Capital Drain

Rick's investment opinion newsletter March, 2014 v.10 no.1

Before printing, think about the environment

Hi Readers,

The markets have been moving around, and there's plenty of news in the world, but it does not add up to any change in the big picture for investors. Some people don't mind repeating themselves, but I go too far the other way. Sometimes people need to hear that the last thing I said (a while ago) is still what I'm thinking.

Here's a summary and a “Carry On.”

In my opinion:

Executive Summary:

- Ukraine is a local problem, except for the light it sheds on Russia.
- China's banking is a local problem, but with bigger repercussions.
- Problems: China, EU, Ukraine, Debt
- The recovery continues, slowly
- A lot of people still out of work, no inflation
- A summary of the normal business cycle
- Your tax refund: save half
- It's Credit Report time again! This time, TransUnion.

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:

There are certainly big historic events playing out in the world, but for long- or even medium-term investors they aren't a huge concern. To be sure, they bear watching, because something could go terribly wrong. It's not likely, though. Nor is it likely that some unexpected crisis will pop up soon. No one can see the future clearly, but we can clarify our sense of what's likely or unlikely.

The current trouble with **Ukraine**, Russia, and Crimea is certainly a big deal for Ukraine, and a huge change for Crimea, but it is unlikely to be a serious problem for the US or for world economic growth. There's a chance that Putin will push his luck too hard and provoke an armed conflict, but only a tiny chance despite the bluster.

Meanwhile in **China** there's been a huge growth in borrowing through non-regulated trusts and other “shadow bank” financiers. This could be as dangerous for China as it was for the US, but China has the advantage of having seen it happen here starting in 2007. They don't need to debate whether to deflate the bubble, they know. They also don't have to convince any free-market fanatics in their power structure that government is an appropriate actor in the economy. In China, there isn't such a big distinction between the government and the economy.

They may well have a slowdown in their growth. They could conceivably have a recession. They are very unlikely to have a crash. If they have a recession, it would not be so bad for US investors; we don't sell that much to them, relatively speaking.

You remember the BRICs: the four big fast-growing countries that were expected to power international growth. Brazil, Russia, India, and China were therefore expected to be very important markets for companies to enter, and for investors.

That list has split into two sub-groups.

Brazil and India have shown bursts of very good growth, but some slowdowns. Some pundits consider them disappointments, but I disagree. Good growth mostly, in a functioning democracy with a reasonably impartial court system, is what we should be looking for. Those are the good long-term investments.

That leaves Russia and China.

Russia is the biggest loser. When it was riding high, it was on oil wealth, which is now decreasing. The population is shrinking and unhappy that their standard of living has stopped increasing. The government internally is an oligarchic kleptocracy in which local and foreign companies are at the mercy of courts controlled by a few powerful (if sometimes competing) factions. The government externally is busily overcompensating for its historic inferiority complex. This is not a good scenario for investing.

China will likely keep growing, but the government throws its weight behind local companies at the expense of foreign ones. Many of the local companies are government-owned, creating a huge conflict of interest. One aspect of what they call their "Capitalism with Chinese Characteristics" is that building and investment decisions aren't always based on actual market needs, so their profitability or even their ability to pay back loans is suspect. In many ways, investment decisions there are less like business and more like government departments fighting over control of a budget pie-- because that's what they are.

That's why many international businesses are cutting back or leaving. China is certainly a huge market, with a growing middle class, just the stuff of opportunity for workers and business growth. Unfortunately, the legal, regulatory, and competitive environment make profits too unpredictable at best.

