# Capital Drain

Rick's investment opinion newsletter *ahem* "December, 2005" v.1 no.10

Hi Readers,

OK, it's mid-January. I'll still call this the December wrap-up issue, because that's what I intended it to be when I started it.

On the new name: I got a resounding chorus of no response (actually one response) to my suggestion of "Ask Why Investing."

Perhaps I should explain my thinking a little better. "Ask why" seemed like a good description of my style, which is based on economic fundamentals. Some are microeconomic fundamentals such as individual company performance; some are macroeconomic such as GDP growth or trade balances. Either way, I'm interested in trying to figure out the environment, as a way to guide investments in the directions that have the odds in the investors' favor. No one can predict the markets exactly, but if you can be somewhat more right than wrong you're doing OK.

Other images that fit that "ask why" theme are "Lookout" (which is already taken) or perhaps "Crow's Nest", after the place whence a lookout would look out on an old sailing ship. "Spyglass" is taken. Apparently I'm not the first person to follow this line of reasoning, because a lot of the good names are taken. Historically, few ships had actual "crow's nests." Instead, lookouts were posted at the "top" (akin to spreaders on modern boats) which were platforms near the tops of all but the highest segment of the mast, or "crosstrees" if the proto-spreader was not enhanced into a platform. On a large sailing ship, the highest of these lookout positions would be the "topgallant crosstrees" or "topgallant top". Taken, taken, and taken. See http://en.wikipedia.org/wiki/Top_%28sailing_ship%29 for more.

By the way, some of you might not be aware: there's a really good, free, open-source encyclopedia on the web, http://en.wikipedia.org . It's not perfect, but it's durn good, it's better every day, and it really is free. No salesmen will call.

OK crew, set the mains'l & let's go. In my opinion:

## Executive Summary:

I still think the Dollar is in for quite a bit of depreciation. I was wrong last year, but that's my story and I'm sticking to it.

For anyone who listened to my comments about gold stocks back when I started writing, you're probably pretty happy now. That said, I'd be scared to recommend a new purchase of gold stocks now.

Inflation is still a real possibility, but this is a case of the centipede economist: the arguments for or against inflation go on the one hand, on the other hand, on the other hand, on the other hand, ...

The Conference Board's leading indicators are still sinking, and you probably heard on the news about the yield curve inverting. Neither is a death knell for the economy, or for the US stockmarkets, but neither do they help anyone's confidence.

As before, I think everyone is best off with a **broad diversification** that includes at least **3/4 overseas** assets, reflecting the distribution of world economic activity.

These are **not the best of times**, so investors need 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 such as Google, Whole Foods, or Taser.

Sure, Google is doing great. So was Pets.com once upon a time. Google's a pretty good company, but at the current price you could only buy based on the Greater Fool Theory: "Sure, I paid too much, but I'll find a Greater Fool to whom I can sell it for even more!"

## The Details:

OK, how could I be wrong about the Dollar falling for the entire first year of my publishing career and still stick to that same story? First, how I was wrong: I failed to realize that as the Fed raised the short-term interest rates, rising past the short-term rates of other major currencies, it would bring "hot" money from overseas eager to earn those higher rates. That's what happened, and that's the extra push that held the dollar up all year.

Those Fed rate rises are nearly over, though, so that source of Dollar buoyancy is about to end. The trade and fiscal deficits are not about to end, but rather are expanding. The pressure for the Dollar to drop will return, and will likely be pretty steady all year.

Gold is a stable element but an unstable investment. Many are tempted to treat gold as an alternative to national currencies during bad times, i.e., when unsure whether the Dollar or the Yen or the Euro has the worst relative problems, they pick gold instead. The problem is that the entire gold trading market is really tiny compared to any big national currency market, so the price can jump around a lot. Since last January, "a lot" has meant rising by 25%. Over the same period the stocks of gold-mining companies have gone up 50%.

That's been a fun ride, but it makes it harder for me to be confident about the future. As long as it keeps going up, I don't plan to sell, but I can't say that I would want to buy at this level. It's risen far more quickly already than I expected. I'd figured that (as I said way back in issue 1, http://www.ricks-cafe.net/CapDrain/CapDrain_v1n1.html ) gold rising would simply be the mirror image of the Dollar falling. Instead, gold rose against all currencies. I was lucky.

