Capital Drain

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Hi Readers,

The month has had plenty of news stories, but not much that has really been new news. Things are playing out pretty much as anticipated.

That leaves me with little to say, so this will be brief.

In my opinion:

Executive Summary:

- Oil & gold surging, dollar falling hard
- US recession likelier
- Rest of World too early to tell
- Up escalator, down elevator: cheerleaders, complacency, bubbles, and panic

> 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:

Why should it follow that a falling dollar exchange rate against other world currencies would be accompanied by rising oil and gold prices? It's not a coincidence.

Metals, oil, and many other materials and foods are priced on a world market. Prices are set by supply and demand, by buyers bidding for goods that sellers offer. That price is set by bids from all the buyers in the world, not just US buyers.

Imagine the world price as being set in an abstract non-national currency, the Mund. Everyone everywhere pays the same price in Mund. The Mund price is turned into a dollar price or a Yen price or a Rupee price by multiplying by an exchange rate.

On a day when the dollar falls against the Mund but the other currencies stay constant relative to the Mund, it looks to dollar buyers as if everything in the world just got more expensive, even though everyone else in the world sees the same price as before. It also looks to everyone as if the dollar fell relative to every other currency.

The Mund is fictitious, of course, an abstraction. Mathematically, though, it is out there, equivalent to the center of the web of exchange rates we have between any two currencies.

So now we see almost every good we buy getting more expensive in dollars, and the dollar falling relative to most other currencies. As it happens, oil and gold and food are getting more expensive for everyone, but much less so for non-dollar buyers.

Rising dollar prices for world-traded goods and falling dollar exchange rates are two sides of the same coin, inevitably linked.

Oh, in case you were wondering: adjusted for inflation, we are indeed approaching an all-time high for the (dollar) price of oil. On the other hand, the price of gold (this evening $788/troy oz.) is not even close to its inflation-adjusted record price of over $2100.

Meanwhile, the housing market continues to plunge. There are no more US real estate bulls, at least publicly, as everyone can see that supply and demand are far out of balance. Home builders over-produced, selling to people who really couldn't afford the houses. Those houses are coming back onto the market either as desperation sales or foreclosed bank sales.

The only realistic way to get that back into balance is for builders to build far fewer houses for quite a while. As I've discussed previously, that has a depressing ripple effect on the rest of the economy.

Economic expansion or contraction is all about ripples: house builders buy nails, nail makers buy boots, boot makers buy celery, farmers buy cars, car builders buy houses, et cetera, et cetera, et cetera. The level of those ripples can be increasing or decreasing.

Right now, in the US, the levels at several points in the chains of ripples are decreasing. The Federal Reserve Bank is concerned that there may be a recession coming, and you should be too. Maybe it will only be a slowdown, not an actual recession. It's unlikely that it will be a happy-happy Goldilocks soft landing, though. It feels more like angling in toward a landing at DFW during a summer thunderstorm. It's really bumpy, and everyone onboard is just praying that there won't be a really really big bump at the end.

The economies in the rest of the world seem to be doing better. Our real estate troubles are largely local, despite the financial sloshing and our decreased purchases of Italian marble and other imported building materials. Even if the US has a recession, the rest of the world may be OK.

A quick aside, though: I've read a lot of pundits saying that the US technology sector is a relatively good bet now "because 70% of their output is shipped overseas," and is therefore insolated from a US downturn. Wait a minute. Much of the tech production goes overseas to get assembled into finished products to sell back to US businesses and consumers. A US recession could hit tech just as much as any other mixed local/export industry.

