.
- Selling oil companies; they've had their day.
- Time to start thinking about selling the dividend stocks.
- It's credit check time: Experian Experian A world of insight

The recovery continues, and many US companies are doing well, and the prices reflect continued growth expectations. I remain leery of the conspicuous high-fliers, especially the "hot" new tech IPOs. Maybe I'm just too stodgy to go for what I think is glamor with insufficient substance.

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.

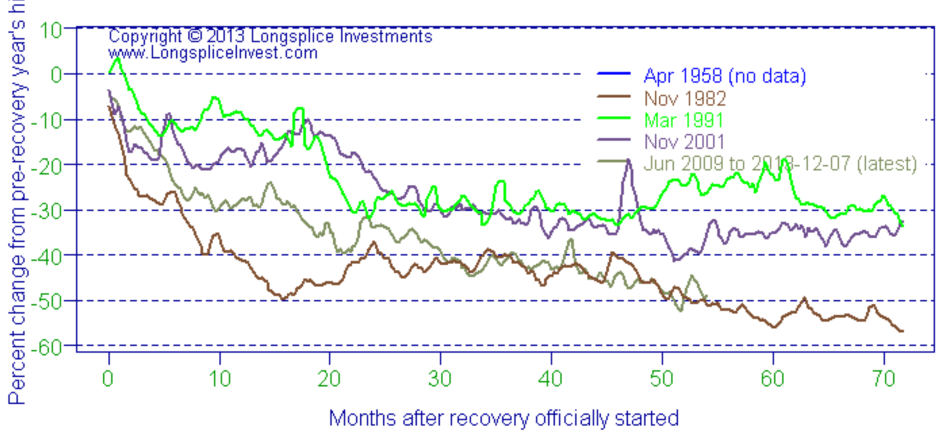
If you're inclined to pick among individual securities, be careful: stick to value, to safety, to high-quality debt, and call me to chat if you're concerned about anything you're holding.

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:

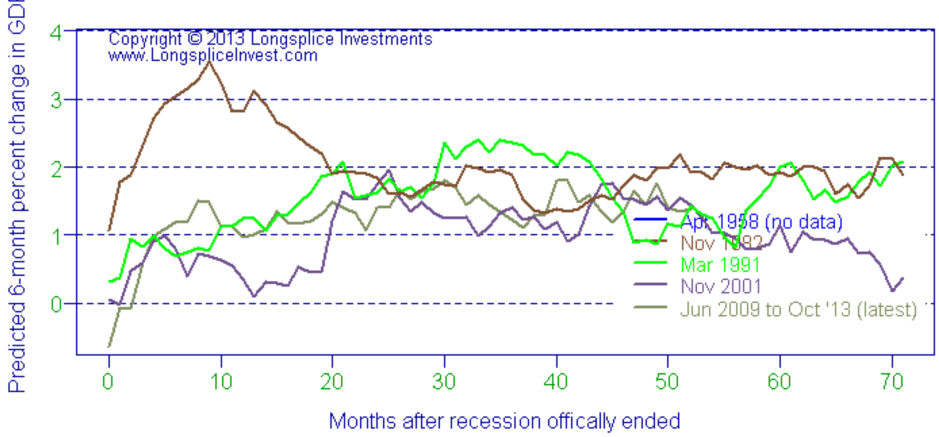
The economy and the jobs market continue to improve, slowly. Such slow improvement is frustrating, but it also gives us a high likelihood of continued good news. We are not approaching any predictable problems that could derail the recovery. That does not rule out some sort of dire bolt from the blue, but it means the odds are with us.

Initial Unemployment Claims in Five Recoveries



Initial unemployment claims are still falling as fewer people each week are laid off. That means less stress for the remaining workers, and more workers with money to spend.

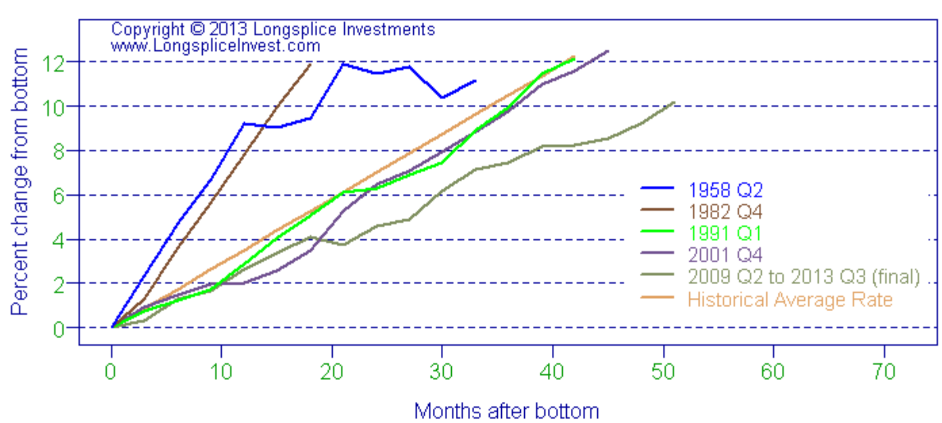
FRB Leading Econ. Indicator in Five Recoveries



