Capital Drain

Rick's investment opinion newsletter November, 2011 v.7 no.4

Before printing, think about the environment

Hi Readers,

Once again we can see that perfection-- or at least a desire for continuous improvement-- can be the enemy of the good.

I've been working on other ideas to include in this letter, and time has passed. With all the chaos in the markets, I realize that you may have questions, to which I may have answers. I'll share that, quickly.

This letter will be about this moment. The bigger picture will come next.

In my opinion:

Executive Summary:

- There is a recovery, but it's anemic.
- Europe is a mess. My Big Fat Greek Debt Crisis.
- The US economy and the dollar become "the least smelly shirt in the pile".
- Treasuries to stay low
- Refinance, borrow, sell TIPS, sell Treasuries
- It's Credit Report time again! This time, TransUnion.

Many US companies are surprisingly 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 renewed bounce. Better to risk a little less gain rather than a lot more loss.

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 (or no E).

The Details:

"Political economy is a mere skeleton unless it has a little human covering, and filling out, a little human bloom upon it, and a little human warmth in it."[1] - Charles Dickens

I'm sure you've noticed, the worlds are chaotic. The political world, the macroeconomic world, and the investment world are all being roiled by major unprecedented events. To put it mildly, that makes investing difficult.

First off: I do not believe any of the dire predictions for the US economy. It is weak, but recovering slowly, as I'll describe in a moment.

Second: I'm still happily holding my selection of strong dividend-paying stocks that I described just over a year ago in the October 2010 letter (bottom of p.5). Dividends have been paid (around 4% yield), some have been raised, and as a group the stocks have appreciated by about 5.25%. Nine percent total may not be as fun as the good old days, but it is very good for these days. I'm sticking with it.

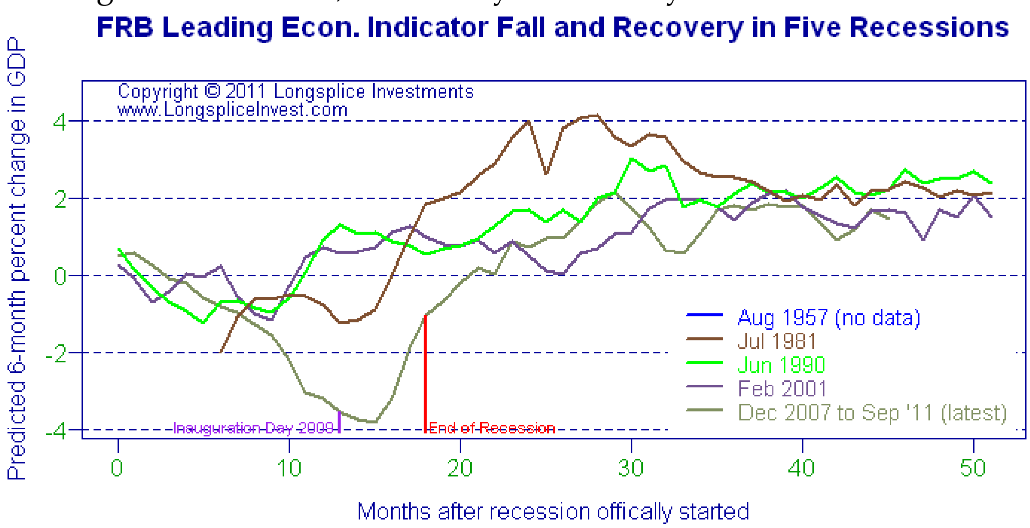
Third: Yes, Greece is in deep deep trouble, and Europe is going to suffer too.

Fourth: The failure of the Congressional Super-committee was all but designed in, certainly not a surprise or a market-moving event.

About our recovery: Despite a faction in the House of Representatives that's doing its darnedest to be unhelpful, we are still recovering, but slooooowly.

The Conference Board's widely cited Index of Leading Economic Indicators (LEI) continues to rise sharply. They don't let people quote the data or graphs, but you can see the latest report here.

