Capital Drain

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Before printing, think about the environment

Hi Readers,

There's a delicate balance in the financial world today. While many of the old driving forces are still active, some may be about to change direction, and new ones may be about to come into play.

It's interesting to watch, but hard to make firm predictions about. It could tip one way, or the other. On the other hand, on the other hand, on the other hand...

Still, there are some directions it will definitely NOT go, so we can make some rational choices despite the uncertainty.

Since I'm already late, I'll try to be quick. In my opinion:

Executive Summary:

- Oil up for real
- Negative real interest rates: inflationary
- Housing and spending still falling
- Dollar.... won't fall forever
- Rates & bonds
- backfill: explanatory note about credit checks

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 only way speculation can have a persistent effect on oil prices, then, is if it leads to physical hoarding — an increase in private inventories of black gunk. This actually happened in the late 1970s, when the effects of disrupted Iranian supply were amplified by widespread panic stockpiling.
>
> But it hasn't happened this time: all through the period of the alleged bubble, inventories have remained at more or less normal levels. This tells us that the rise in oil prices isn't the result of runaway speculation; it's the result of fundamental factors, mainly the growing difficulty of finding oil and the rapid growth of emerging economies like China. The rise in oil prices these past few years had to happen to keep demand growth from exceeding supply growth.[1]
>
> \- Paul Krugman

Likewise for food. Prices are high because world prosperity has created more demand faster than it has created more supply. These high prices are fundamental, not financial market artifacts.

We've been trained to think of "core" inflation, inflation excluding **food and energy**, as the correct inflation measure to watch. Sort-of. If you are a Central Bank, it makes sense to ignore food and energy inflation because there's not much that monetary policy can do to affect those prices. The Bank can only adjust interest rates to limit the flow of food and energy inflation into "core" inflation in the prices of manufactured goods, labor, and services.

If, by chance, you are not a Central Bank, then headline inflation is the inflation you see in real life. It matters. The current high food and energy prices are real inflation, having a daily effect on our real lives.

Meanwhile the Federal Reserve has lowered interest rates to try to forestall or at least cushion the drop in the housing market and the broader economy.

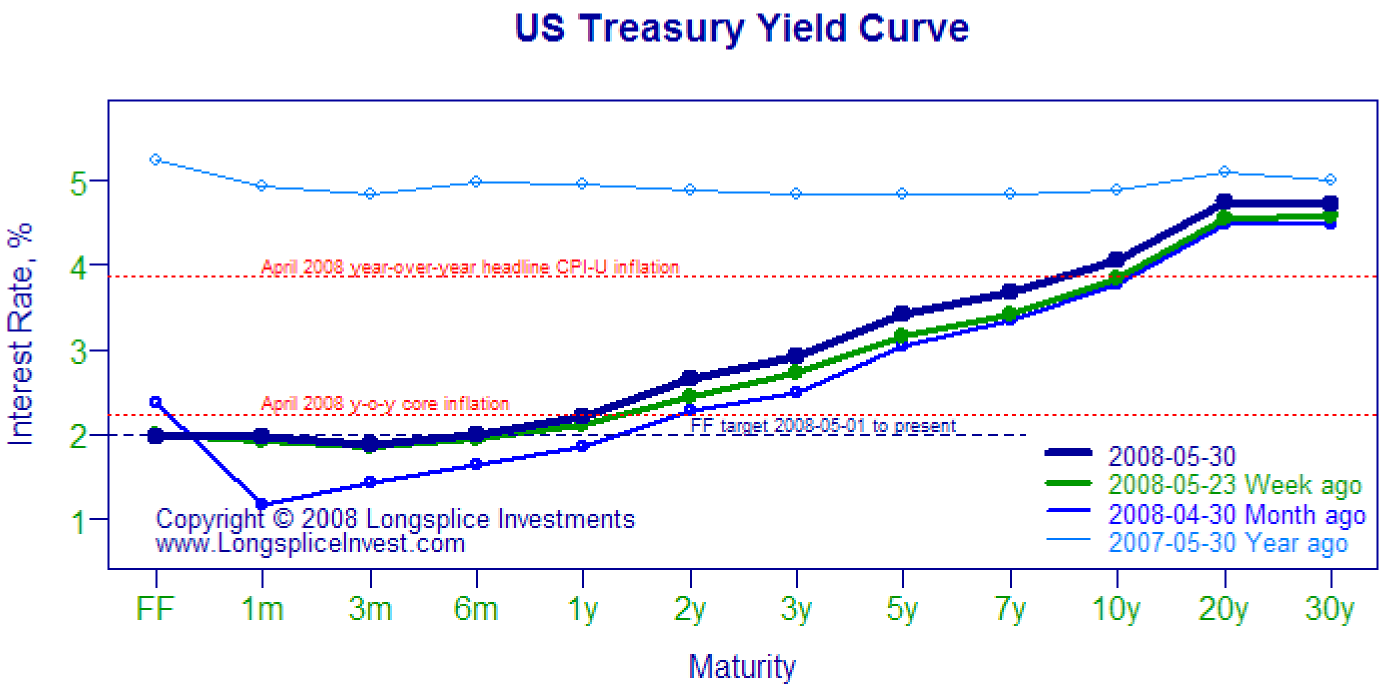
There's a delicate balance they are seeking. Interest rates too low will feed inflation. Too high could cause a recession that might otherwise not have happened.

