Capital Drain

Rick's investment opinion newsletter July, 2007 v.3 no.6

Hi Readers,

It's been a busy few weeks. I had a great break driving down to La Jolla to visit a sister and brother-in-law. On the one hand, we had ate, surfed, swam, and hung out. On the other hand, I helped them pack for their move back to New England. Sigh. I'll miss being able to see them so often so easily.

By the way, the drive south on US Highway 101 (the old El Camino Real, which was built to connect the Spanish missions) from San Jose to Santa Barbara is breath-takingly beautiful. Three-quarters of the trip gently but inexorably winds up the Salinas River valley, then after Paso Robles and San Luis Obispo the road PLUNGES down out of the mountains to the sea. Whee!

OK, let's make this quick. In my opinion:

Executive Summary:

Get out of debt derivatives: CDOs, etc.

> **SERIOUSLY.** They may be in your Bond or Income or Balanced mutual funds.
> Ask your account rep to help you check.
> If you find any, move to a safer fund.

Housing deteriorates
Whistling past the graveyard: why record stock prices!?!
Same old same old: the dollar

> As I've written before, I think everyone is best off with a **broad diversification** that includes at least **3/4 overseas** assets (easily purchased via US mutual funds and Exchange Traded Funds (ETFs)), reflecting the distribution of world economic activity.
>
> 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.

The Details:

> "Should liquidity dry up and correlations among asset prices rise" (That's central-banker-speak for: too many investors trying to sell all sorts of things at the same time.) "the concern would be that prices might also overshoot on the downside." (That's central-banker-speak for "crash.") "Such cycles have been seen many times in the past," it adds. (That's central-banker-speak for "We told you so.")[1]
>
> -- David Wessel,
> quoting the Bank for International Settlements annual report

There's an old saying that a banker will lend you an umbrella on a sunny day, but demand it back if it rains. That's half-analogous to the current situation.

What we've seen lately is that since 2002 the days have been so steadily sunny that bankers have been lending money (umbrellas) to just about anyone, including many people who won't be able to repay the loans at all.

In the April newsletter I described in general how loose lending has set us up for rainy days to cause some big losses-- by someone. Don't let it be you.

But hey, you didn't make any loans, how could it be you who loses?

Welcome to credit derivatives.

In a nutshell those dicey loans have been repackaged into new bond-like securities called Collateralized Debt Obligations (CDOs), given bond-like quality ratings, and sold as if they were bonds-- possibly to you. They may be in your Bond- or Income- or Balanced- mutual funds.

It turns out that the quality ratings given to these pseudo-bonds made some rather rosy assumptions about the underlying debt, and rated most of the CDOs as very high quality indeed. Many of the rosy assumptions have been found false, and the market prices of these CDOs have dropped precipitously. At least half a dozen hedge funds world-wide have been shut down (some wiped out) by the drops.

Remember the April letter's metaphor that there's never just one cockroach?

The CDO downgrades so far are just the first few cockroaches. It's likely going to get a lot worse. Get out while the getting's good.

If you have any mutual funds or broker-selected bond holdings, contact your account representative and say emphatically that you want to get out. They could be called CDOs, or CMO, CLO, MBS, RMBS, CDS, or yet other names. Tell the rep that if

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[1] David Wessel, "If a Quake Hits Markets, At Least Shock Absorbers Have Improved Since 1987," The Wall Street Journal Online, June 28, 2007, Dow Jones & Company, Inc., June 28, 2007 <http://online.wsj.com/article/SB118298231245450684.html?mod=hps_us_editors_picks>