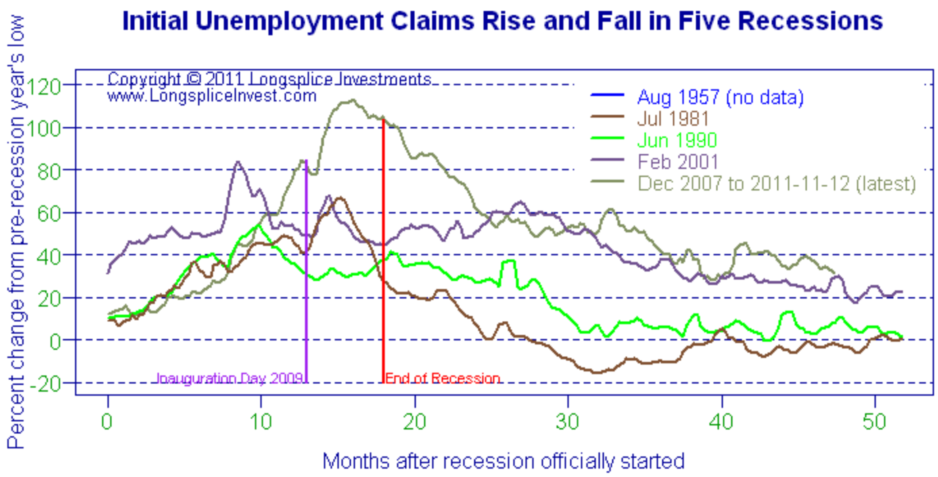
The Federal Reserve (which is not, in fact, the Root of All Evil) have their own leading indicator series, which they share freely.



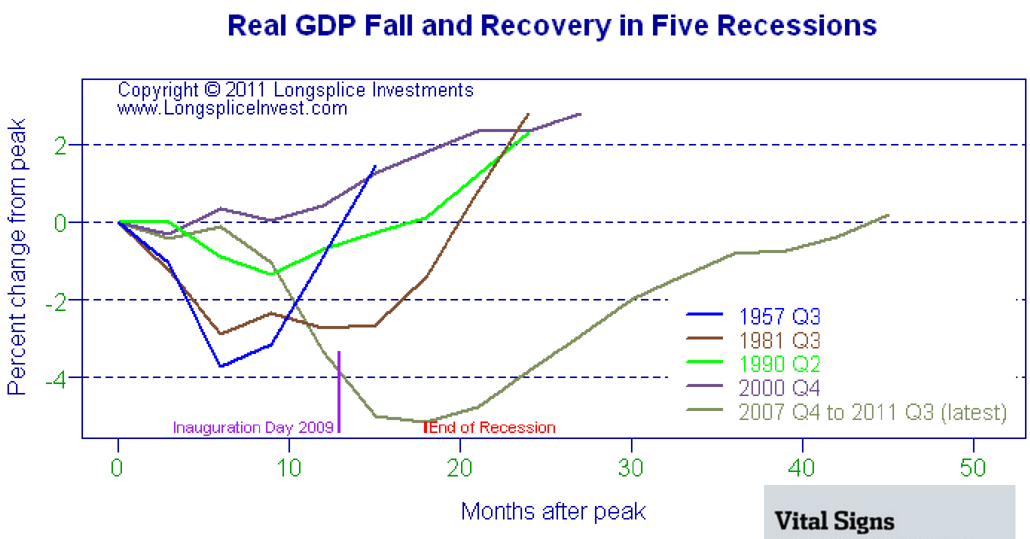
As you surely recall, a leading economic indicator is a composite of measurable economic variables that tend to move up or down before the overall

