Capital Drain

Rick's investment opinion newsletter November, 2007 v.3 no.10

Before printing, think about the environment

Hi Readers,

On the one hand, I've been getting a lot done on the MF, so that's good.

On the other hand (see, the MBA taught me how to talk like an economist!), I've been dragging my feet on writing this letter, hoping for some insights beyond what's on the nightly news.

I hope I've found some under-reported tidbits that will interest you without trying your patience. Actually, some of this is better described as having been mis-reported, as the cheerleaders are still leaping on every favorable bounce, even as the score mounts against them.

In my opinion:

Executive Summary:

- Financial Market Jenga
- Don't expect much from the mortgage market plan
- Stagflation Lite
- Relativity
- Credit Report time: Experian A world of insight

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:

The financial markets at the moment are like the party game Jenga. One piece at a time is being removed, while we all hold our breath to see if the entire tower will fall. So far, no. Whose turn is it to pull out the next piece?

Specifically, the debt trouble is cascading. Defaulting mortgagees caused CDO tranches to drop in value (some to default outright), decreasing the capital of hedge funds, banks, insurance companies, and even money market funds. Each loss makes investors and banks less eager (and less able) to lend. Decreasing flows of lending push other borrowers toward default.

> This horse isn't just out of the barn. It crossed the county line last Christmas and got itself killed trying to dodge traffic.[1]
>
> \- Jonathan Weil, Bloomberg.com

The Paulson/Bush **mortgage reset plan** is not going to amount to much, positively or negatively.

On the putative positive side, the subset of borrowers who are even eligible for the "fix" is tiny compared to the overall excesses of the borrowing during the end of the housing bubble.

On the putative negative side, the plan is voluntary for all parties. It does not, as some have claimed, "interfere with contracts." It is simply trying to clear the red tape of the many layers of intermediaries between the borrower and the current holder of the debt.

In many cases, the CDO holder is likely to get a better return, not worse, by agreeing to some debt rescheduling rather than forcing a foreclosure and a cheap house sale. At the moment the only thing holding up many win-win (actually loss-minimizing) solutions is disconnectedness. The mortgage broker, the mortgage bank, and the investment bank(s) that re-packaged the debt don't have clear authority to re-negotiate with the borrower, even in the cases where they could improve the situation for both the borrower and the CDO holder.

IF the government can open an easy line of communication and quick deal-re-making, then the overall damage to everyone would be decreased. That's asking a lot, though, so don't expect much.

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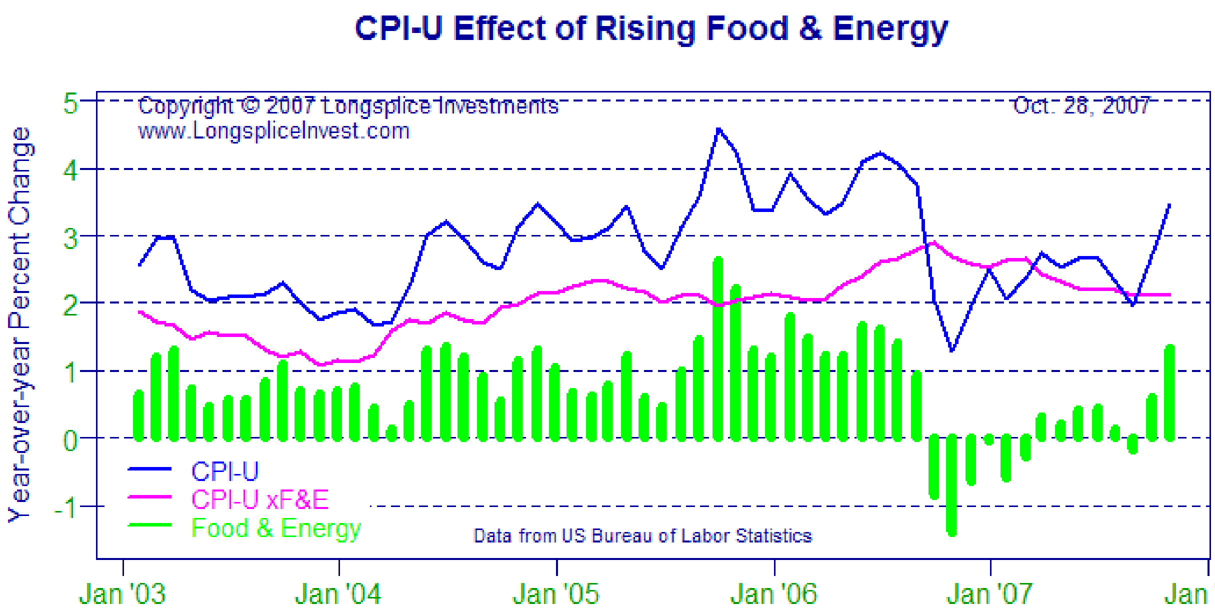
[1] Jonathan Weil, "If MBIA Is AAA, Britney Spears Is Pure as Snow," Bloomberg.com, 10 Dec. 2007, Bloomberg L.P. , 10 Dec. 2007 <http://www.bloomberg.com/apps/news?pid=20601039&refer=columnist_weil&sid=aapRV5jR2uc0>

