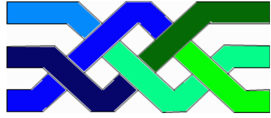


Capital Drain

Rick's investment opinion newsletter April, 2012 v.8 no.2

Before printing, think about the environment

Hi Readers,

I don't have much new to say, but I suppose it's useful to say a little, even just to say "still like before." In particular, anyone who watches cable news too much will have been bombarded by excited and conflicting new opinions, so I'll calmly offer my same old theory.

In my opinion:

Executive Summary:

- Recovery continues.
- What comes next for investors? Watch for the next phase.
- Chasing yield: don't.
- Dollar-denominated investments are still safest.
- Credit Check: EQUIFAX

The recovery continues, and 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, especially the "hot" new tech IPOs, you might consider selling into this enthusiasm. Better to risk a little less gain rather than a lot more loss.

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 stocks, be conservative and 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.

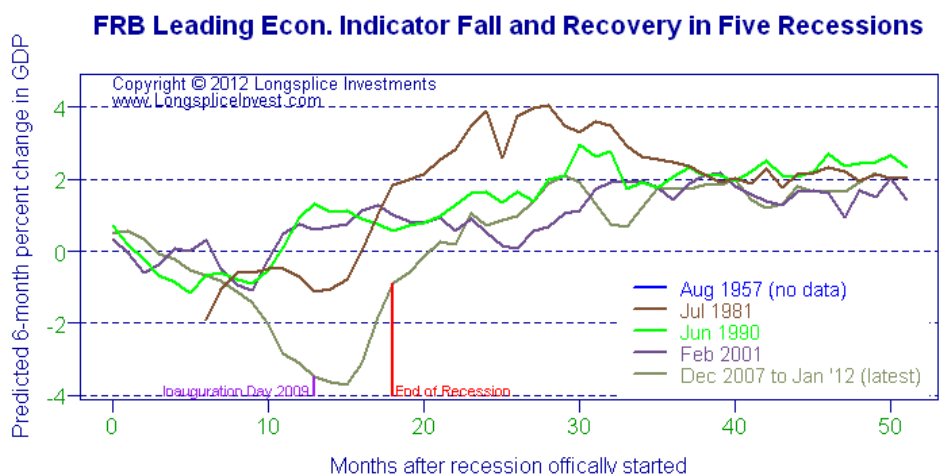
The Details:

The recovery continues, and is picking up momentum and credibility going into Spring. This part of the recovery is self-reinforcing, with no significant macroeconomic resistance. More people are being hired, leading to more income and thus more spending. More spending leads to businesses needing to hire more, and the cycle continues upward.

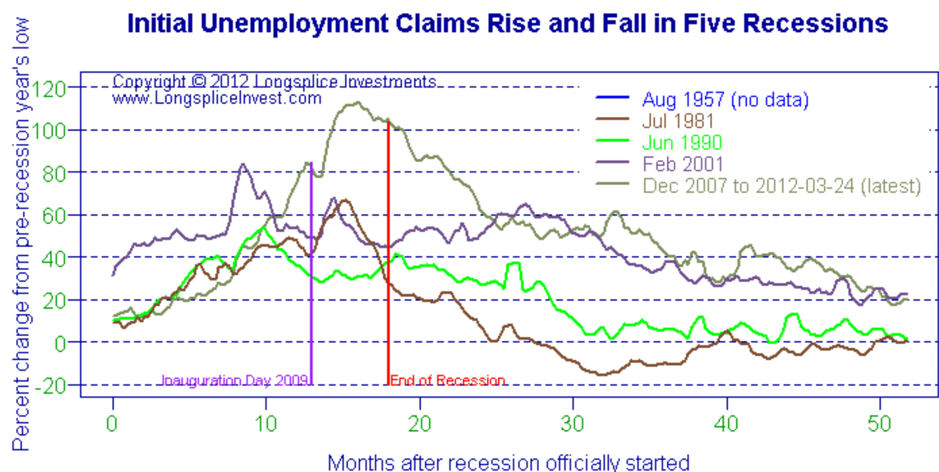
If we were already in a healthy fully-employed economy, we might need to worry about inflation. For now, though, new hiring is drawing on the (still far too large) ranks of the unemployed, and new production is coming by running existing businesses a little closer to full capacity.

