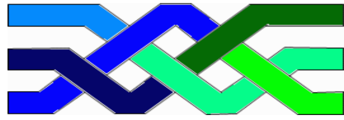


Capital Drain

Rick's investment opinion newsletter June/July, 2008 v.4 no.5

Before printing, think about the environment

Hi Readers,

It's been a while since I wrote, and a lot has changed. Not just the logo, either. The parallel run up of reckless loans and inflated real assets (land, commodities, metals) seems to have peaked. Certainly, the reckless lending is over. Now there's "just" the cleanup to deal with.

How does one invest for this new environment? It's a bit complicated, but I think there are some investments that will do much worse than others. It is time for the financial invocation of the Hippocratic Oath: "to help, or at least to do no harm."

So, get comfortable. In my opinion:

Executive Summary:

- Denial in the markets
- it's a trader's rally
- market sentiment indicator: my gym's TV
- wait for Actual Good News
- Inflation is real, and it's costing you dear
- Currencies: Euro too high, Asia too low
- Time to shift investment focus
- frustration: recession hurts stocks, inflation hurts bonds and stocks

This is different from my previous few years of general advice:

Inflation plus recession is the worst combination for investments. To the extent that you feel comfortable not "buy and hold"-ing, for a while to come cash will be king. Almost everything else is reasonably likely to suffer losses.

Short of that, 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:

> The mood in financial markets has worsened during the past six weeks, though it has been punctuated by brief waves of optimism.[1]

True, the mood has worsened, but I think the optimism is premature, and we will see less-welcome changes. Specifically, the Five Stages of Grief described in the Kübler-Ross model:[2]

These are:

1. Denial: "This can't be happening."
2. Anger: "Why me? It's not fair!"
3. Bargaining: "I'll do anything, can't you stretch it out? A few more years."
4. Depression: "I'm so sad, why bother with anything?"
5. Acceptance: "I can't fight it, I may as well prepare for it."

Different parts of the financial market are plumbing different depths. The housing market, including housing-related bonds and their derivatives, has mostly made it as far as “Bargaining.” Most of the rest of the investing world is still firmly in “Denial.”

“Definitely a slowdown, but not necessarily a recession” is the hot phrase this month (1,190 Google hits for “definitely a slowdown” just now). It's likely to become an unmistakable recession lasting at least into the start of next year.

Now, a recession doesn't actually mean there has to have been a disaster. It just means that people collectively spend a lot less. The reason they'll spend a lot less is that it's almost impossible to borrow. Simply putting American consumers back on a “if you can't afford it, you can't have it” basis is going to shrink spending, which is likely to make the total spending smaller than last year, which means falling GDP, which is a recession.

The reason it's so hard to borrow is that almost all lenders are holding on by their fingernails, trying not to fail. A few are slightly better off, but even they know that their margin for error is smaller than usual. Also, twice burned, thrice shy: all lenders are now looking MUCH more carefully at their prospective borrowers' collateral and ability to pay. New home equity loans, for example, are basically nonexistent.

In the March newsletter I tried to illustrate how a bank that has big losses then has to either cut its lending a lot, or sell more shares. The new wrinkle is that many banks have been shamed into taking back huge volumes of loans that they had packaged and sold as Auction Rate Securities (ARS). By taking back the loans, and