> Federal Reserve Chairman Ben S. Bernanke said the U.S. economy is likely to ``slow noticeably'' this quarter while high commodity prices and a weaker dollar may stoke inflation ``for a time.''
>
> The inflation outlook was ``subject to important upside risks'' from prices of crude oil and other commodities and the weaker dollar, Bernanke said. ``These factors were likely to increase overall inflation in the short run and, should inflation expectations become unmoored, had the potential to boost inflation in the longer run as well.''[2]

Warnings fly daily: "It's inflation!" "It's recession!"

Which is it? Probably both, for a while, until the recession part really crimps consumption and demand.

Inflation has been higher than the Fed would like, and it is not going away gracefully. The Consumer Price Index for all urban consumers (CPI-U) is what the Fed watches most, and it looks like the blue line, below

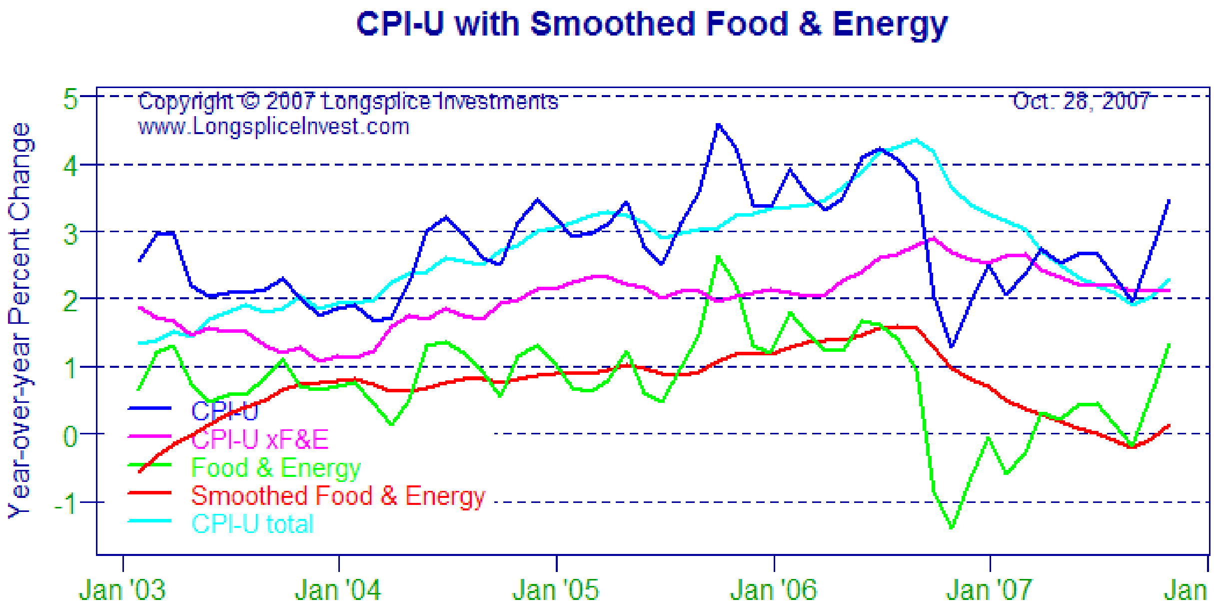


Conventional wisdom says that what really counts is not the "Headline" CPI-U but rather the "Core" CPI-U minus food and energy prices (magenta line.) The argument is that food and energy are more volatile, so they are excluded.

Yes, they are volatile, but that does not mean that the volatility cancels out to zero. Food and energy have, on average, been rising consistently (green bars) for half a decade. Treating that consistent rise as if it simply didn't happen is completely misleading.

[2] Craig Torres and Scott Lanman, "Bernanke Says Fed Sees Slower Growth, Inflation Risk (Update3)," Bloomberg.com, 8 Nov. 2007, Bloomberg L.P. , 8 Nov. 2007 <http://www.bloomberg.com/apps/news?pid=20601068&sid=aJ32UMzYWYsA&refer=economy>

A more sensible approach would be to smooth out the volatility, for example with a moving average, then add the smoothed food and energy inflation back to form a non-volatile, comprehensive total:



Dark blue, magenta, and green are the same values as before: Headline CPI-U, Core CPI-U, and food & energy.

The red line is the smoothed (12-month moving average) value of food and energy.

Light blue is the new CPI-U total. That's the Core CPI-U with a de-volatilized (smoothed) food and energy component added back in. As you can see, for most of the past five years total CPI-U was about 1% higher than Core. Also, we know and can see on the chart how food and energy prices have risen this year. That rise will show up in the smoothed Food & Energy over the coming year.

In summary: inflation has been significantly higher than the widely-cited Core value, and it's rising again, not falling.

It seems almost everyone understands now that there's a recession likely, so I'll skim over that quickly.

The holdouts who don't think there's a recession coming (or happening already) point to the relatively high recent employment report. First, it's only relatively high; 80,000 may sound like a lot of jobs, but because of our rising working-age population it's fewer than we need to keep unemployment from rising.

Second, that employment count uses a sampling method (asking companies about their hiring) that is notoriously slow to react when the economy is turning up or down. A far more timely count comes from the household survey, which asks households about their jobs. That survey is showing slowing employment.

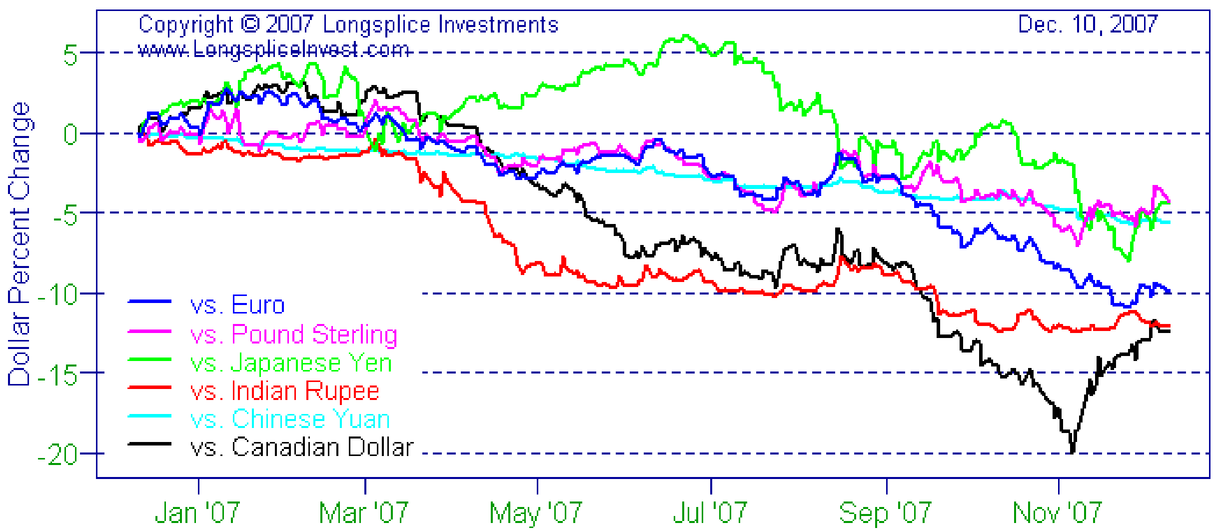
As some of you know, employment is a lagging indicator, that is, surveyed job numbers fall after a slowdown starts. However, new unemployment claims are a leading indicator, because the data is so timely; the system is centralized (per State,) computerized, and new unemployment claims are reported weekly.