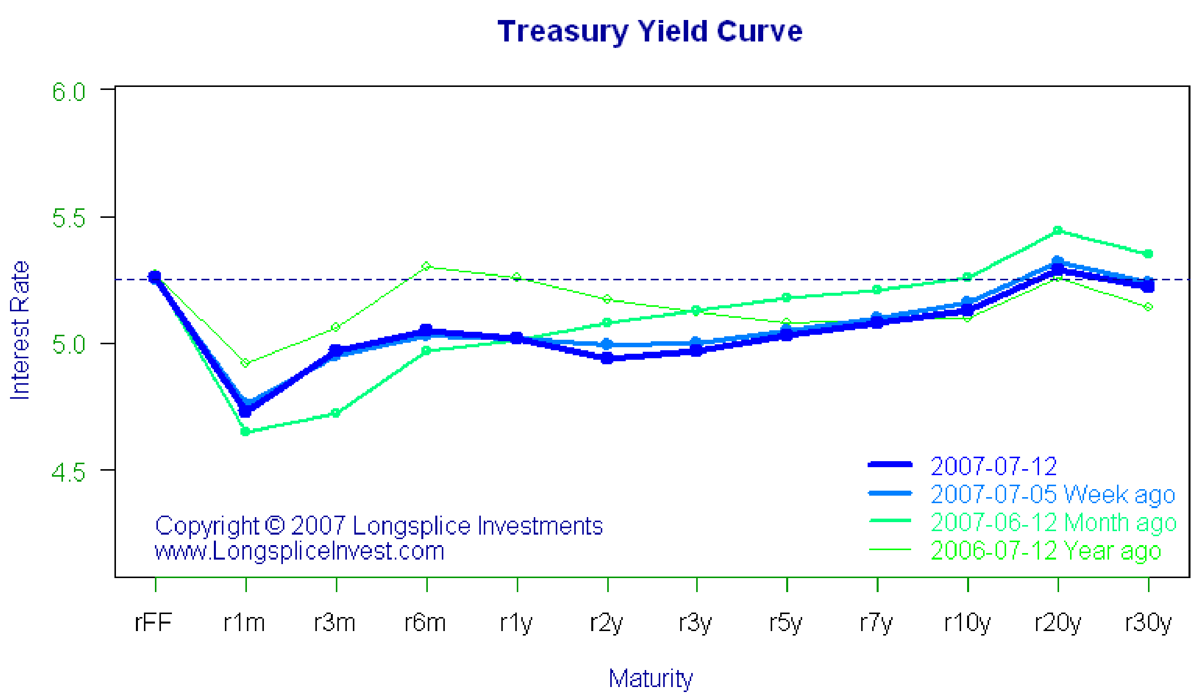
the debt securities you hold, or your mutual funds hold, have anything that involves "tranches" (telltale jargon) and was created within the last five years, sell.

Many of these CDOs were given the very highest bond ratings (AAA) but they were rated based on a different analytical framework than your Treasury or GE (or other Blue Chip) bonds. The CDOs aren't all garbage, but it's going to be a while before we learn which are the better ones and which are worse. Sell and watch the painful lessons from the sidelines.

As you know, the first part of the loose-lending house of cards to crumble was housing. New house sales volume is way down, resales are way down, prices are falling slowly, and mortgage rates are rising. Even the industry cheerleaders are now saying that things will get worse until 2008. In addition to being bad for the mortgage-based CDOs, it's also a drag on the economy.

And yet, the Dow Industrials and the S&P 500 just hit new record highs. I truly cannot understand why. At almost all companies, earnings (profits) are falling, so P/E ratios are rising, which should rationally imply prices falling. I'm inclined to say that investors are whistling past the graveyard, hoping that hope alone will carry the stock market higher.

Meanwhile, the bond market is still acting as if bond investors expect a slowdown at least, if not a recession. The Treasury yield curve is no longer inverted in the classical steady downward slope from Federal Funds (FF) rates to 30-year bond rates. Neither is it a steady rising slope, the usual sign of a healthy economy.

