Capital Drain

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Hi Readers,

Perhaps you've noticed my first change: I'm trying to make this look a little spiffier.

The second change is still in the works: I'm casting about for a new name for the newsletter, something a little less flippant without becoming truly boring. I'm eager to hear any ideas that pop into your heads.

The third change is that I'm experimenting with delivery formats. Today I will send you this in .html format, in the email. Tomorrow I will send it as an MSWord .doc attachment. The day after, I'll send it as an Acrobat .pdf attachment. Please let me know which works best for you, and particularly let me know if one of these doesn't work at all for you. Thanks.

OK, on with the show. In my opinion:

Executive Summary:

Behavioral Finance tip: It is possible to check your portfolio value too often. Once a week is plenty; monthly is enough; quarterly is OK.

The Dollar: Central Bankers of the world were watching to see if Bush's new Federal budget would address the fiscal deficit. It doesn't, and the stage remains set for the dollar to drop.

Macroeconomics: The economic expansion is bumping along and should continue, but don't expect any more roaring great profit increases. Stocks should do moderately well, nothing special.

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.
Above all, avoid the investments that are at all-time extreme valuations: junk bonds, developing-country bonds, and headline-grabbing stocks such as Google or Taser.

The Details:

"It is difficult to make predictions, especially about the future." -attributed to everyone from Mark Twain to Yogi Berra to Neils Bohr. For the record, it wasn't me, but I'm happy to quote it.

First, 'bout that **Dollar**. There have been articles lately about how China won't unpeg their currency, so the dollar will just stay high. Ask yourself, though, who wants to keep lending big money to a borrower who just won't reform his spendthrift ways? The US has to borrow more that $1B with a capital B per day from overseas because of its deficits. You can say many things about Central Bank officials in general, and Chinese ones in this instance: "arrogant", "stubborn", "obscure", "inscrutable". But "rocks in head?" Seldom said.

Currency traders the world over paused their pressure on the dollar because of the Bush administration's broadcast hints that this budget would show a significant change in our directions. The budget is out, and it shows no such thing. "Decreasing deficits" will be this year's "WMD"-- widely promised but never found.

So, two points:

1) I expect that the dollar will continue sliding sooner rather than later. Maybe not, but that's my prediction.

2) Even if it doesn't go down, it sure as heck won't go up. Thus, investments diversified overseas have negligible downside currency risk, have as good a chance to perform well as dollar investments, and have the advantage of being the right place to be standing if the dollar dam breaks.

Perhaps I should back up and add a **Macroeconomic** note on the dollar. Currencies trade and find their equilibrium price based on supply and demand, just like eggs or artichokes or Superbowl tickets or anything else. If supply goes up faster than demand, price goes down. Normally. At the moment, though, the supply of dollar-denominated IOUs is growing fast, and the price hasn't gone down yet. The US buys its imports, but has to borrow the money to do so, so these IOUs pile up. Japan and China in particular do not want the price of the dollar to fall, so they act as an artificial demand, buying the dollar trade IOUs, using those IOUs to buy US Treasury Bonds, and holding the Bonds. Their bond buying holds down our long-term interest rate, but eventually they will decide that they have more than enough bonds. In addition to the dollar dropping, long-term interest rates would rise.

Given the fact that we still have negative or zero real short-term interest rates (quoted rates minus inflation), the Federal Reserve is likely to keep raising their benchmark Federal Funds rate roughly every meeting for the rest of the year. This introduces two curious puzzles:

1) The low rates were to stimulate the economy by making it easy to borrow. After all this stimulus, is the economy finally healthy enough to carry on without the special stimulation? What happens to the economy if it goes off life support?

2) More curious, if the short rates rise and the long rates fall just a little more, they'll be flat. Beyond that, and short will be higher than long. That is one of the very few macroeconomic measures which reliably predicts a recession.

3) Or, the long rates could start to rise, which is also not good for the economy.

That's all more difficult than usual to make predictions about. The economy appears to be OK now, but there are reasons to worry about it.

In closing, here's a tip for not driving yourself crazy, courtesy of **Behavioral Finance** research. The classic model of financial investors is that they're rational calculating machines. Close, but not true. There are a lot of ways documented now in which investors, even the smartest investors, behave in ways which are contrary to rational choices. One of these is how we experience-- how we feel-- gains and losses.

In short, an $x loss hurts more than a $x gain pleases. If you have one of each, you won't feel neutral; you'll feel like you're losing. This is just one observation from many, collectively called Prospect Theory.

What does that mean for you? Stock and even bond price are volatile... even when the trend is basically up, they go up and down around that trend a lot. A lot. And the decreases will make you feel worse than the corresponding size increase. Watching your investments too closely can make you pretty unhappy, even if you're doing OK.

Is there hope? Yes, and it's simple. The price volatility is highest at short time scales and averages out to lower values over longer times. With lower volatility, the favorable trends can be more apparent. The trick, then, is to not look at your portfolio too often. Instead of being heartsick on Tuesday and Wednesday, but cheerier on Monday, Thursday, and Friday, try looking at your investments less often. Weekly is plenty. Monthly is fine. Quarterly is OK. You do want to pay some attention, but paying attention on too fine a scale isn't helpful economically or emotionally.

Similarly, look at your entire portfolio, not just single securities. The portfolio should average out the volatilities of the component securities, causing less heartache.

Having said that, there is value in selling securities which are losing, so you want to check once in a while. I'll talk about that next month, or more properly in about two weeks.

That's about all I have to say for now.
If you have any questions, please please write or phone.

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

A collection of fine industrial Boilerplate, but true:

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