Capital Drain

Rick's investment opinion newsletter June, 2016 v.12 no.2

Before printing, think about the environment

Hi Readers,

It's been two months again since I wrote. As I'm sure you know, something momentous has happened in world trade-- the British people have voted to leave the European Union. What will this mean?

Far closer to home, about six weeks ago I helped trap a family of marina feral cats-- including two new kittens. The mother and yearling older brothers were neutered and vaccinated and released. The kittens have been attending “living with humans school” (food bribes and ever-increasing physical contact). They are ready to graduate and look for a new life-long home as pampered pets.

I would like to introduce brother and sister Pretty Boy and Ms. Kitty, 12 weeks old, neutered, vaccinated, and socialized. They're now accustomed enough to us to walk up and demand petting, to take the best chair in the room, and to play or sprawl on the floor asleep as we go about our human business. Let me know if you might like to adopt them, please.

Back to investing. In my opinion:

Executive Summary:

- US economy chugging along, slow but not stopping
  - Low interest rates-- re-finance your mortgage?
- China, Brazil having their problems, elsewhere doing OK
- BrExit: What does Britain, the UK, voting to leave the EU mean?
  - Investing? Nothing yet-- nothing has actually happened yet.
  - The EU economy? Some EU countries have problems, but they won't change.
  - Britain's economy? The EU wasn't really the problem.
  - Politically? Leaders seeing pissed-off working class.
- A sea change has begun in understanding the economy, better late than never.

The recovery continues, and many US companies are doing well, but some 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 corporate 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:

First, despite the big drop in the stock markets and all the breathless reporting you've likely seen, all is well for us. The US stock market went way down for two days, then bounced back up. I hope you didn't do anything rash during the drop.

Growth continues to be slow but steady. Inflation is low. Employment (in number of workers) is rising and unemployment (in percent) is falling. I'm sitting tight with the portfolio I described some time ago.

Because interest rates have gone so exceptionally low, many Americans may be able to re-finance their **mortgages** to lower their monthly payments. It's worth checking to see if you can. Stick to basics, though. No balloons, teaser rates, cash-outs, or any of that fancy nonsense that ruined so many homeowners eight years ago. Just lower the monthly payment for the same term, or shorten the term for the same payment.

Elsewhere in the world, **Brazil** is making headlines with budget, corruption, and political problems (and hosting the Olympics in August). **China** is clearly beginning to have a problem with excessive bad debt within their economy, which will probably hurt their investment markets and may lead to an actual recession. Countries heavily dependent on selling fossil fuels, metals, and other industrial commodities are getting vastly lower prices and sales.

In better news, India and many smaller countries are quietly moving forward.

Now, the big news of the week: what is this **BREXIT** thing?

A simple majority of the British electorate voted for the United Kingdom (England, Wales, Scotland, and Northern Ireland) to leave the European Union (Europe minus Switzerland, Norway, and the micro-states like Monaco, and including candidate members Iceland, some non-member Balkan states, and Turkey).

The European Union is the current form of a system for allowing European countries to trade more easily with one another and contribute to their collective growth. Precursor organizations first sought to lower tariffs on trade among the members. As the rules for encouraging trade covered more and more items, more rules had to be added to keep the trade fair and resolve differences. For example, each of the countries had its own safety standards, like our Underwriters Laboratories. The European governments got together and settled the differences so there was just one standard. Rules for travel got simpler and were phased out so members' citizens no longer needed visas to visit the other member countries, and eventually so that they could live and work in the other countries if they wished.

To make a long story shorter, in the interest of Europeans being able to treat all of Europe as their homes (although they would still vote in the national elections of their country of citizenship), a lot of rules had to be worked out and agreed on. That required a bureaucracy, and created the impression that the bureaucracy was imposing rules on the member states. All the rules were by mutual agreement of the countries, but many Europeans including many Brits felt as if they were now being ruled by the bureaucracy as much as by their national governments.

The free-travel rules caused particular anxiety. The theory was good, that if country X couldn't hire enough workers of a certain skill, then workers from other countries could go apply for the jobs. The model for that was the US, where we have a lot of worker mobility among our cities, states, and regions, decreasing the pain of local recessions or business closures.

It became a bit strained when the EU expanded to include more of the smaller or poorer countries, mostly to the east of the founding core. It also got strained when there were recessions, because newly unemployed people in one place could move and add to the difficulties of the unemployed elsewhere.

This became acute in the latest (for many member countries, current) recession, because of a number of factors that pointed people toward the UK. The UK is the second largest economy in the Union. It was affected less and has recovered more in the current recession than most of the others. And finally, while workers throughout Europe would grow up knowing primarily their birth language, almost everyone's second language was English. Native speakers of Polish or Romanian or Greek were more inclined to go to the UK rather than the other large economies like Germany or France or Italy. So many did.

This was exacerbated by the flow of refugees from Africa's and the Middle East's armed conflicts.

