Capital Drain

Rick's investment opinion newsletter March, 2013 v.9 no.1

Before printing, think about the environment

Hi Readers,

I've moved into my new office and I'm getting back to work. It's nice having a separate 'work' space where I can spread out far more than I could while I was working from home, the boat. My office is a four-minute walk from the boat, both within the Alameda Marina complex. The walk is just long enough to deter me from going back and forth for trivial reasons.

Meanwhile, the economy has been improving, albeit slowly. We got past the Fiscal Cliff, but now we're looking with apprehension at the beginning of the Sequester. Despite the confusion coming from Washington, Wall Street is confident. The Dow Industrial Average set a new record, followed a week later by the much broader S&P 500.

In my opinion:

Executive Summary:

- The Sequester was designed to be a dumb idea, and it is.
- Despite politics, the recovery continues
- Europe is recovering, generally, but a mess still.
- The housing market is returning to normal.
- I'm still in my dividend stocks, but studying alternatives.
- If you haven't yet, refinance your house for a fixed rate.
- A glimpse of the new office.
- It's Credit Report time again! This time, TransUnion.

The recovery continues, and many US companies are doing well, but some of 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.

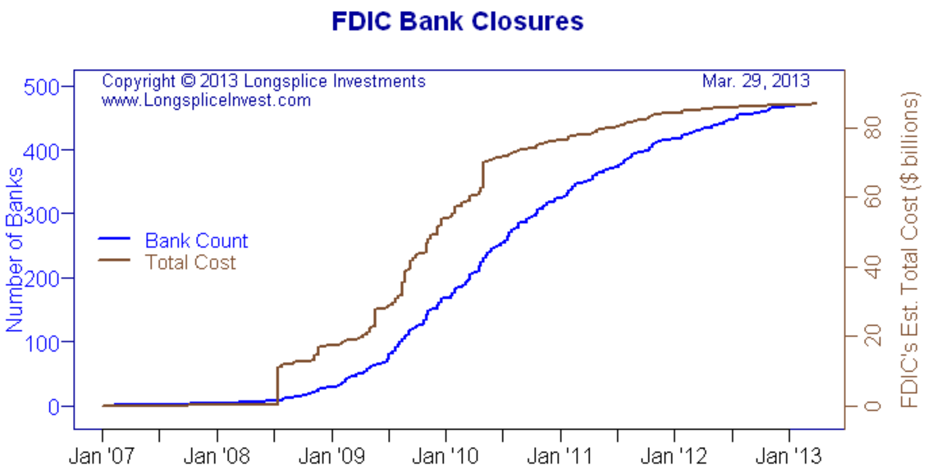
As confidence in the economy spreads, investing in all-market index funds becomes more attractive. We are likely reaching the phase where a rising tide will lift (almost) all boats.

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.

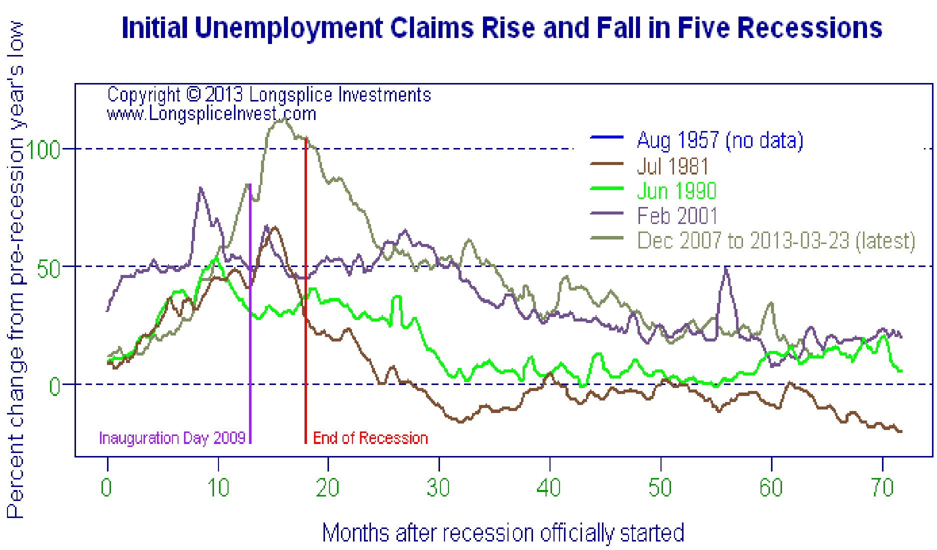
The Details:

The Sequester: it's hard to say what will happen in the short term, but easier in the long term. If the president and Congress make a more-revenue-less-austerity deal, then the recovery will continue and even accelerate. If they stick to cutting spending only, or name-calling only, then the economy will crawl at least until the 2014 mid-term Congressional election re-shuffles the deck.