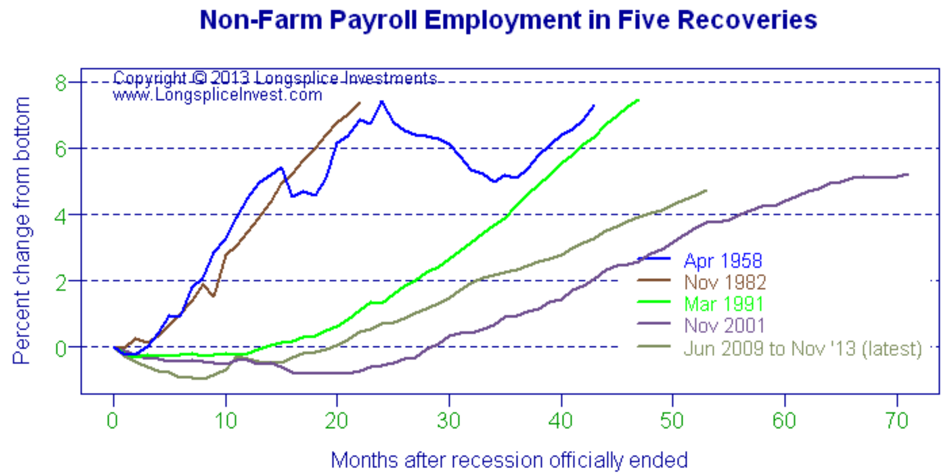
Other factors that tend to predict future growth are also positive. The Federal Reserve Bank's index of leading indicators continues right in the middle of the healthy growth range, although higher would be better.

Growth in the overall economy, measured by Gross Domestic Product, is the first chart that shows how we lag compared to our potential. We're growing, that's good, but we're growing more slowly than during any of our

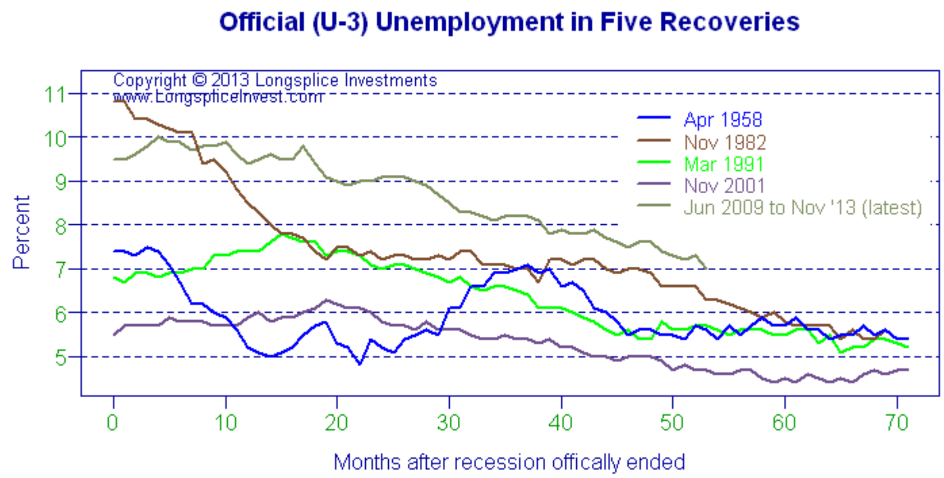
Real GDP in Five Recoveries



comparison periods. We're also growing more slowly than the historical average rate. You can see how some recoveries grew much faster, at least initially. We could do better. That's promising, because it implies we could grow faster without causing inflation or other problems.