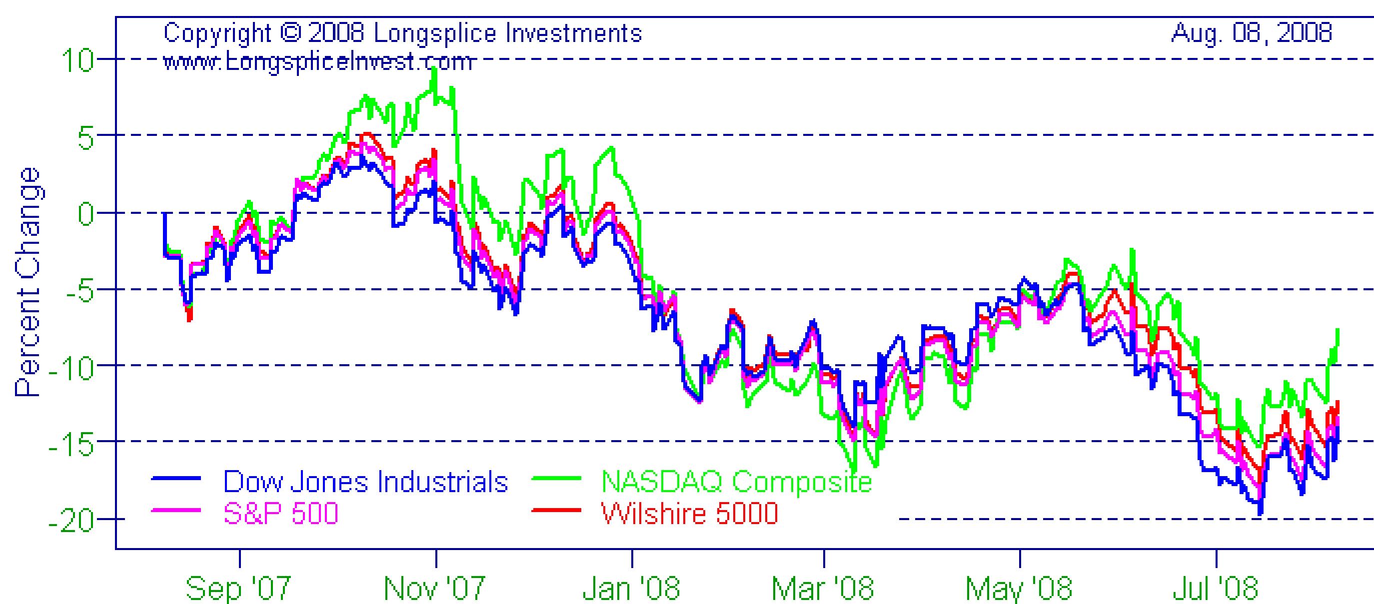
1 Sudeep Reddy, “Federal Reserve: Economic Triple Threat Is in Focus as Officials Meet”, The Wall Street Journal, 4 Aug. 2008, Dow Jones & Company, 10 Aug. 2008, <http://online.wsj.com/article/SB121779054489508059.html?mod=rss_whats_news_us>.

2 “Kübler-Ross model”, Wikipedia, 6 Aug. 2008, Wikimedia Foundation, 10 Aug. 2008, <http://en.wikipedia.org/wiki/5_stages_of_grief>.

paying the allegedly (and for the most part, actually) hoodwinked customers full face value, these banks are both taking losses on those loans and increasing the amount of loans leveraged against their capital. This is really bad news for those banks' shareholders, but also really bad news for those banks' erstwhile borrowers. New loans will be extra hard to get for a while. Spending will decrease.

Meanwhile, the stock markets just rallied a bit. Even the homebuilder stocks rose, even though the country won't need any new houses for about a year. Why? Denial, coupled with a trader's rally. Some investors have fallen for the “it's down so far, it has to go up” fallacy, and traders are willing to goose the rise for a short-term profit. It won't last. Note how the previous spring of eternal hope ran from March to May, but no further. This one will likely be shorter.

US Stock Indices



I have a personal informal market sentiment indicator. There's a TV in the locker room at my gym.[3] When the market's been going up for a while, I find it reliably blaring CNBC's breathless nonsense. Let the market fall for a week or two, and the TV is always on the minor-minor sports channel.

For the moment the Olympics will probably overwhelm, but just before they started, that TV was more often on sports than the market. I don't think Joe America believes in this rally yet. I don't know what's on the TV in Jane America's locker room.