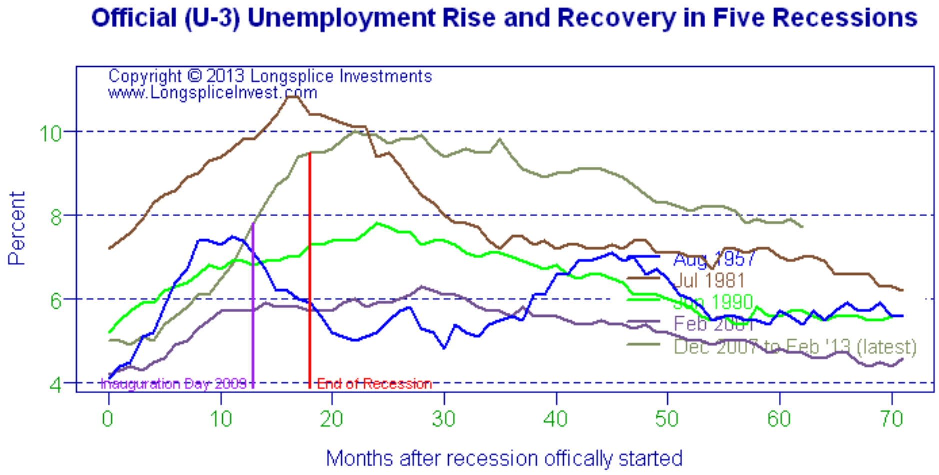
This is probably the last time you'll see this chart. The bank failures that tore the economy apart five years ago have tapered off.

We still have important loose ends to clean up, especially in bank regulation and ending "too big to fail or jail". Still, this crisis is over, and our policy issues are more about how to prevent the next crisis, and not about surviving this one.



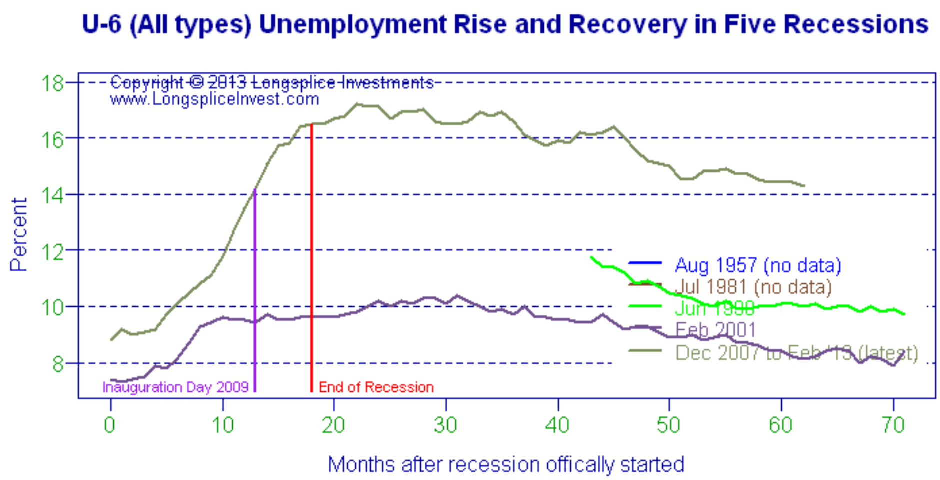
While no longer critical, the economy is only improving slowly. New unemployment claims are still falling, at a level that's typical of prior recoveries. They are not back down to pre-recession levels yet.

The population rose too, of course, so unemployment is not yet satisfactory.



Headline unemployment is down, but still higher than it was at this point after any of the four prior big recessions. That's not surprising, as Congress has allowed far less fiscal (stimulus) support for the economy than it did for the others.

Surely it is only a coincidence that the prior four occurred during Republican presidencies (Eisenhower, Reagan, H W Bush, W Bush), and got lots of fiscal stimulus, but this time Republicans in Congress raised an almighty din about not being able to afford stimulus, and it doesn't work anyway, etc. Oh, and there is that little detail that Senate Minority Leader Mitch McConnell said “Our top political priority over the next two years should be to deny President Obama a second term” on camera, speaking at the Heritage Foundation.[1] There are similar statements from other him and other Republican leaders in print and on news shows. Really, guys, that did not help the country.