At the moment, the Fed is leaning far toward helping the economy at the risk of letting inflation take off. The current overnight-lending Federal Funds rate is lower than the core inflation rate. That means that adjusted for inflation, the Fed is *paying* banks to borrow from them. It's called a **negative real interest rate**.

Generally, interest rates rise for longer loans. The same is true for government borrowing, so the interest rates of Treasury bonds rises as the maturity lengthens from

1 Paul Krugman, "The Oil Nonbubble", NYTimes.com, May 12, 2008,The New York Times Company, May 12, 2008, <http://www.nytimes.com/2008/05/12/opinion/12krugman.html?_r=1&oref=slogin>.

overnight to 30 years. Adjusted for inflation, Treasury debt rates up to one year maturity are lower than core inflation.



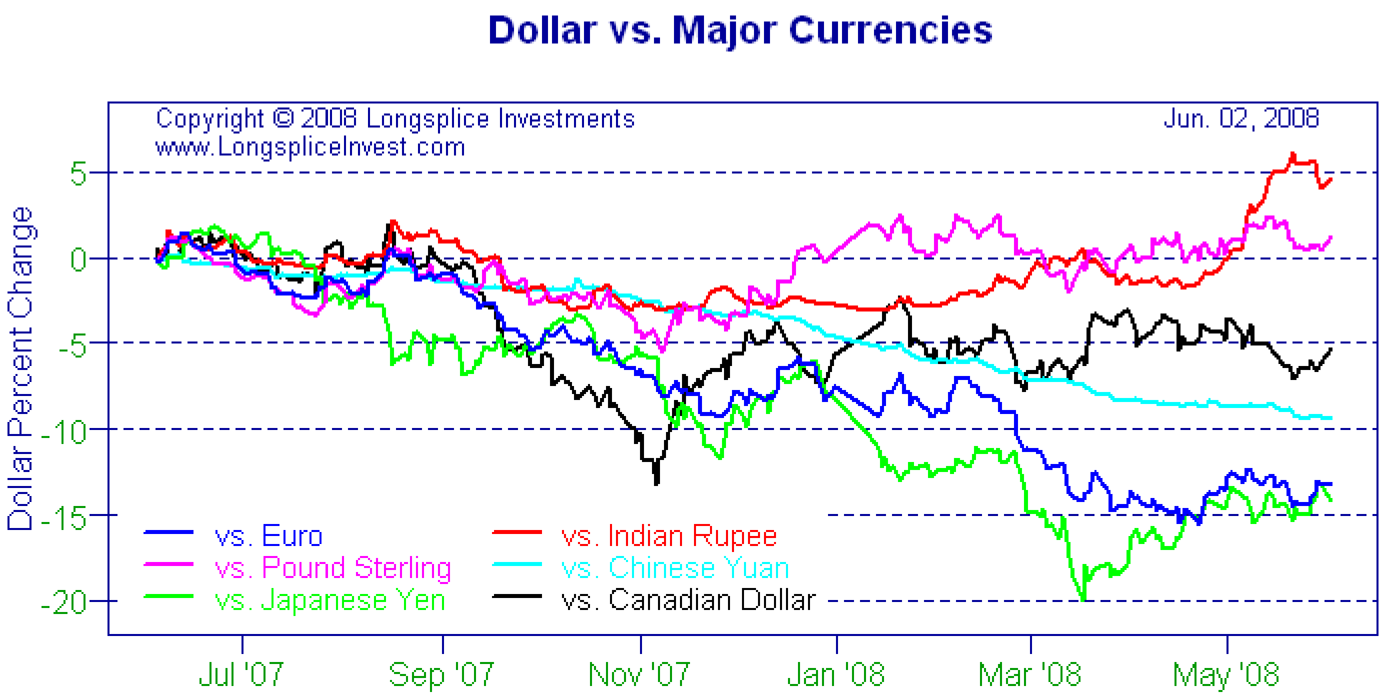
And what about our actual inflation including food and energy? Treasury bonds up to almost 10 years maturity are at rates lower than headline inflation.