1 Charles Dickens, "On Strike", Household Words: A Weekly Journal no. 203 (February 11,1854)

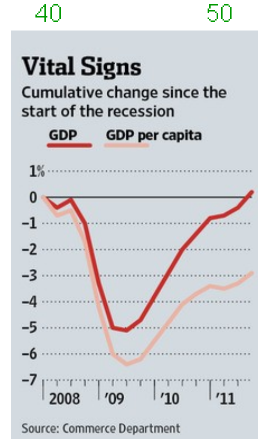
economy moves that direction. During a recession, a leading indicator will start to rise well before the economy is perceptibly improving. In the chart above, rising values mean that the economy will likely be getting better (or getting worse more slowly), while values above 0 indicate actual expected growth, actual improvement. About 24 months into our current recession, we crossed back into real growth. We've kept growing, in fits and starts but with no backsliding. As you can see, the rate of growth is slower than in any of the other example recessions. Still, growth is growth. That's what we need.

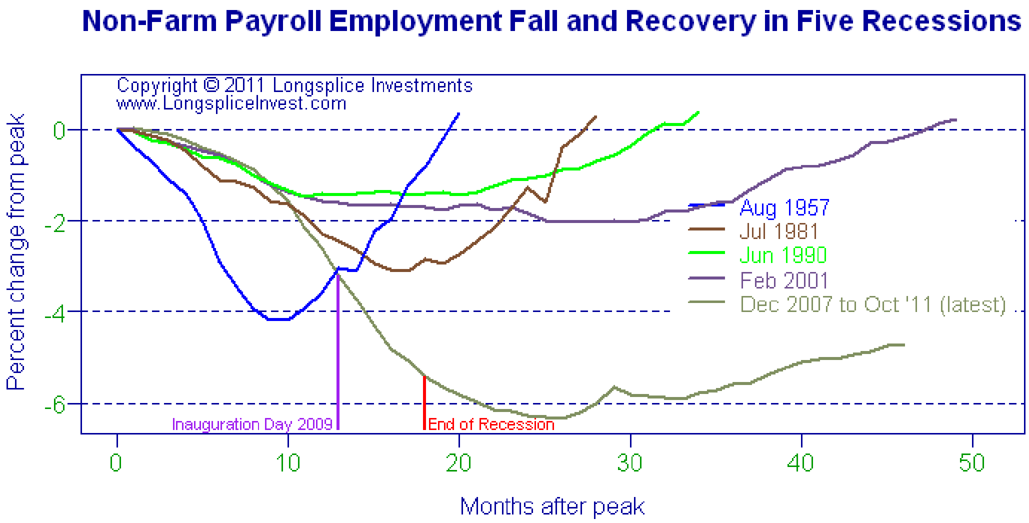


One crucial component of the LEI is the rate of job loss in the economy. This is measured via the new unemployment insurance claims each week. This has been improving, but it's still running at a higher (worse for everyone) rate than during the "jobless" recovery of the early- to mid- Noughties. Other recent recoveries were already back to pre-recession normal levels by this point.



In the simplest terms, the GDP, the level of economic activity, is back to the pre-recession level. However, that ignores the fact that the population has been rising. Adjusting for population, the per-capita GDP is still far below the pre-recession level. That measure is consistent with real workers' experience of the economy. It is still low, and the real per-capita growth is painfully slow.





Finally, there are (or aren't) jobs. Employment always rises well after a recovery has begun. This time, the fall was the worst since the Great Depression, and the rise has been the slowest as well. Two years after the lowest point, the jobs total is still lower than the lowest point of the previous recessions. This is one reason why it doesn't seem like a recovery at all to so many workers.

All that sounds bad, and it's clearly not good. Still, it is improving. With no useful assistance coming from the split Congress, what we see now is probably what we'll still be looking at next November: slow growth, and many workers who will have been unemployed for yet another full year. With luck, we'll get election results that can pick up the pace after the new Congress is sworn in in January 2013.

The main wild card in the US prognosis is Europe. If the European governments do their jobs tolerably, they'll muddle through too, although in even worse shape than here. If they make a critical error, or if a key political block decides to block real solutions in favor of theoretical perfection, then it could be worse.