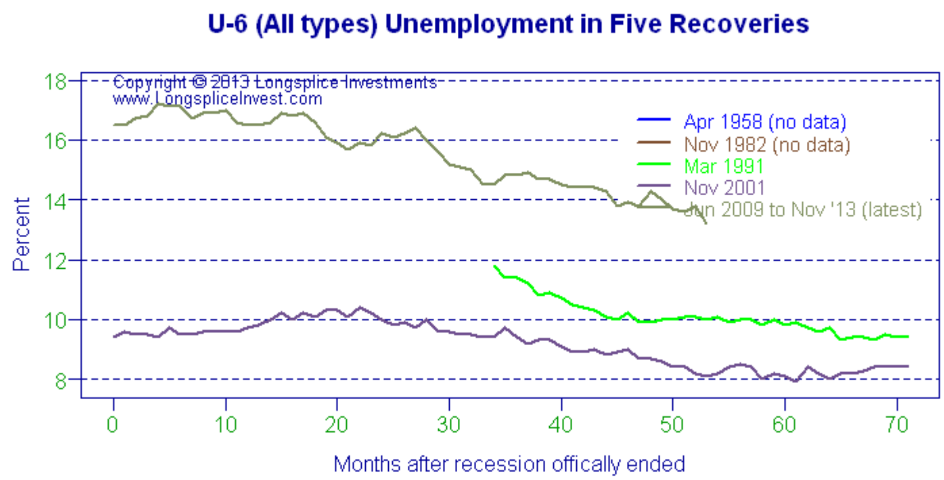


The number of employed people is also rising, but again much more slowly than in most previous recoveries, and only barely faster than the so-called “Jobless Recovery” of 2001. Again, this is growth at a pace that could get faster without harm.

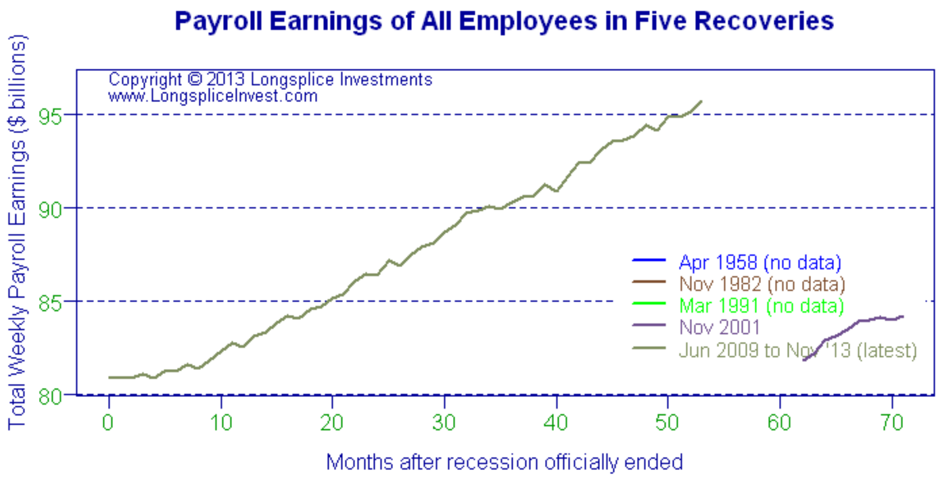


The weakness shows up most clearly in the unemployment numbers. The recession was deep, and we're only now returning to unemployment levels that were the *worst* of most prior recoveries.

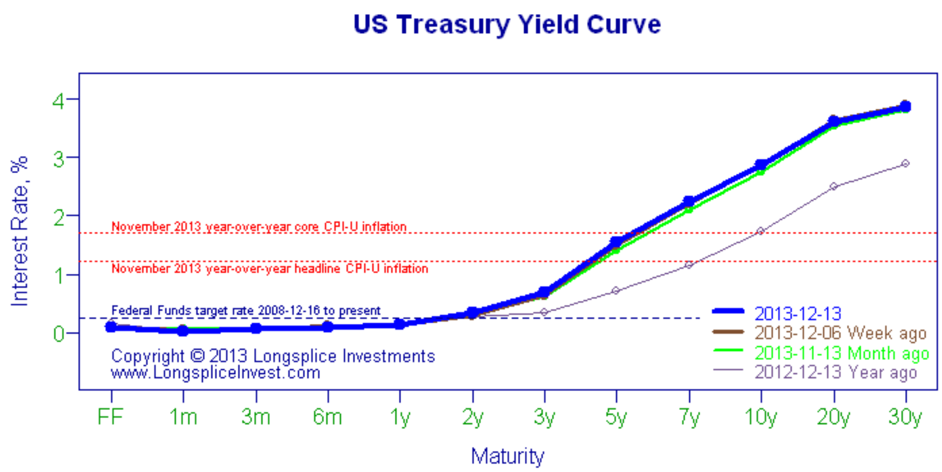
It is improving, though.



The broader U-6 measure includes jobless people who have become discouraged and stopped looking, but would like a job if they thought they could find one. This has been very high in this recession. The improvement is nice, but there's a long way to go.



Recoveries depend on positive feedback. Every new or returning worker is a consumer with money to spend. Every spending consumer creates more demand for production, sales staff, and so on. The growth in workers' earnings is promising.