Giving money away like that is, itself, inflationary. It may yet help the economy, but it may yet create a big inflationary problem. By contrast, the European Central Bank (ECB) is holding its interest rates higher, putting more emphasis on their concern about European inflation (which is *ahem* *lower* than ours) and willing to slow their economy if that's what the economic facts require.

We'll see whose approach works better.

Meanwhile, our housing market really is a mess, and it's sloshing over into the real economy. The official statistics say we're not in a recession yet (as of the end of March), but it seems like a recession to a lot of people. Auto sales are falling, retail sales are falling, and airline ticket sales are falling, to name a few.

Oh, yes. And the **dollar is falling, mostly**. Against the Euro, the dollar may have fallen more than enough, but that doesn't stop it from falling further in the short term. Against Asian currencies, particularly the Chinese Yuan, it has a ways to go. Overall, the theme will remain one of a falling dollar, even if it starts to rise against the Euro. The dollar and the British Pound have stayed nearly even, and the Canadian dollar and Indian rupee have made big swings and corrected partially.



There's a balance here, too, affected by interest rates. If the US were to start raising rates, the dollar's fall would, in general, slow or reverse. Similarly if the ECB or Central Bank of China were to start lowering rates.

For the moment, neither of those scenarios seems imminent. Still, this bears watching, because the dollar won't fall forever. When the dollar's fall reverses, it will make good sense to bring money back to US investments.

I'm still pessimistic about US stocks, somewhat pessimistic about US bonds and overseas stocks, and still somewhat optimistic about overseas high quality bonds.

I'll be sure to write again quickly if the news makes me think that we've tipped to a different investing phase. Also, next letter I'll write about the typical phases in an economic cycle.

Last month I got a few questions about **Credit Reports**, so I'll go back and fill in some info.

Three independent companies called the Credit Rating Agencies track whether you've been a responsible borrower, in order to predict whether you'll be a good risk for a new loan. They do this with information from all your past creditors, and their business is to sell the summary info-- not the raw data-- to potential lenders. These agencies are in a privileged spot, seeing your non-public information and passing judgment on what they see in order to tell their customers whether you're a minimal risk or a probable problem. This privileged spot has prompted a measure of government regulation: there are limits to what information they can give out, and to whom. More important, they are required to let you check on the information they have, and correct it if it's wrong. To check it, you need to ask one of the agencies for a copy of your Credit Report.

The report contains a list of all the loans, credit cards, revolving charge accounts, etc., that you've had in the last decade or two. Even the accounts that have been closed are listed. For each account, it lists your credit limit, maximum balance, and payment history. In particular, they'll make a big fuss if you had significantly late payments.

You really ought to check your Credit Report. Identity theft is accelerating, and spotting something fishy in your report, like an account you don't remember opening, may allow you to catch a problem while it's small. Also, if you may need a loan someday, the time to clear up any credit-history errors is now, not at the last minute.

It's free, once per year per credit agency, to get a copy of your report. Since there are three agencies, that means that you can go to one agency every four months.

It’s time to check the spelling and zap this to you.

If you have any questions, please write or phone. If you want to read more, I’ve got a web site with archived editions of this letter and some links to other interesting sites. There's also a web log 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

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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