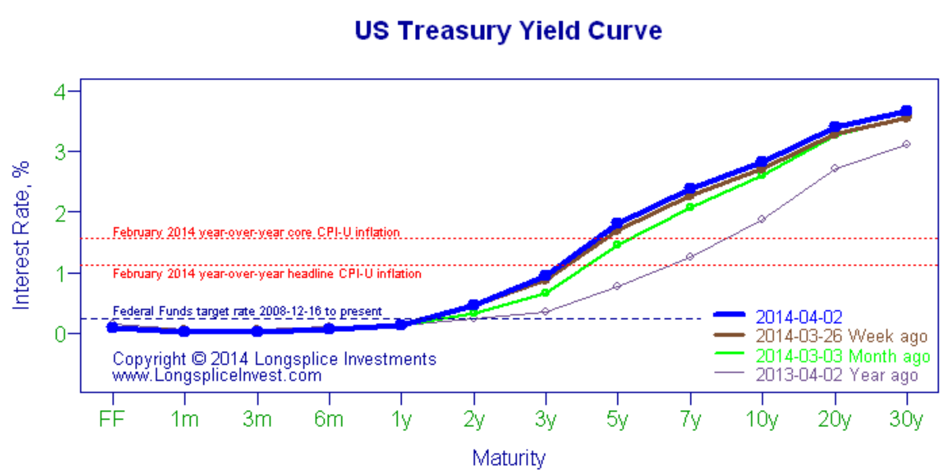
In the bigger picture, economies are growing slowly around the world. We are still recovering from the enormous disruption of the banking crisis and the deep recession it spawned. There is progress in every region, but it is slow.

The **European Union** in particular is still hamstrung by its leaders' insistence on fiscal austerity, meaning crushing the economy as a side effect of holding down government **debt**. Government debt can be excessive and harmful, to be sure. A recession is not the time to focus primarily on debt, though. Judicious spending programs can get people back to work, improving everyone's lives and the GDP, and decreasing government debt by increasing revenue.

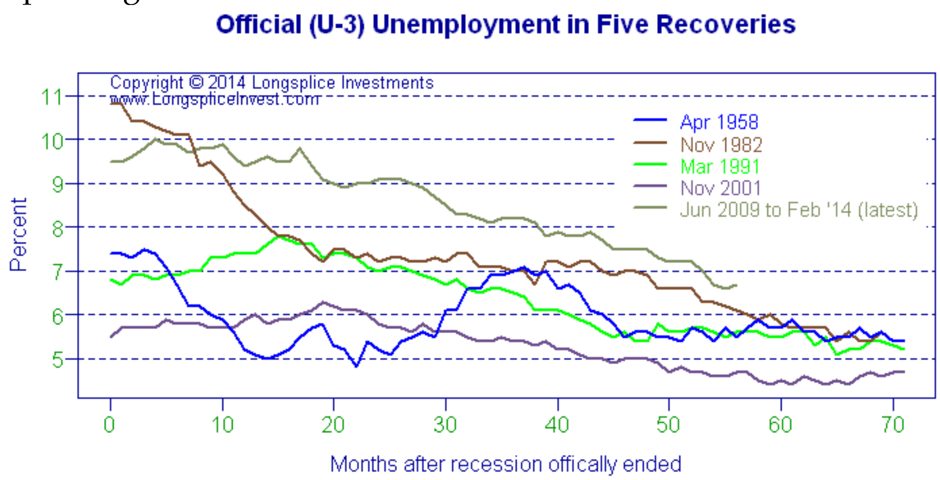
For us as US investors, there is no reason to go abroad yet. Our recovery is relatively strong, and slow and steady is winning the race.

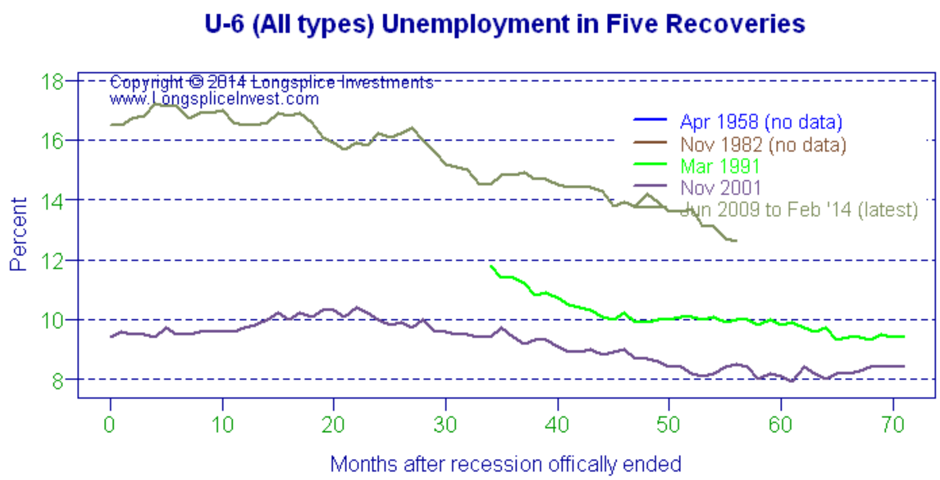
I'm still fully invested in the stock market. As I described before, I sold the Chevron shares that I've had since 2010. The other stocks, including the ones I added last June (2013), I still have and I don't see any reason to get rid of them. They're rising with the market, and paying healthy dividends.