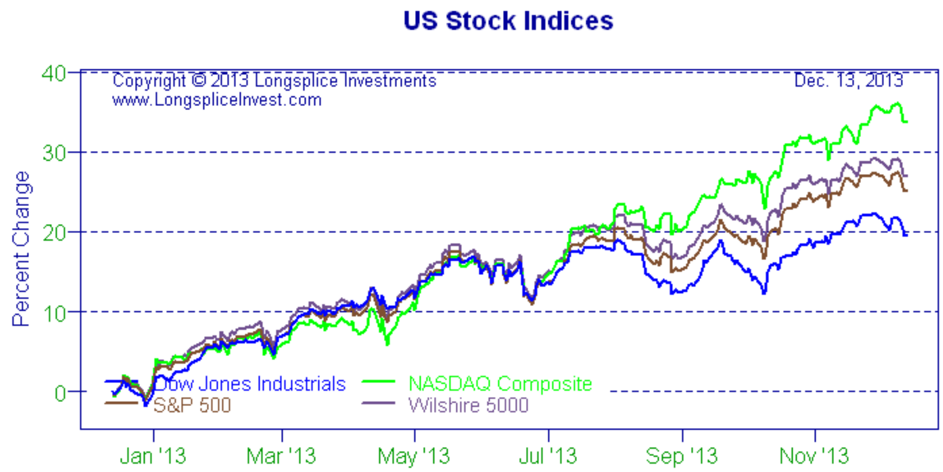
One of the sharpest debates since the recession began was whether the Fed's extremely low interest rates and Quantitative Easing would cause inflation to rise.

Inflation has fallen. This supports the idea that inflation is not caused by money supply itself. If the money is just sitting in bank vaults, it does not push prices for goods and services up at all. The only thing that can push up consumer inflation is high and rising consumer spending. We have quite a bit of growth to do before we get to the levels that could cause that.

That's not to say that QE has been harmless. The low rates have hurt everyone, from retirees to pension funds to insurance companies, who depend on bonds for steady safe income. You can see on the chart that even a 5-year Treasury bond yields less than the current rate of inflation. Out to a 1-year maturity, the bonds yield essentially nothing before inflation, and a loss after adjusting for inflation.

That hurts the savers who stick to safe debt like Treasuries. It also encourages many bond buyers to move to much riskier debt, just to get the yield they need to reach their targets. This phenomenon of “chasing yield” has caused problems before: sooner or later, the risks appear and some bondholders suffer some actual defaults. That reminds everyone else that risk means risk *of losses*, as if that hadn't occurred to them, so they try to sell their risky debt before any of it blows up. Trying to sell anything in a hurry and in sync with a lot of other sellers is the quickest way to lose a fortune on Wall Street. We saw this before at the end of the 1980s junk bond craze, and the end of the recent mortgage bond craze.

Seriously, stick to safe debt. The yield you can get for the riskier debt right now is not worth it.



For the past several years, I've had my money parked in solid Blue Chip type stocks with good dividends. That worked wonders as interest rates fell, making the dividends more attractive. Those stocks also had the virtue of being strong companies. In a scary economic situation, these were companies that were likely to weather the storm.

Those advantages are wearing off. Partly that's the simple good news that the improved economy has made all the rest of the stock market more attractive, as the chart shows (the dividend stocks are approximated by the Dow Jones Industrials). Earnings are better, layoffs are mostly over, and growth has returned to growth stocks. Another aspect is that we're starting to look at rising interest rates eventually. The dividend stocks will look less appealing.

With that in mind, it's time to start selectively selling the dividend stocks and moving the money into the general market.

Depending on your tax bracket and your income to date this year, you may prefer to take the guarantee of today's selling prices, or wait until the new tax year while taking the risk (small, in my opinion) of a market drop in the next few weeks.

One of the stocks in the group which I definitely intend to sell soon is Chevron (CVX). It's had a very good run, but various factors in the energy market make it unlikely to be able to keep rising. In fact, it has been wobbling around the current level for the past 9 months. Time to go, and thank you for the generous capital gains as well as the dividends.

The other oil company on my list, ConocoPhillips (COP) is not yet such a clear decision. I'll write more as my thinking gels.

In general, the economic growth is slow but very solid. We have every reason to expect continued growth for a long time, perhaps years. The stock market doesn't always follow the economy closely, but stocks do not seem overvalued for the growth prospects the companies enjoy.

It's **Credit Check** time again.

Why? Identity theft has become a big big business, with professional thieves adapting daily. Your best hope for protecting yourself is to keep an eye on all your financial accounts, watching for suspicious activity.

How? Once per year per Credit Agency, you're allowed to get a free copy of your Credit Report. If you've been following along with my every-four-months pace, you're ready to revisit Experian. Experian A world of insight

It's easy. I've taken notes from my own recent visit, so you can follow the instructions at www.longspliceinvest.com/CapDrain/Experian.pdf .

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