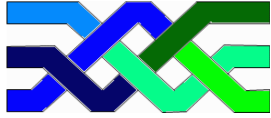


Capital Drain

Rick's investment opinion newsletter August, 2011 v.7 no.3

Before printing, think about the environment

Hi Readers,

Not for the first time, I found myself thinking "I wish I'd taken my own advice." In the July newsletter (p. 5), I wrote

> "Even if we get through the debt ceiling kerfuffle with no disaster, growth in the economy will be slow, and growth in profits will probably be much slower than they were over the past three quarters. I'm looking at selling those stocks, even though I have no good idea where to invest next. Sometimes avoiding losses is the closest you can come to a gain. There may be a stock market bounce back up after the debt debacle decision. I'll probably sell then."

There was exactly such a bounce up after the debt deal was announced, but I was working on something else. I hope some of you sold before the S&P downgrade of Treasury debt caused the markets to plunge; I didn't.

If you sold, you avoided losing about 15%. Even with the recovery since, you're ahead by about 7%. If I had sold when I thought about it, I would be comfortable buying back in now.

For those of us who didn't sell, at least we can see the value of the dividend-paying stocks I mentioned. Bank accounts and high-rated bonds are paying very little interest. Tech & growth stocks got knocked down much more than the "boring" stocks on the list. It's still a good position to be in.

So, in my opinion:

Executive Summary:

- It's an uncertain, in-between time for the economy
- Some economic data look bad, some of it looks promising.
- Where to invest? not bonds, not gold, not growth-- stick with dividends
- Making a new BRIC: up-and-coming country list

US stocks have had a pretty quick recovery from the Tea-Party Plunge. Many US companies are doing well, but the prices reflect high continued growth expectations. If you're holding shares of any of the conspicuous high-fliers, you might consider selling into this renewed bounce. Better to risk a little less gain rather than a lot more loss.

Given the US uncertainty and the world (except Europe) recovery, I think everyone should consider overseas assets (easily purchased via US mutual funds and Exchange Traded Funds (ETFs)), reflecting the distribution of world economic activity.

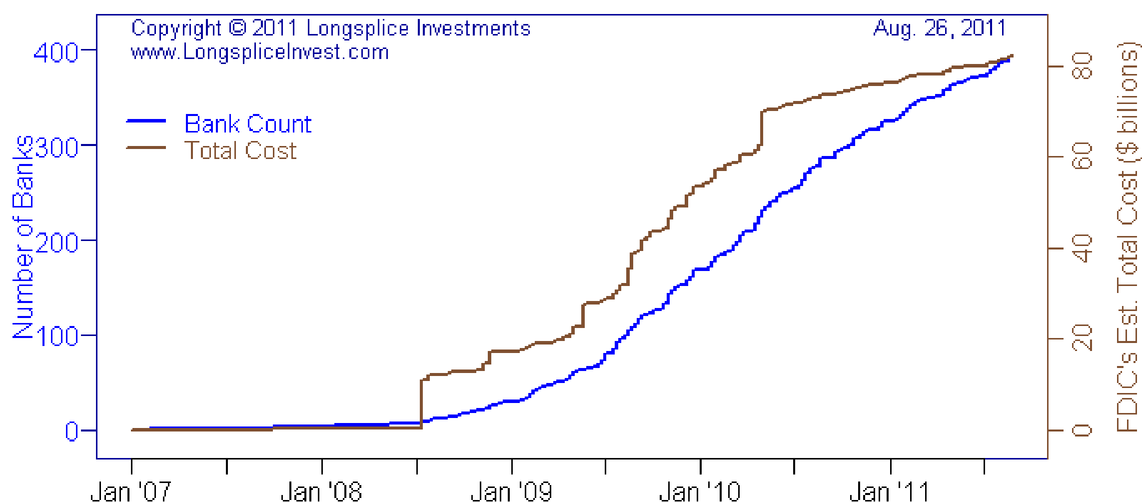
This is a good time for investors to be conservative, to be in the best of securities: stick to value, to safety, to short maturities (for debt), and call me to chat if you're concerned about anything you're holding.

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:

We've got good news, and we've got bad news. Quite a bit of each, actually. Some of the financial press seem to be pouncing on all the bad news, but the stock markets seem to be taking the good news seriously as well. It is a very **uncertain** investing environment, not sure if we'll resume the recovery, or return to recession.

On the positive side, let's return to the problem that started the crash: big banks are now well-supported and making money. The small banks that are more directly exposed to personal and small-business lending are stabilizing, and the FDIC is having to close fewer, and smaller banks than they were a year or two years ago.