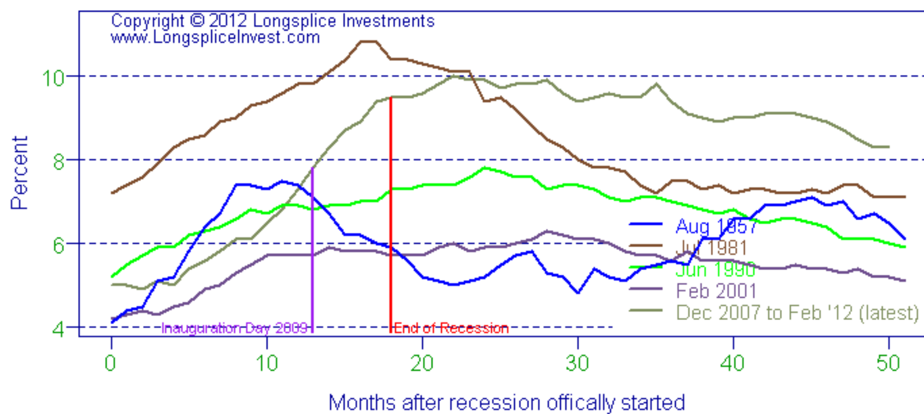
I've rounded up the usual charts, with minimal comments. If you're new to reading the newsletter, you can get more commentary from the February newsletter or from the web site's Economic Charts page.

The Federal Reserve Bank of Philadelphia's Leading Economic Indicator (LEI) index is up to a healthy normal post-recession level. This index gives a pretty reliable prediction of the state of the economy six months from now: growing.



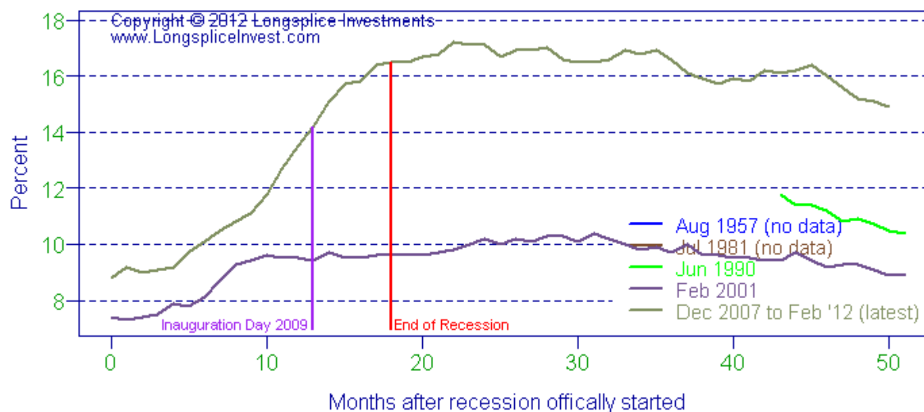
Everyone's favorite input to the LEI, new unemployment claims, is down to the level seen after the "jobless" 2001 recovery, although it's still above pre-recession levels.





Employment is up (not shown), but the official unemployment rate stayed the same.

How can that be?



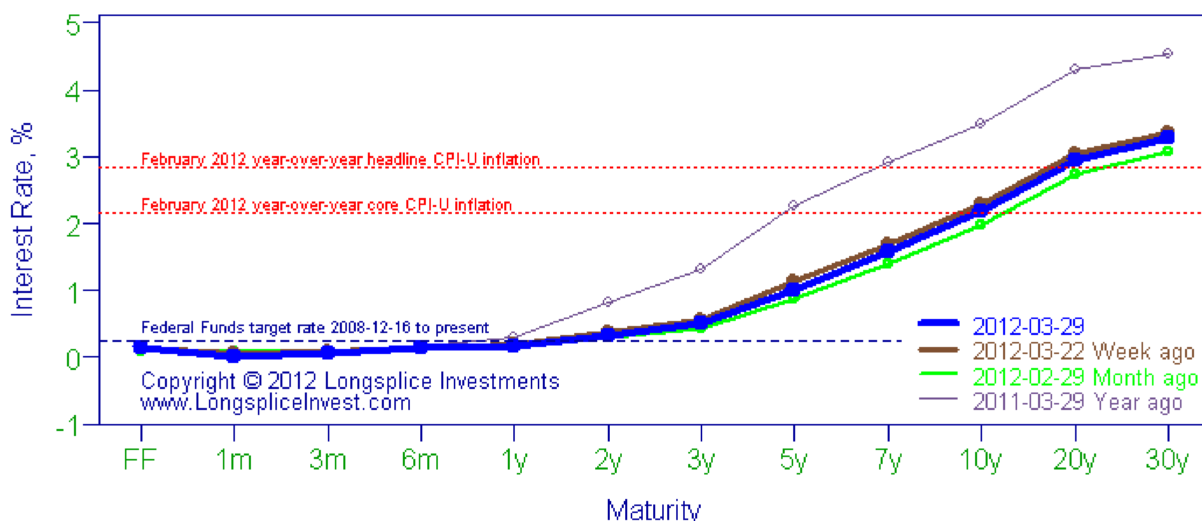
It's because the official rate does not include discouraged workers who have (at least temporarily) quit looking for jobs, and workers who have taken part-time jobs but would prefer to work full time. The comprehensive U-6 unemployment rate does include them, and it has finally started falling. This means there are now more of the right jobs to match the skills and work goals of job-hunters. This is great news.