Inflation: is it is or is it ain't?

Well, it is, a little, but only a little. Despite the huge rise in the price of oil (and a rise in the price of vegetables, but I'll bet you didn't notice), inflation is up only a little for the year. The counterbalancing factor is that at the same time, globalization has been lowering many prices for many goods and services. Net, it's only a little rise in prices.

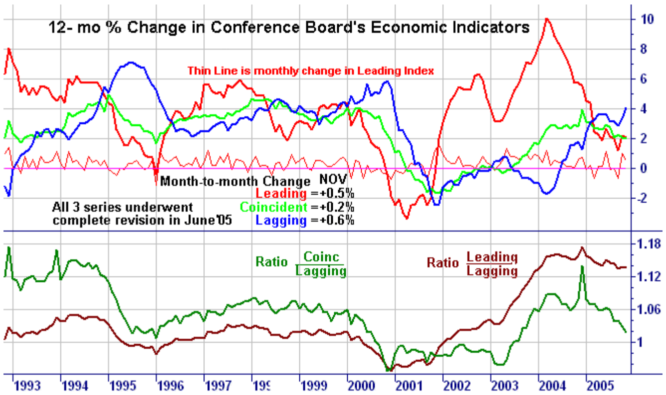
But now it gets interesting: if the Dollar starts to slide, then the price of everything we import can be expected to rise. That includes oil, but also all the clothing and cell phones and practically everything else-- will all rise at once. Net, that could be a bigger rise in prices.

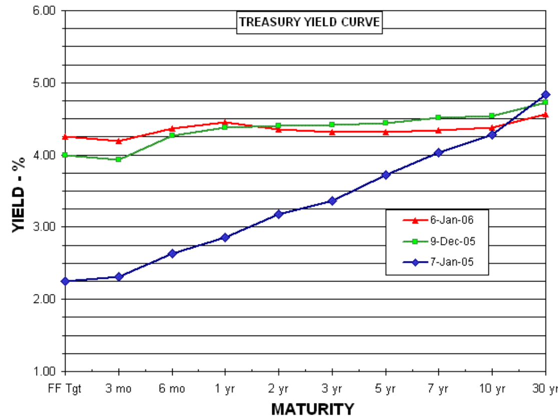
Now, I said "could be." For a while, as the Dollar slides, foreign exporters may try to keep the price to us low by decreasing their profits. That could, net, keep our inflation from rising much more.

The other inflation consideration, of course, is our own economy. If we were to have a recession, or even a slow slowdown of the economy's growth, then we could expect many prices to fall. The recession/inflation tradeoff has been familiar to most of us over the past few decades.

But in Washington, they say the economy is going great! How could I think about a recession? Well, even in Washington not everyone believes what they hear in press conferences. There are others, many of them professional economists, who note that the economy has been stumbling along slower than any other post-WWII recovery, despite record government stimulus. It wouldn't take much bad news or bad luck to make a sickly economy actually sick.

The Conference Board's leading indicator index (which is selected because it generally leads, i.e., predicts, economic performance) has been falling for nearly two years (see left-hand chart, below). The Coincident (moves generally at the same time as the economy) index has been falling for one year. That's not very cheery news, not great at all. I don't know if this has been mentioned much on TV. Certainly not in certain Washington press conferences.




(both graphics courtesy of [Martin Capital](#) )

Something that did get a lot of TV time lately was the inversion of the yield curve. On the right-hand chart above, the blue line shows a classical, typical yield curve. Short-term rates are low, medium-term rates are higher, long term rates are highest. The blue line was one year ago.

Last week our yield curve was the red line. Note that the yields from 2-year maturities to 10-year are lower than the 1-year rate (thus "inverted"). This isn't typical.

It's not-- yet-- as bad as some on TV have made it sound, saying that an inverted curve predicts a recession. Not so fast. This was just one week. It's true that a protracted (scale of months) inverted curve has been quite an accurate predictor of recessions. One week or a few, however, isn't so meaningful. For this, we should just wait and see.

That's all for now.

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

Please feel free to forward this to any friends or associates who may be interested.

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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