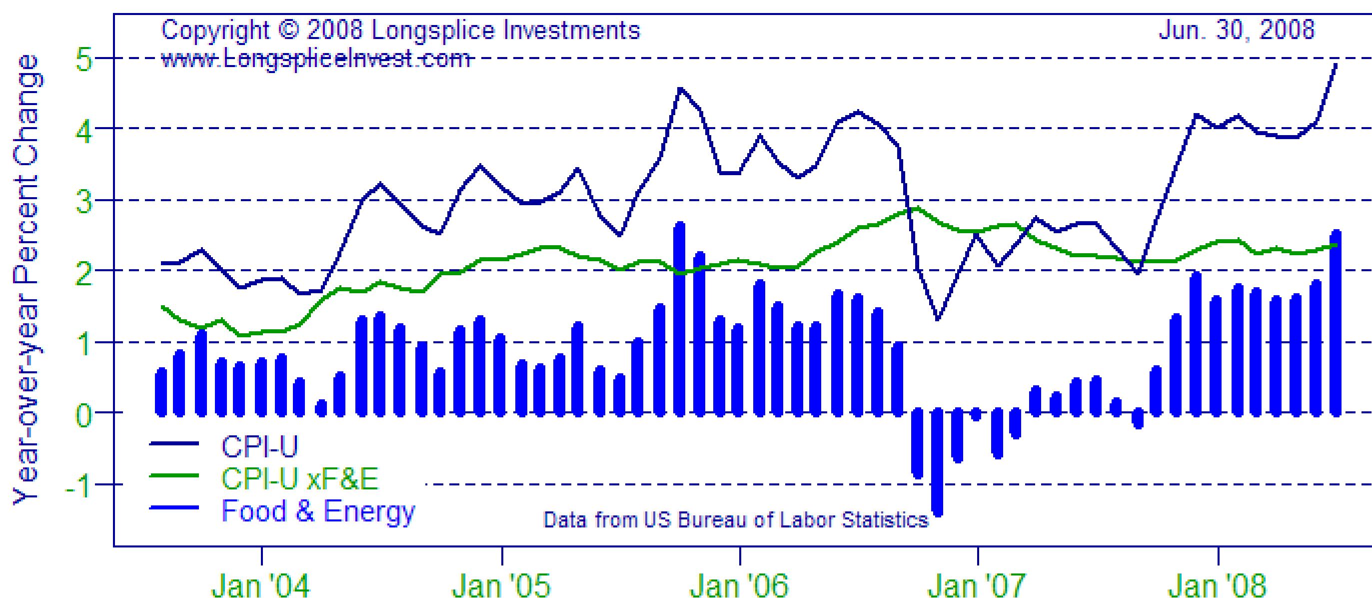
The time to believe in a rally is when there is ACTUAL good news. “Shot at and missed” is not good enough. By the bottom, the overall mood of the market may have reached “Depression.” That's why the first few good news bits will dribble out and be ignored. That will be the time for stocks.

3 No, I have no idea why they need a TV in a locker room.

The latest "shot at and missed" is the fall in oil. Falling from $160 to $110 per barrel is certainly welcome, but a year ago the price was at about $70. The full inflationary effect of that 50% jump in price is still arriving.

It's not too difficult to decide what investments to avoid, but it's harder to decide what investments to choose. Sometimes, "do no harm" means staying in cash or high-quality very-short-term bonds. Unfortunately, those are yielding less than inflation, but some yield is better than an outright loss.

I'm sure you've started to notice: inflation is eating you alive. For all the talk about the Core rate being not-so-high, and Food and Energy not counting, and promises of declines, the underlying fact is that your dollars are really worth only 95% of what they were a year ago.



This is not just a dismissable artifact. For every dollar you had a year ago, you lost a nickel of purchasing power.

So, where to invest? It's a mess. We have inflation and a recession. So, now, does Europe. The Middle East has big inflation. Japan is back from an anemic recovery to a robust fall. Most of the rest of Asia has too much inflation. Brazil is pretty good, but it's much too small a basket to hold all your eggs.

By all accounts, the Euro and Pound are now far overvalued, while most Asian currencies are still far under-valued. Based on currency alone, one would think of moving into top-shelf Asian bonds.

Unfortunately, inflation is the bond market's Kryptonite. Central banks will sooner or later have to raise rates; that will make bond prices fall, creating a capital

loss. It's very frustrating. The recessions hurt stocks, but should eventually help contain inflation. Inflation hurts bonds, and often hurts stocks as well. Gold, oil, and other commodities ran up so high that it's hard to rationalize using them as an inflation hedge.

Really, the best advice is "don't just do something, stand there!" If you have profits in investments that are now declining, taking profits is likely a good idea. Shorting some of the most vulnerable stock sectors is still attractive, but shorting is not for everyone.

Next letter I'll write more about the business cycle, and why this "nowhere to go but cash" phase comes once per cycle.

It's dinner time, the spellcheck is clean, so this is off to you.

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

Please feel free to forward this to any friends who may be interested.

Take care,

Rick

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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

A collection of fine industrial Boilerplate, but true:

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