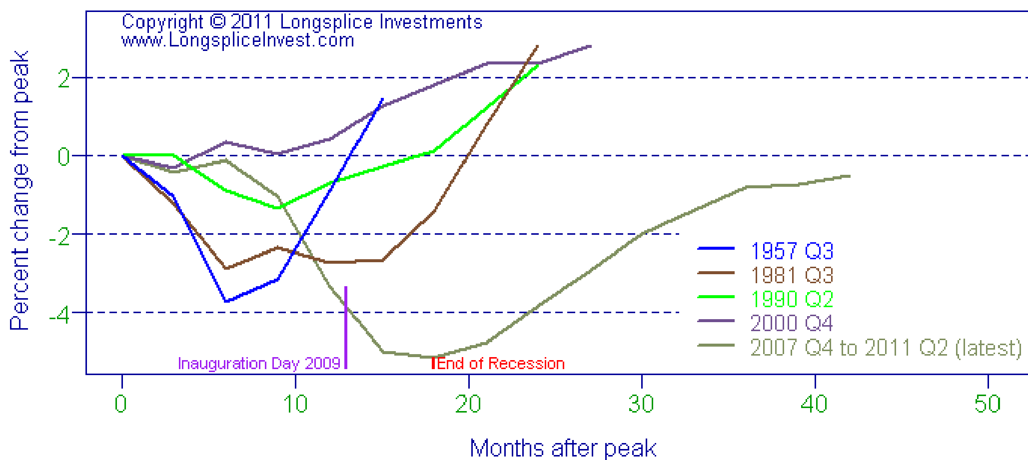


Fewer failing banks may only count as "less bad", but the Conference Board's Index of Leading Economic Indicators (LEI) is quite positive. You can see the graphs on page two of [their press release](). The LEI is built from economic data that tends to predict the future behavior of the overall economy. It started rising well before the

recession ended, and it's still rising steadily. The Concurrent (CEI) index is a quick estimate of how the economy is doing right now. (Very useful because the government's GDP estimates take so long to compile.) It, too, is rising steadily.

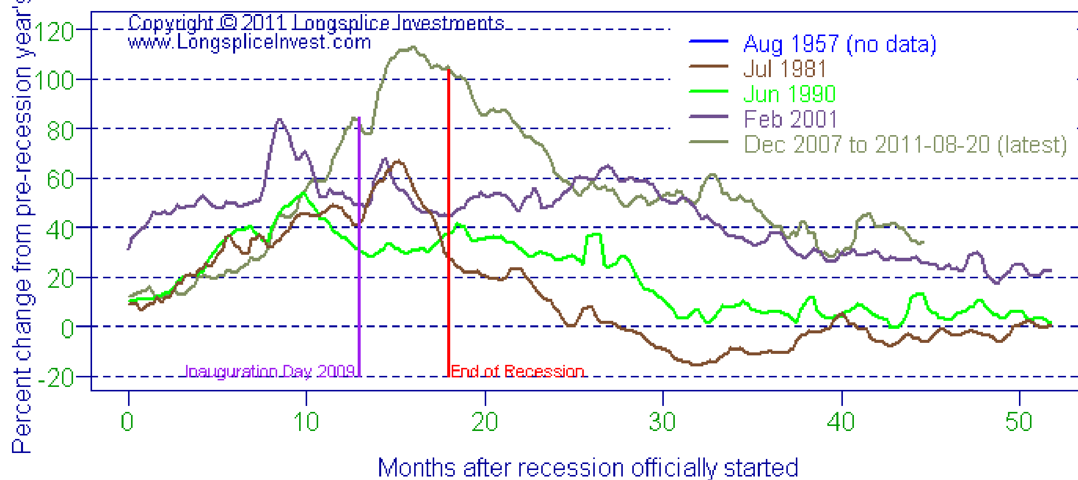
This week we also learned that consumer spending continues to pick up. That's good.

On the other hand, the revised estimates of GDP in and after the recession were quite low. The recession was worse than we thought it was at the time, and it's recovering more slowly than it had seemed. This chart is now dire.