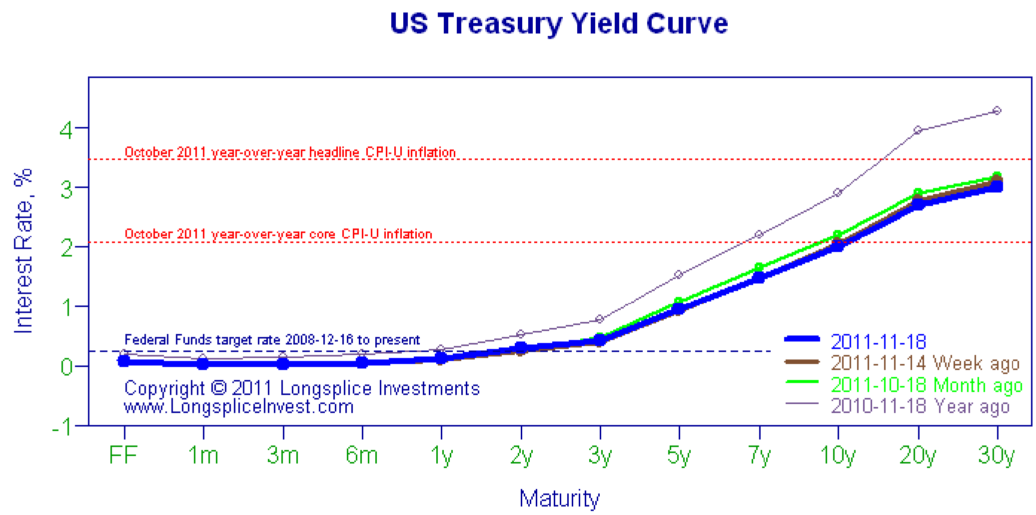
I expect that they'll muddle through.

For all our troubles, the rest of the world's investors still appreciate the US economy's strength. You can call it the least smelly shirt in the laundry basket, but the fact is that all the big economies have problems, and the US is still the richest. Most important, the dollar is still the world's reserve currency.

Why does that matter? Greece, or even France, can't print Euros to pay interest on their debts while they sort out renewed growth. The US can. There is no actual chance of a US debt default, politics notwithstanding.

That means that investors here and around the world see the US as the safest place to invest. You'd think our troubles, implying the treat of printing dollars, would devalue the dollar in world markets, right? Quite the opposite. It's been rising against all except China's Yuan (still ~~manipulated~~ “managed”) or Japan's Yen (still a truly comatose economy.) I agree; that's why I'm keeping my money here, rather than diversifying worldwide, as I usually do.

The interest rate you can earn on Treasury debt is laughably low. It's lower than inflation. Why bother? Safety. Many investors are piling into Treasury bonds because, again, they're the least-smelly shirt in the pile. They're safe, and the loss of value to inflation (which most investment managers gloss over anyway, BTW) is considered worthwhile as an insurance premium.



This is a big problem for savers, and for retirees who are trying to live off the interest from their savings. It's a guaranteed slow loss, drawing down the principal and losing buying power. IMO they'd be better off in dividend-paying stocks, despite the possibility of a capital loss.

Speaking of capital losses-- what happens when interest rates go back up, as they someday must? Capital losses for bond holders. The price of the bonds goes down as the interest rate goes up. They probably won't go up anytime soon, but they will eventually.

Is there any good side to that? Brett Arends of SmartMoney.com suggests a few. First of all, he agrees: sell Treasuries, sell TIPS.[2] They're dead money, waiting to become losses.

Anything else, Brett? Yes! Refinance your mortgage, if you have one, and still have good credit. Borrow, if you have productive uses for money. Lock in the low rates, while you can. And of course, cut costs. A penny saved remains a penny earned.

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.

2 Brett Arends, “Dark Days: 10 Money Moves to Make Now”, SmartMoney.com, 23 Sep 2011, Dow Jones & Company, 23 Sep 2011 <http://www.smartmoney.com/invest/strategies/crash-ahead-ten-smart-moves-to-make-now-1316718981677>.

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 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 . This time I had no problems.

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.

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