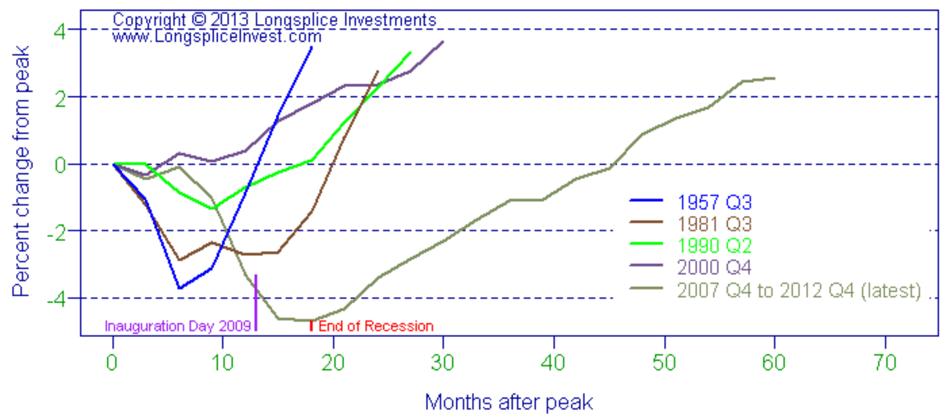
The broader unemployment including part-timers and discouraged searchers is also falling, although from a very high level. It's not too late to do some infrastructure spending, for example, or job training, to address this.

For us, it's enough that the economy is improving.

1 http://www.youtube.com/watch?v=W-A09a_gHJc

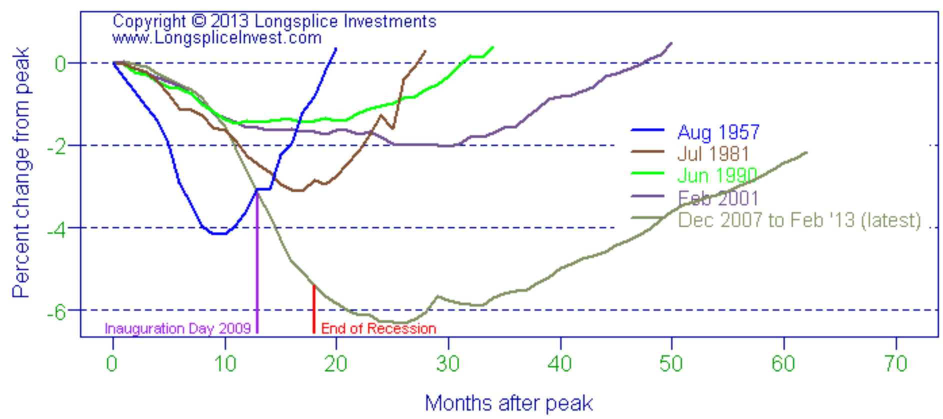
National economic output, GDP, is still rising, although less quickly in the pre-Fiscal Cliff quarter. We don't know yet how it did in the just-ending pre-Sequester quarter. Evidence implies a recovery strong enough to withstand the self-inflicted headwinds.

Real GDP Fall and Recovery in Five Recessions



Employment is rising but is still below the level prior to the crisis and is rising more slowly than in any prior episode except the W. Bush "jobless" recovery.

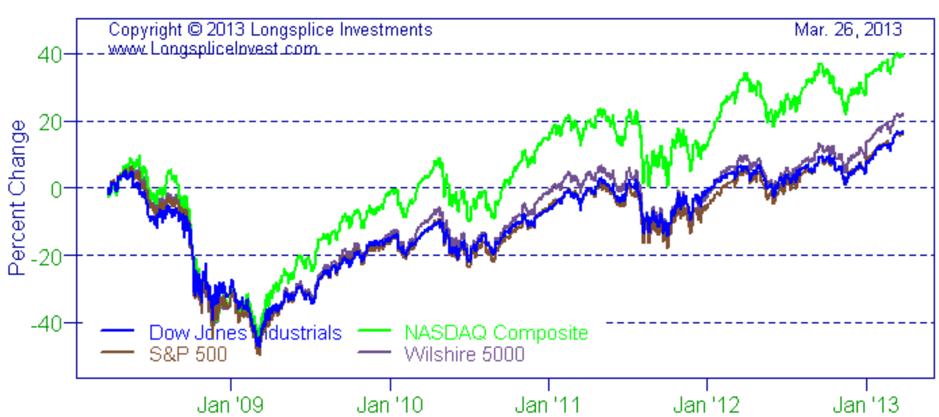
Non-Farm Payroll Employment Fall and Recovery in Five Recessions



The total wages earned (not shown) is rising similarly.