The capping evidence of an oncoming recession is that the rate of rise of new unemployment claims is at a recent record high.[3]

Oh, and a recession is going to cause a lot of losses for junk bonds and high-leverage companies. Stay tuned.

The **dollar** is still falling against almost every world currency.

Dollar vs. Major Currencies



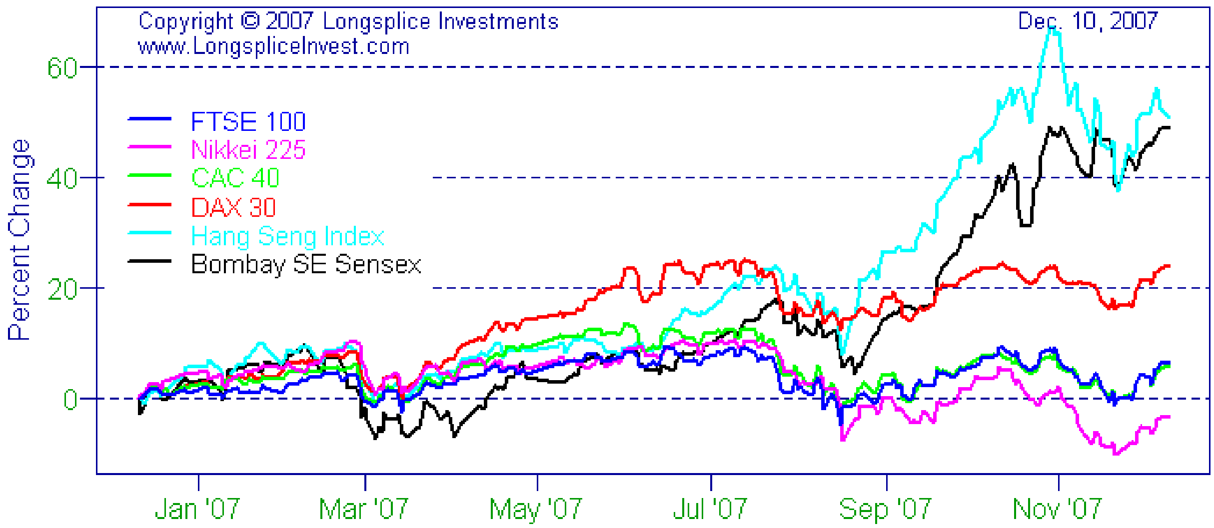
"So what?," you may say. "I work in dollar-land, I save and invest in dollar-land, and I'll retire in dollar-land."

Well, yes, that's true for most people in America.