The final factor that led to the “Leave” vote was the decision to have a referendum at all. This was a promise that UK politician David Cameron made-- to his own party's “Euro-skeptic” wing-- while he was campaigning to become Prime Minister. He won, he kept his word and held the vote, and he lost. The referendum was not as he expected. He has resigned effective this coming October.

There are some points that need to be made:

- All that's happened thus far was a vote, which is not formally binding. It can be overridden by Parliament if they're willing to take the public anger.
- The “Leave” campaigners do not have a plan for how to go about leaving. They made conflicting claims during the campaign, and now no one really knows what, specifically, leaving will mean. Many in Parliament are wisely saying they need to do some careful thinking before moving forward.

- If Parliament chooses to continue, they have to file a specific formal request to the Union.
- Once that request is filed, the UK and the EU have *two years* to agree on the terms of separation. No one knows yet, but even those terms may include delays and phase-outs of some parts of the EU agreement, and will almost certainly continue to agree on many others.

Markets hate uncertainty, so almost all markets dropped on the news of the vote, but most have come back or will soon.

This is **unlikely to hurt the EU countries in any way**. Some of them, particularly in the south, have real problems, but nothing about Britain's alleged eventual exit from the union will make those worse in any direct way. There may be extra continental European investment that would otherwise have gone to the UK, so that would be positive.

Several companies have already said they may delay or relocate investments from the UK (especially London) to Europe. At a minimum, that makes other companies and consumers more cautious. Further, a large portion of the UK's exports were to the EU, but only a much smaller share of the EU's exports were to the UK. The eventual re-negotiated terms of trade could be less favorable to the UK than they are now.

Finally, the UK may hypothetically be able to dramatically restrict free movement of people from Europe, but that will likely come at a very high cost to their relations with the EU countries, and, more importantly, immigration was never really the root problem, as I'll describe shortly.

Politically, the UK is seeing a huge shakeup. The heads of both dominant parties are likely to be changed. A new Prime Minister needs to be chosen. UK members Scotland and Northern Ireland voted overwhelmingly to remain in the EU. Scotland has voted before on whether to stay in the UK, and there is talk about another vote so that Scotland could leave the UK but stay in (or join) the EU.

At least among the UK's Labor party, there may be a significant re-assessment of why the working classes were so eager to leave the EU. It is very clear from the results that educated, wealthy, and professional people voted overwhelmingly to stay in the EU, but they were outnumbered by the less-educated, less-skilled, lower-earning tradesmen, farmers, service workers, and unemployed who voted to leave. Why did all those people vote to leave?

Much of the discussion focused on stopping immigration, but the economic numbers show that immigration was not the reason that the middle and lower classes were earning so poorly. Rather, the relative impoverishment of the workers compared to the professionals started before the immigration surge, and was caused by the disappearance of good-paying jobs, and more people having to take low-paying jobs just to get by.

That problem is not unique to the UK, but is also seen in the EU itself and most flamboyantly in the US where Donald Trump has won the Republican primary votes and is their presumptive nominee to be the President of the United States. There are a lot of workers in the west who are realizing that for decades their national economies have been doing well as measured by GDP, but they personally and as a segment of society have not been getting a share of the gains. Their lives have become uncomfortable and low-hope for the future, and they want a change.

Happily, some people with influence are listening. In fact, some have been predicting this moment for a while. Trump, while a horrible choice to lead to a solution, does see that many voters care intensely about this problem. Senator Bernie Sanders, Senator Elizabeth Warren, Congressman Alan Grayson, and others in government and in politics have been pushing this message since at least the Wall Street collapse and the Occupy Wall Street movement. Likewise some business people and financiers including Warren Buffet, Bill Gates, and a plethora of economists most prominently Robert Reich and Thomas Picketty have been warning us.

Starting in the 1980s in the US and the UK Reagan's and Thatcher's shift toward "supply side", or "trickle down" economics transferred economic power away from working people and toward big companies, their owners, and their senior managers. As wealth was transferred, political power shifted to corporatism as well. Some businesses were deregulated far too much, most notably the financial industry.

Further, the way globalization was implemented, in a laissez-faire government-hands-off manner, created too many losers. Yes, global trade was great for our national GDP, but the gains went to the professional and investing classes, and the jobs were taken from the working classes. Taxing some of the gains of those who gained, and using the money to re-train and otherwise assist those who were being harmed, could have prevented this from becoming a crisis.

Part of what made western economies work so well for everyone from the 1950s to the 1980s was that the rules of the game assured that a rising tide would lift all boats. It has been changing since the 1980s so that a rising tide lifts only the yachts.

The BREXIT vote and amazing fact that Donald Trump can be polling in double-digit percentages to be president are a sign that the shift has gone far too far. We need to re-jigger the rules so that gains for the wealthy also produce gains for the rest, so that everyone will want to keep the system going.

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..

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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