Inflation, which many feared would soar because of the Federal Reserve's bank rescue and Quantitative easing, is steady at about 2%, the Fed's target.

US Stock Indices

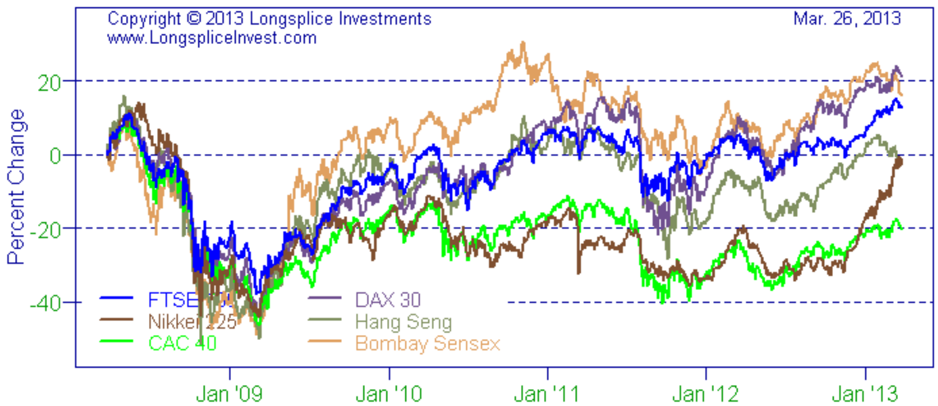


Curiously, while much of the media and political punditry told us that the country was destined to be ruined, professional investors were generally upbeat.

The bottom for the stock market was shortly after the new administration was sworn in four years ago, and the various indices are at or near records.

I have not done the math, but I suspect that the reason the NASDAQ outperformed the others by so much is that Apple and Google have a very large effect on the capitalizationweighted index. In layman's terms, they really really big companies, so averaging them weighted by size gives them a dominant effect. If they were subtracted from the NASDAQ, I think it would be in the group with the other three indices.

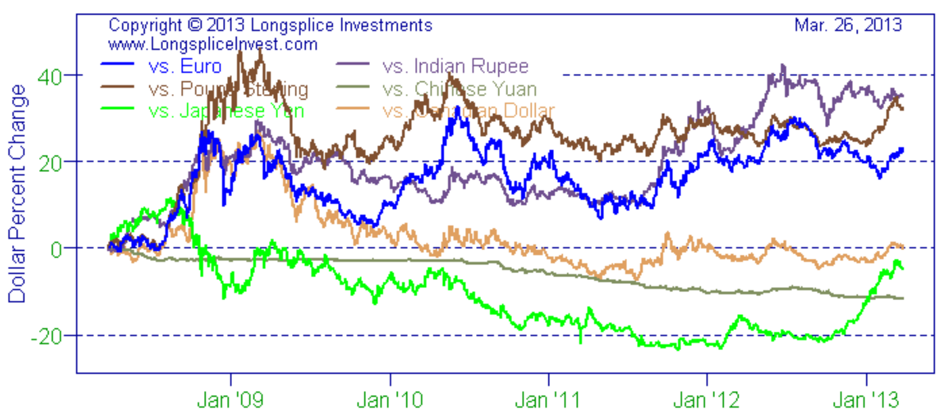
World Stock Indices



World-wide, there are local effects. Europe is struggling, because the banking crisis hit several of their countries hard, and because this is their first big crisis as a single currency. They're having to figure out how to make that work. They will, eventually.

Curiously, it's France's stock market, the CAC 40, which is still down from the start of the crisis. Japan and Hong Kong are back to even, and the UK, Germany, and India are up by about the same percentage as the US markets (not adjusted for currency changes). France has a new Socialist leader, who has imposed a higher tax on the very rich. The tax, the likelihood of more social spending, or both has discouraged investors. They may be overreacting.

Dollar vs. Major Currencies



Again contrary to doomsayers, the dollar has fared well through the crisis. Even though the US financial system was the initial epicenter, the country's wealth and the government's relatively free had in monetary (Federal Reserve) policy has made the US dollar the preferred refuge from risk, rather than a pariah. The dollar has risen 20% or more relative to the even-more-troubled Euro and Pound Sterling, and against the Rupee because of inflation in India. Japan's Yen rose far more than the Japanese government wanted, but they've lately been using their own monetary policy to bring it back to roughly its pre-crisis level. China has continued steadily raising its Yuan, as we have strenuously requested (demanded) and as is best for them now that their economy is not just a source of cheap labor making cheap exports.