I've read some comments in the business press that the apparent strength of the job market through the winter is partially an illusion, because the milder-than-usual weather has let more outdoor work go on with fewer interruptions. Yes, but no. If the economy were running at a normal employment level, that could be a reasonable argument. Because we're still in a recovery with a long way to go, though, the good winter jobs numbers are a gift that needn't be returned. Again, recoveries are self-reinforcing. More work through the winter means a compounding increase of even more work available in the spring, summer, etc. By the time next winter comes, the economy will be nearer to full employment. Even if it's a more normal stormy winter, it will only cause the normal storm-related work-stoppages, not a give-back of the prior winter's gain.

What comes next? Barring, of course, some huge unforeseen problem like a natural disaster destroying a city, what comes next is more recovery, for quite a while.

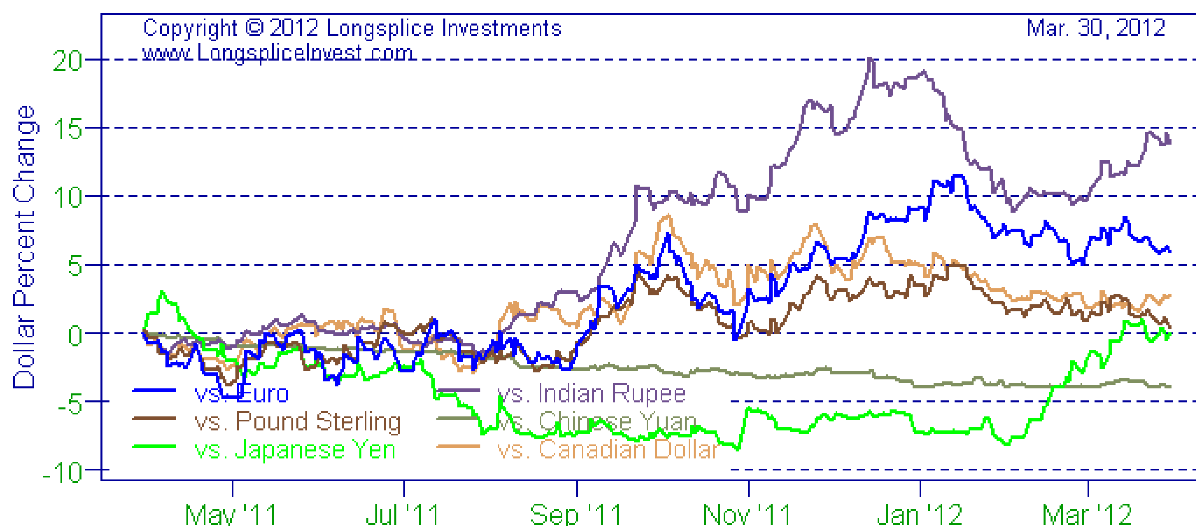
Eventually, a more-fully-busy economy will start to cause inflation. The Federal Reserve will certainly raise interest rates if inflation starts to accelerate, and will likely raise rates when they think inflation is becoming probable.

In the meanwhile, I think US stocks remain the most likely investment to do well. As I've said before, interest rates on Treasury bonds are so low that they're below the current inflation rate. That means you're losing value even on the principal, in addition to getting a miniscule interest rate. Treasury debt with maturities of a year of less yield approximately nothing even before inflation. From two years maturity to about 10 you're at least getting some return, but still losing to inflation. Above ten years maturity you can actually earn money in real terms-- but those bonds are extremely sensitive to changes in interest rates. Rising rates will mean capital losses which would eat up the nominal positive real (after-inflation) interest.



During our previous era of very low Treasury rates, the mid-2000s, we saw the phenomenon of “chasing yield.” Investors were dissatisfied with the yield on safe Treasury and blue-chip corporate bonds, so they “chased” the higher yields they wanted by buying riskier bonds. We saw that turn out very badly when 2008-9 arrived. It's always a bad idea to chase yield. Decide what risk level you're comfortable with, THEN look at whether the interest rate is appealing. If not, I continue to think that the best alternative if you want current yield (for example, for a retiree to live off the income) is top-quality stocks with strong earnings paying good dividends.

Dollar vs. Major Currencies



For quite a few years we've been reading doomsayers' reports that the dollar was imminently to become worthless. All along, I've explained why I thought that was nonsense.

In fact, the dollar has risen against a variety of currencies over the past year. Among the majors, only the Chinese Yuan has risen against the dollar, and that's because the Yuan was never a free-floating currency at all; the Chinese government had held the value low for a decade, and has only recently started to let it rise.

Long-time readers know that I usually recommend diversifying to include stocks in other major world economies. For the moment, though, I'm keeping my money close to home. The US' recovery is good, and our economic growth is better than Europe's, still better than Japan's, and at least comparable to other smaller quickly-recovering countries. Thus, I think that the US Fed will start raising interest rates sooner than the other central banks. When the US rates start rising, that will boost the attractiveness of dollar-denominated investments. I think that's the most likely scenario.

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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

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