However (part 1): if you were investing even some of your money overseas, from a dollar perspective you'd be earning relatively more to retire on. If you had taken some dollars a year ago, converted them to the Euros, Yen, etc., and bought a sample of those world stock indices, the dollar value of those indices would be greatly increased. Not only have overseas markets mostly been rising,

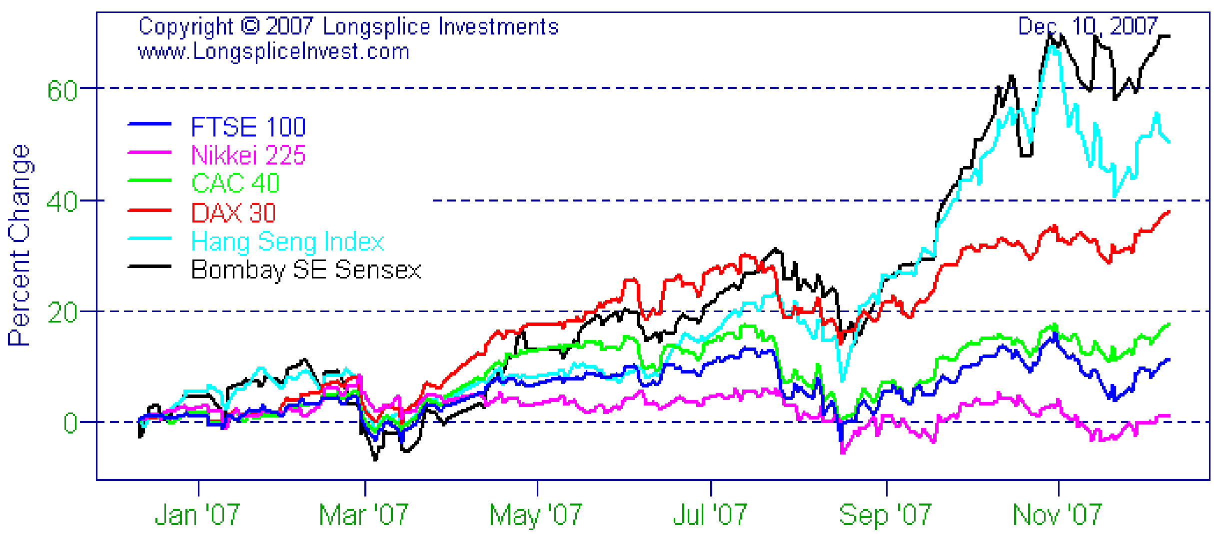
[3] Ruth Mantell, "ECONOMIC REPORT: Trend of jobless claims highest in two years," MarketWatch, 6 Dec. 2007, Dow Jones & Company, 6 Dec. 2007 <http://www.marketwatch.com/news/story/trend-jobless-claims-rises-highest/story.aspx?guid=%7B2D266A56%2D489E%2D43A4%2D9484%2D7068E6FC4D48%7D&siteid=yhoof>

World Stock Indices



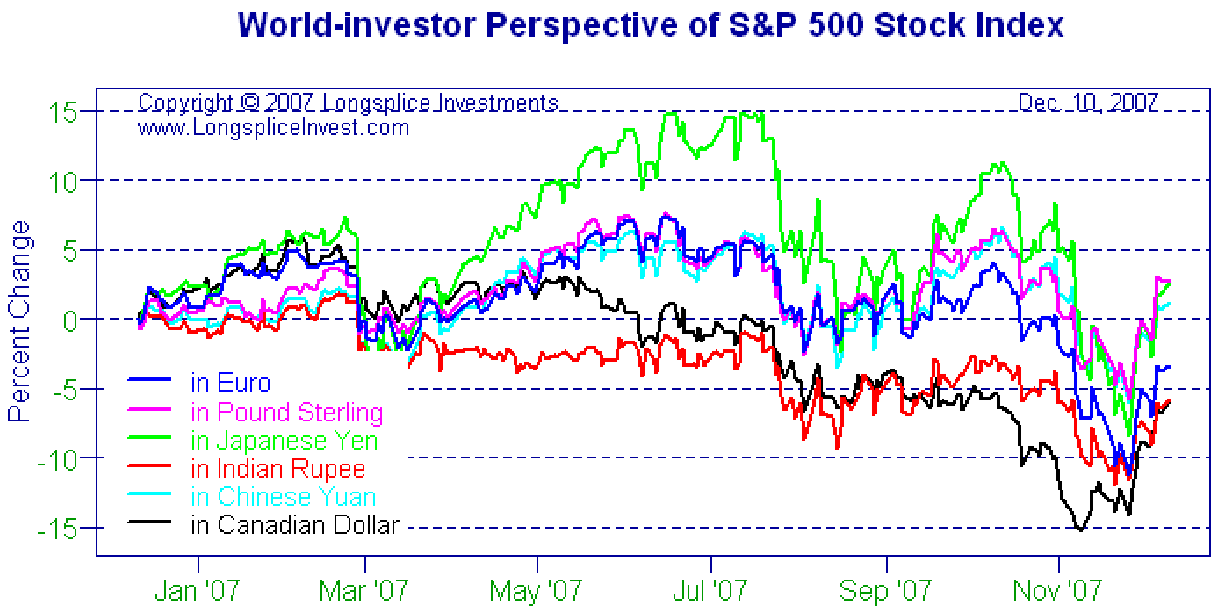
but add to that the fact that those currencies are rising and the picture gets even more attractive. Your gain today (converted back into dollars) would look like:

Dollar-value Perspective of World Stock Indices



But maybe you just want to stick with good old US dollar stocks that you know about. They've been doing tolerably well, and after all, people from all over the world invest their money here.

However (part 2): overseas investors may not be sticking around for long. From the relative perspective of their home currencies, they've taken a beating over the past year:



The Brits, the Japanese, and the Chinese could have earned a tiny profit (similar to a bank savings account) but except for the Japanese they could have done better in their home markets. Investors from Europe, India, or Canada, to name a few, lost money here when they could have made money at home.

Well, too bad for them, eh? But it doesn't mean anything to dollar investors, does it?

It easily could. If overseas investors start leaving US stocks en masse, that could further depress both US stock prices and the dollar. That would mean something significant to even to domestic dollar investors.

If I had to pick just one investment right now to buy and hold for a year, I'd pick German government bonds. Why?

Not dollars.

Benefit from a recession.

Negligible risk aside from currency exchange rate.

Now for some personal-finance housekeeping. Let's visit Experian for a free check on our Credit Report:

- Open your favorite browser and go to https://www.annualCreditReport.com
- select your State and click "Request Report"

- Fill in the form with your personal information.
  - Click the little box that says "show only last 4 of Social Security Number in report"

  - Enter the security code (this prevents automated logins)
  - Press "Continue"

- Click the little box next to Experian A world of insight
  - Click "Next"

- Click "Next" again

- Enter the last 4 digits of your SSN
  - Click "Submit>>"

- Ignore the offers for other services (unless you really want one)
  - Skip down to "No thanks, I just want my free..."
  - Click on "Annual Credit Report"

- Click on the little box marked "I have read and agree to Experian's Terms & Conditions for the Experian Credit Report."
  - Click on " Submit "

- Answer the security questions
  - Click "Continue"

- You should see the Report Summary page and instructions to make a note of your report number.
  - Make a note of your report number.
  - Notice where it says the number of potentially negative items, number of accounts in good standing, etc. Do the totals seem right?
  - Click the little link that says "Print your report". (It's on the same line as your name)

- This pops open a new page (or tab) with your actual report.
  - Read through it
  - Click "Print Report"

- Assuming you haven't had any problems with these steps, you're done.

- Click "Close window" to close the print page/tab.
  - Click "Return to AnnualCreditReport.com" at the very top of the page. This logs you out from Experian.
  - If you then get a message that your session has timed out, ignore it. You're done.
  - Close the browser window.

Congratulations, you're now one of the 0.1% most fiscally responsible people in the whole world. Reward yourself.

Each of us is allowed one free report per year per credit agency, of which there are three. That works out to allow you one report every four months.

It's time to send this on its merry way.

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.

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

Take care,

Rick

Rick Drain
P.O. Box 5425
Redwood City CA 94063-0425

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