Unless there's some dire surprise, that's my last survey of where we are in the recovery. From now on I'll frame my discussion in terms of an ongoing expansion, albeit from a recession-induced low level.

Where are we in this recovery?

Housing is doing pretty well, basically back to normal. The foreclosure backlog is tapering off, and prices and sales volumes are generally rising. Note that 'normal' does not mean 'back to the boom'. We're back to the 1990s, for which we should be grateful.

I think I mentioned in prior letters: if you haven't yet, **re-finance** your house for a **fixed-rate** mortgage. One way or the other, interest rates will start rising eventually.

For that reason, I continue to think that bonds are a dangerous investment, offering too little yield and too much chance of capital losses when interest rates rise.

I'm still quite happy with my selection of solid, dividend-paying stocks, which I picked two and a half years ago. They're so BORING. They just go up along with all the other stocks, and pay on average a 3.8% dividend. Boring is exactly what you want in a crisis.

Now I'm dusting off my old notes to see what I want to switch to for a sustained expansion.

Neither inflation nor the end of civilization is imminent, so gold is losing its appeal as a safe store of value. The price of gold has begun to slide. I've said for a while that I wouldn't buy it; double that. If I had any, I'd sell it.

Around the world, many countries were not directly caught in the financial crisis, and only had recessions because some of their big export customers were having big recessions. India and China never had recessions, only slowdowns. I expect Brazil to get back to steady growth, along with a pack of smaller countries that will likely be the new post-BRIC overseas investment story. Next month I'll look at them in more detail.

The US stock markets should continue to do well. As you can see above, since the bottom was made, there have been several ~10% corrections within the steady climb. I think that pattern will continue.

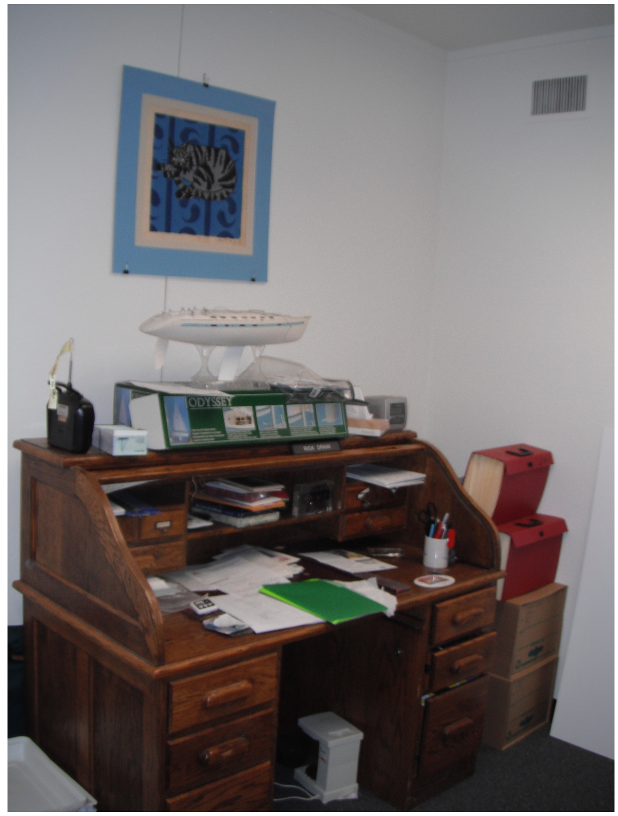
There is lots of room for non-inflationary growth as Europe and the US climb back toward full employment, and developing countries continue to prosper and grow their middle classes.

Don't just skip over the Credit Check section below.

If, like the scene in the movie *The Graduate*, I were to give a bright young college graduate advice for a dynamic career field, it would be “cyber security”. The more we do online, the more the crooks will come, and the more valuable our security innovators will be.

While we wait for them to make the web secure, it's wise to check periodically to limit the damage if you do get hit.

The new office:



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,

Rick

Rick Drain
1815 Clement Ave SPC 16
Alameda CA 94501-1373

CapitalDrain@LongspliceInvest.com
www.LongspliceInvest.com

"Our doubts are traitors,
And make us lose the good that we oft might win,
By fearing to attempt."
--W. Shakespeare