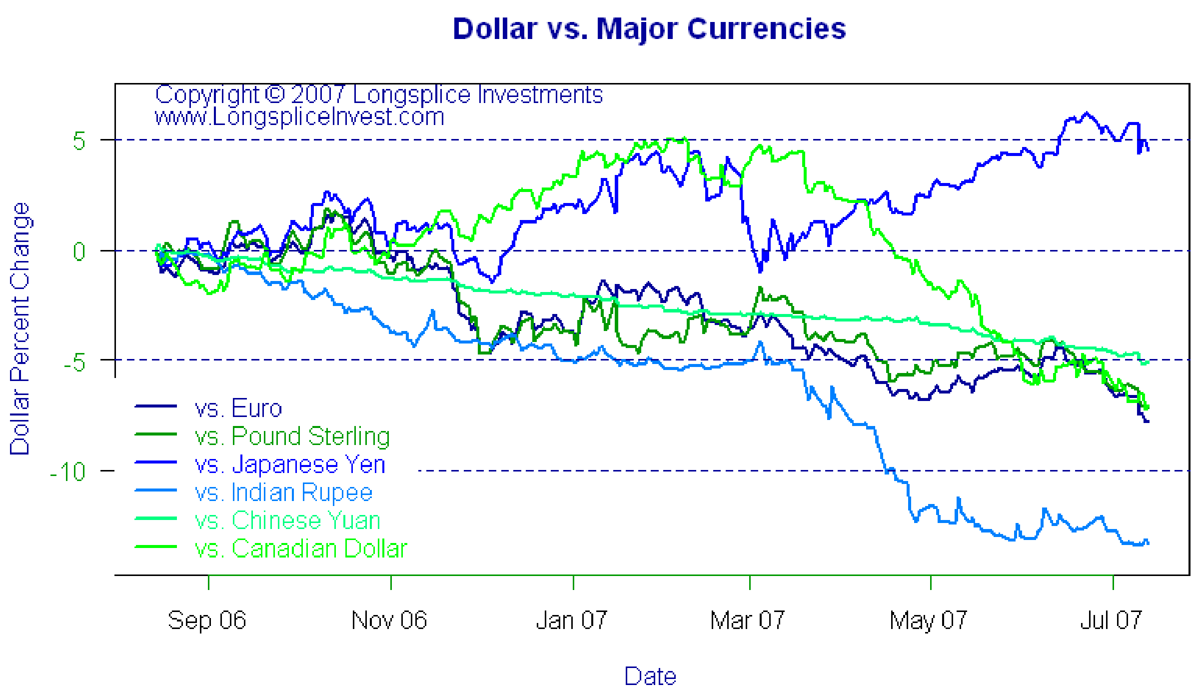


What could explain the curve? It's the latest phase of the Greenspan "Conundrum," as he called the fact that rising FF rates weren't raising long rates. It could be that there's a huge interest in buying treasury bonds, especially short-duration ones, because they're simple, safe, and easy to sell later. Or it could be that bond buyers expect the FF rate to fall-- by a lot-- to make the curve look normal.

Neither of those scenarios points to investor confidence. In the former case, what are investors seeking safety from? Too many junky bond derivatives and overpriced stock, perhaps? In the latter case, the Fed Chairman Bernanke has been as clear as anyone can be that he isn't going to lower FF rates until inflation is lower, barring some sort of market calamity (see case #1.)

Meanwhile, most of the rest of the major economies are doing quite well. Even Japan may finally get its growth going again. Overseas central banks are raising their interest rates, to head off inflation.

This brings us back to my old standby, the falling dollar. You can see in the chart below how the dollar has fared since the end of last summer. It's unmistakably, fairly steadily, down substantially against all but ailing Japan's ailing Yen.



It's interesting to note how steady the decline of the Yuan has been compared to the volatility of any of the freely-traded currencies.

I included the Rupee for comparison; it's not really a major currency in US trade yet. Also, some may scoff at the idea of the Canadian dollar being "major," but Canada remains our largest trading partner (we import energy, grains, timber, metals, beer) so their exchange rate is significant.

I think it's likely that the slide of the dollar will continue for a while, on average. Japan may be about to join in, i.e., the dollar may fall against the Yen, too, if their economic recovery actually works well enough for their super-low interest rates to rise.

It's time to send this and get back to Fund work.

If you have any questions, please write or phone. If you want to read more, I've got a web site (see URL below) with archived editions of this letter and some links to other interesting sites. There's also a weblog where I discuss the process and progress of starting the mutual fund.

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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