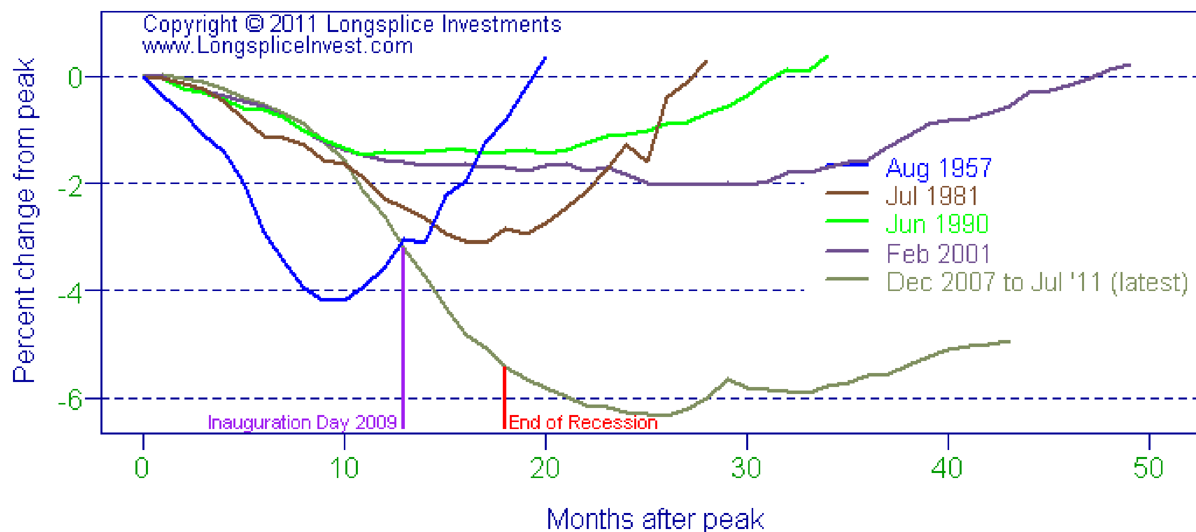
Mind you, it's still improving, but the recession was so deep compared to others of the last half-century, and the recovery is so slow, that there's a lot of economic hardship in this country, causing both a lot of personal pain and a plateau in the nation's real overall strength.

New unemployment claims (a leading indicator) and employment (a lagging indicator) are similarly very disappointing.



Given the huge peak in new unemployment claims (i.e., new layoffs) during the recession proper, in relative terms the improvement has also been impressive. Compared, however to the rate at which layoff rates returned to normal in most other recessions, this recovery is near, but worse than, the 2001-2005 performance that's known as "the jobless recovery."

Non-Farm Payroll Employment Fall and Recovery in Five Recessions



Actual job growth lags well behind unemployment claims. The picture of total US employment is improving, but it's as bad as most living Americans have ever seen.

That, and the farcical debt limit hostage crisis, can easily explain the return to falling Consumer Confidence, a leading indicator. That's not a good sign at all.

Given all this cheery news, **where can one invest?**

As I describe before, bonds are a bad bet: the rates one can earn are very low. Even if things keep getting worse, the capital gains available from falling rates are nearing their physical limit. When, on the other hand, the economy starts to get better (OR inflation takes off, Fates forfend) then interest rates will rise and bond owners will face capital losses. Any way the coin falls, there's either a loss or no significant gain.

Growth stocks will have to wait for growth in profits, which will come from growth in the economy. That might be a while.

I'm still happy with the idea I described back in October 2010's letter (p. 5): big solid (boring) companies with **dependable earnings and good dividends**. That's where I'm staying.

Then there's gold. Do whatever you want, but **I would not touch gold with a ten-foot pole.** Anyone who bought gold long ago has huge gains, which it would be better to keep than to lose. Anyone who bought more recently could lose a lot if the recent spike in prices reverses.

Yale University's Prof. Robert Shiller argues that bubbles are born when (most) people buy into the "next great thing" and "they accept that this [insert your favorite here] is a game-changing asset (like housing and the Internet) that cannot fail. The Internet and the media are singled out by Prof. Shiller as integral drivers of such recent feeding frenzies:

> "If you watch cable television, it would certainly appear that gold is in a bubble. Commercials abound for buying gold. Commentators on CNBC talk about gold hitting $2,400 an ounce, which would be a genuine record (the previous high of $850 in 1980 would be about $2,300 today, adjusted for inflation). In fairness, other CNBC commentators have said this is foolish and that gold prices are too high. Still, the marketing of gold to the masses is an ominous sign."[1]

Gold shares another trait with past bubbles: rewards for the true believers. Those who bought during the rise are eager to tell you how smart they were and how much they gained. They believe it, and they convince many others. When the decline comes, though, the true believers and the newly converted will hold on while the professionals, whose egos are less wrapped up in the concept of gold, sell.

Another idea for post-crisis investing is to look more broadly around the world for countries which have reached the point of taking off on big growth spurts.

The popular acronym for the past decade has been the BRICs: Brazil, Russia, India, and China. All have done well. Brazil and India still offer a lot of growth and very little political or social risk for investors.

I'd like to offer a new acronym for the decade of the 20-teens: the IMMPATT. These are Indonesia, Mexico, Malaysia, Philippines, Argentina, Turkey, and Thailand. Reading that list, you'll note that there are some well-known problems: drug wars, or political violence, or bad monetary management history, for example. None the less, these are: 1) relatively big economies, 2) with good GDP growth rates, 3) with the capacity to deal with their problems within the decade.

If these seven seem too risky, go back and look at the BRICs again. When that acronym was proposed, each of the four had at least one serious problem. Arguably, at least two of them still do.

Next letter I'll discuss my method for picking and winnowing the IMMPATT.

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1 John Nadler, "Turkish Delights", In the Lead blog, 31 Aug 2011, Kitco.com, 31 Aug 2011, <http://www.kitco.com/ind/Nadler/aug312011.html>.

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.

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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