Capital Drain

Rick's investment opinion newsletter December 2004 v.1 no.1

Hi,

I'm new to this newsletter business. If you'd like me to write more or less about any topic here, or anything else, please let me know.

In my opinion:

Executive Summary:

- The US Dollar will likely be devalued ~30% over the next 3 years OR QUICKER. Maybe much quicker.
- Investing in non-US stocks and bonds is a reasonable alternative in its own right.
- Investing outside the US then coming back after a 30% devaluation books a 30% gain OVER the local-currency return.
- Some overseas investments are better bets than others.
- US interest rates will rise-- US bonds will fall.
- Real estate will be vulnerable to a "soft spot" or correction.

In general, by the time an investment trend makes the headlines, it's nearly over.

The current decline of the US Dollar is an exception. The extent of the US trade and budget deficits is dooming the dollar to a substantial devaluation. The problem and the inevitable result have been clear to most economists for quite some time, but now the inevitable is slowly becoming the immediate. Even Fed Chairman Greenspan and administration apologists have shifted from "it hasn't gone wrong yet, so it won't ever," to "the market will decide, but don't worry." What, us worry?

"Wait, why a devaluation?" Excellent question.

The US collectively, corporately, personally, and governmentally, has been consuming beyond its means, consuming lots of imported stuff, and paying for the consumption with money borrowed from abroad. Nice game, as long as "abroad" wants to keep lending money.

Why would they lend? To keep their sales to us up, by keeping their currencies down, by recycling the dollars they receive into purchases of Treasury bonds.

OK, then why wouldN'T they lend? Because they're slowly realizing that we're not about to stop borrowing, and certainly not about to start repaying old debts.
You probably don't want to hear all the Macroeconomic rationale, but basically, the same thing that inevitably happened to Argentina when the lenders got scared can happen to us too. Sure, we're Top Dog, they're just Argentina, so we get a lot of extra slack, but the basic rules are the same. When the debtor can't pay, the currency devalues as debt-holders rush to sell their bonds.

"Such gloom!" you may say. Yes, it's not cheery.

There is, however, a bright spot.
The US is only about 25% of the total world economy. [Europe is another 25%, Japan is another, and the final 25% is everyone else: China, Canada, India, Korea, Brazil, and many more.]

The reason that's good news is that a sensible investor who wants to diversify among stocks and bonds in the overall market is still investing in 75% of the overall market even if she ["she" is more likely a sensible investor than "he", by the way, more on this some other time.] ... rewind... a sensible diversified investor is still investing in 75% of the overall market even if she completely excludes dollar-denominated stocks and bonds.
Put another way, investing in the stocks and bonds of the rest of the world (principally Europe and the Far East, via reputable US mutual funds) is still very widely diversified. Further, whatever ratio of bonds and stocks make sense for your investment/retirement plan can be achieved.

All other things being equal, "the rest of the world" would be a perfectly reasonable investment; broadly diversified across regions and industries. The overseas stocks and bonds will, on average, have returns similar to typical US stock and bond returns.
All other things are not equal, however.

If you invest abroad, even if the investment had NO return while the dollar is devalued 30%, you can then bring your invested money back to the US... as 30% more dollars than you started with. That's the tail-wind that makes overseas investments a particularly good bet right now. Add in a normal diversified return, and you're way ahead of the person who stayed in dollars.

What's the downside?
The dollar might not be devalued? Then you merely get normal investment returns.
The dollar might rise? Pigs might fly; yes, this is the downside where one could lose value, but economists would pirouette in their graves.
Overseas markets aren't as efficient as here? Several big, reputable US mutual funds put a lot of effort into smoothing out this problem for us. Their records speak of their success. Anyway, with a 30% tail-wind, small inefficiencies wouldn't be noticeable.

Is it "anything but dollars", without any distinctions?
No. There are definitely better and worse bets. Worse first, because some of them have been popular lately:

WORSE bets abroad:
Developing country debt.
Old Europe stock.
Stocks in countries that are highly dependent on selling to us. [How can you tell? If they have a substantial middle class, they have a substantial domestic customer base and aren't so dependent on exports to us.]

BETTER bets abroad:
Central European stocks.
Canada, Australia, New Zealand, stocks & bonds.
High quality government and highest quality corporate debt.

How to invest? I've made a list (and checked it twice) of a handful of nice no-load mutual funds that specialize in the promising areas. That list and a further discussion of why I picked each one is available to subscribers to my Model Portfolio newsletter. Email me at CapitalDrain@Ricks-Cafe.net if you would like to learn more.

If you don't want to bet all your investment money on "just" the other 75% of the world, here are some thoughts on US assets:

WORST bets domestically:
High-yield debt
High-yield debt
High-yield debt (got it?)
Any other debt

BETTER bets domestically:
Blue chip stocks that export a lot, especially if they pay a big dividend (for your IRA) or have a big stock-buyback program (for your taxable account).
Inflation-indexed Treasuries, if you simply must have domestic bonds.

Why am I so down on debt? And for that matter, damning almost all domestic stocks by omission? Because a likely side-effect of the dollar devaluation will be a sharp rise in domestic interest rates. Those overseas Treasury buyers would become Treasury sellers, driving down the price (which raises the interest rate.)
In turn, higher rates would cause slowing growth (at best) for the domestic economy. High-yield debt (aka junk bonds) are currently priced for a very rosy scenario, so their prices will fall fast (and yields leap up) if the economy starts to look even a little sour.
The domestic silver lining is that dollar devaluation will, after a lag, increase the exports of US companies.

Real Estate

A corollary to the warning about rising interest rate is that Real Estate (RE) has been rising at historically unheard-of rates for the last few years. Falling interest rates have brought buyers into the market, which has raised prices. Rising interest rates would likely do the opposite, especially painfully for those buyers with adjustable-rate mortgages.

At a recent family gathering, my parents' living room was filled with people talking about how very much money they'd made in RE on their houses THAT YEAR.
I was here in Sili Valley during the tech stock bubble, and that's exactly what it sounded like. When everyone is so excited about an investment that it dominates social conversation, the top is approaching.
So, if you have a house you like, great, keep it. I would however be VERY careful of investment/speculation at this point. RE is much less liquid than stocks are, (ie, you can't sell fast w/o depressing the price) so when you first smell smoke, quietly start heading for the exit.
In addition, if you have an adjustable-rate mortgage, look carefully at the contract to see how fast and how high your payments could rise. Ask yourself whether you would like to make those higher

payments.

And finally, Gold.

The price of gold has been on a tear upwards lately-- the dollar price. In the rest (75%, remember?) of the world, it's been pretty steady. In general, as the dollar falls, the dollar price of gold will rise. I say in general because the market for buying and selling gold is tiny compared to the markets for trading currencies. Gold will roughly follow currency moves, but it will have eddies and feints and surges and plunges all its own.

I've made a pretty good profit owning gold & silver miners (again, a no-load mutual fund) this year, but I'm out now. I believe that gold will likely have one of its little idiosyncratic plunges in the next few-to-ten weeks, after which I'll buy back in. I seldom do that kind of market-timing, but this is an exception.

That's about all I have to say for now.

If you have any questions, please please write or phone.

In particular, would you like for me to include links to background articles, or do you prefer the summary-discussion format?

Again, for those of you getting this gratis, I intend to charge $120/year for this newsletter. If you're not sure, you could subscribe for 3 months for $40.

Special rate for self-unemployed entrepreneur friends: remember me when you break into the black.

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

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"Delenda est Microsoft"