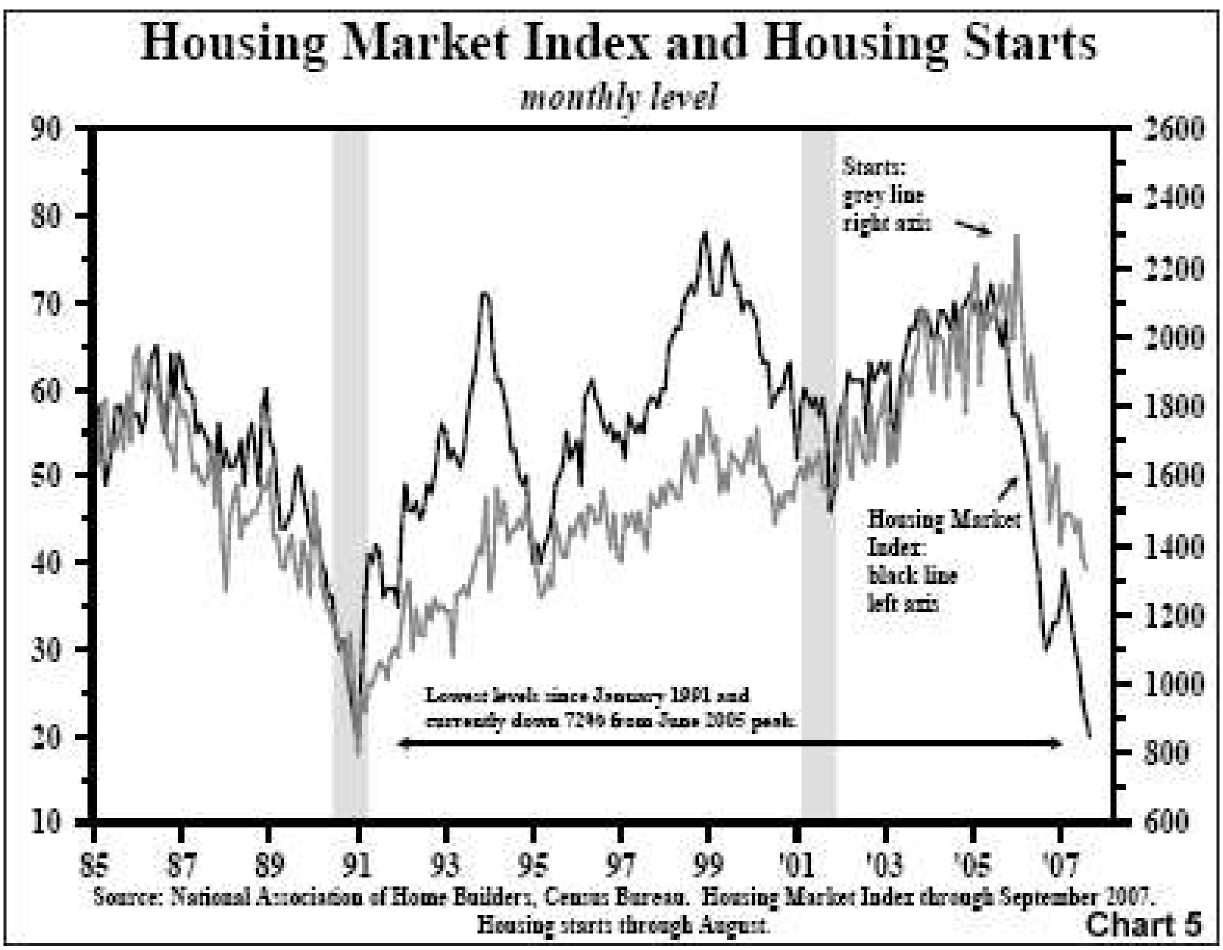
It was interesting that Caterpillar, a Dow Industrials Index company, warned that while it was true that the falling dollar was increasing their export sales, the domestic sales were decreasing even faster.

US-based exporters are relatively well-off in a US recession, but not immune.

I heard an interesting phrase the other day:

"**Up on the escalator, down on the elevator.**"

That seems appropriate when looking at the housing market from 2000 onward:



The housing market (solid dark line) rose pretty steadily for years. Well-paid people in expensive suits on respected TV shows said it would keep going up 'indefinitely.' Toward the end of the run, the pace of the rise was fast, by historical standards, but not even close to as fast as the pace of the fall is now.

The classic bubble recipe: borrowed money, early success, cheerleaders with a 'bold new era' story, mass complacency about risk, historic rises... and historic fall.

There's nothing we can do about this bubble now, but if we remember this we won't be among the victims of the next one.

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,

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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