Since the banking crisis burst upon us and the Federal Reserve started supplying extraordinary amounts of available loans to banks, people have been worried that we would find ourselves with either **hyperinflation or new investment bubbles**.



First off, inflation in the real world of goods and services has been falling. That's not surprising. Many people are still out of work, or underemployed, or retired far earlier than they'd intended. These people don't have much money, so they're surely not going to drive up prices with their spending.





I don't think we'll see inflation really pick up until unemployment is much lower, including after the people who have dropped out of the labor force (quit looking, or retired earlier than they wanted to) are back in jobs.

That's a lot of people, a huge number compared to previous recessions.

Until most of those people are comfortably back to bringing home paychecks, we won't see real-world inflation.

I've specifically said goods and services (real-world) inflation, because there is another kind-- asset inflation. That was what we had in the few years before 2007, when consumer inflation was low but real estate prices were rocketing up. Similarly, before the tech bust, it was only stock prices which were rising, not butter and eggs.

We still don't know whether all the bank bailout money from the Fed these past seven years has created a dangerous investment bubble, or where. Some argue the banks (and big investment companies) have put all the money in overseas stocks, or US housing, or US stocks, or stockpiles of oil and metals, or currency speculation.

Certainly, some of the Fed's stimulus has gone to each of those places. We don't know which assets will drop and by how much. We'll see, and I'll certainly be watching closely.

The asset I'm least worried about still is US stocks. Markets can take little tumbles any time for no reason, as they did this past January. None the less, I think the US economy has a lot of room to grow, and the forces to create that growth are working. In general, that will boost company earnings, which in general will increase company stock prices.

The normal **business cycle** would have growth continue until consumer and business demand strains the production capacity of companies and the supply of available labor, causing inflation. The Fed then starts raising interest rates, which slows the economy down.

In the Treasury Yield chart on page 3, you can see that mid-term interest rates are starting to rise a little based on the Fed's intention to stop their special increases in the money supply (QE). Even with that gone, the overnight Federal Funds rate is set between 0 and 0.25%, rates lower than most investment professionals though they'd ever see in their lives. Long story short, it will be a long time before the Fed's rising interest rates will become a normal type of brake on the economic growth rate.

Jumping to another topic, April 15th, the due date for US individual income taxes, is coming up soon, and an interesting psychological phenomenon, and an opportunity.

Most working people have some tax pre-paid (“withheld”) from each paycheck throughout the year. Most people have somewhat too much withheld, and get a refund of some of that pre-paid tax.

Generally people don't mind the pre-payment, even though it's really an interest-free loan to the IRS, because they hate having to write a special check to the IRS in April, and because it feels good to get a refund. It feels like good luck has showered a bonus on them. For many American workers, their tax refund is the biggest single check they get in the year, and certainly the biggest that hasn't already been budgeted for other things.

There's the opportunity: **Save half**.

Just half, I don't want to be a Scrooge and prevent you from enjoying your feeling of enjoying finding money that you didn't know you had. By all means, treat yourself to something with half the refund. But save the other half. Put half the money in long-term savings before it becomes real to you, before your imagination gets a chance to make a list of ways to spend it. That extra bit of saving each year will give you a valuable safety net against bad fortune, or more money to enjoy when you retire.

This is important. It's **Credit Check** time again. I sincerely hope that my regular reminders and simplified instructions are helping you to check your credit report regularly.

With all the ID theft and fraud happening today, checking your Credit Report is a free way to assure that nothing is being done to you. Once per year per Credit Agency, you're allowed to get a free copy of your Credit Report, quickly, online. Do it now!

If you've been following along with my every-four-months (-ish) pace, you're ready to revisit TransUnion

I've taken notes from my own recent visit, so you can follow the instructions at www.longspliceinvest.com/CapDrain/TransUnion.pdf . I had no problems whatsoever.

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..

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.

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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