Capital Drain

Rick's investment opinion newsletter September, 2006 v.2 no.7

Hi Readers,

September rushed by, the first for three years that I'm not a student. I got my MBA diploma in the mail. It's official now; they didn't change their minds.

I'm still working on the mutual fund idea, as described before. Last week I had the pleasant experience of hearing a finance professor from down south (UCLA?) speak about an investment idea that's a recognizable but distant cousin of mine. On the one hand, it was good that he showed that this kind of idea could, in his opinion, work. On the other hand, it was also good that his idea was sufficiently different from mine, so that the concept isn't about to get published.

This month, in addition to being slightly late, will be very quick. In my opinion:

Executive Summary:

Did you check your credit report? It only takes about 10 minutes, 20 max.

The economy looks worse and worse, even as inflation measures stay high. This would be a great time to take some profits in stocks and move the money into short-term or inflation-protected bonds.

The dollar is quietly but steadily falling, particularly in Asia.

As always, I think everyone is best off with a **broad diversification** that includes at least **3/4 overseas** assets (easily purchased via US mutual funds), reflecting the distribution of world economic activity.
Play it safe: stick to value, to safety, to short maturities (for debt), and call me to chat if you're concerned about anything you're holding.

The Details:

I heard from one wise reader who followed my directions for checking one's **credit report** on Equifax. He reported some old cards that were still apparently active accounts that should not be, but otherwise no problems. My experience has been similar.

The instructions worked, it's quick, and if you didn't do it yet you should.

Late last week and early this week, various economic reports came out, all pointing to a slowdown in the economy.

That's no surprise; as I mentioned again last month, the Index of Leading Indicators has been plunging for a year. The whole purpose of that index is to try to predict the economy. Its prediction is now becoming clearly true.

Similarly, the interest rate curve (described in detail in my December '05 letter) has stayed inverted, and in fact become more so. This is one of the most reliable (nothing is perfect) recession predictors there is. A slowdown is now undeniably happening; a recession is likely, if only a mild one.

So why is the Dow Industrial Index stretching to pass its bubble high and set a new record? A few points:

- The stock market is not as simple a predictor as some think. Remember 2001 when the Dow set its last record? The broader indices were already down, and a recession was imminent.
- The Dow Industrials are the ~~frumpy~~ defensive stocks, the ones people buy when they have to be in stocks but are afraid of the risks. Having the Dow lead to records while the NASDAQ lags is not a good sign.
- Some people are using the logic that
  - The economy is worsening
  - That leads to lower interest rates
  - Lower rates usually mean rising stocks
  - Thus a worsening economy should mean rising stocks. QED

  - Tragically wrong. Stocks will fall in a recession, on average several tens of percent.

First of all, the assumption that slower growth automatically brings lower interest rates will be tested this year. The Federal Reserve's biggest concern is inflation. They could, at a minimum, keep rates up at their current level for months longer than many people are betting. Depending on the inflation rate, they could conceivably even raise short-term rates. It's not the most likely scenario, but it could easily happen.

What to do? As I said, this could be a great time to take some profits, sell some stocks, and move the money to bonds. The safest bonds to move to would be short-term treasuries, or even money-market accounts. When we see a little more clearly what will happen with inflation and interest rates, then we can re-visit the question of whether or when to buy longer bonds.

If you want to have longer bonds, and you have some money in a tax-sheltered account, you might consider Treasury Inflation-Protected Securities (TIPS) which are bonds for which the principal value is guaranteed to rise in line with inflation, all the while paying coupons at an agreed rate, calculated based on the adjusted principal.

I think the folks at PIMCO can explain this better than I can: http://www.pimco.com/LeftNav/Bond+Basics/2006/TIPS+Basics.htm

The US central bank may be ending its increases in short-term interest rates, but the European central bank is continuing. Rising short rates in Europe relative to the dollar make the dollar (and all dollar assets) less attractive to world investors.

Meanwhile, the dollar decline against the Chinese yuan has resumed and even quickened after several weeks of seeming stuck at the psychologically significant level of 8 per dollar. As the yuan rises, so do almost all the other Asian currencies, i.e., the dollar falls across the board.

A quick Behavioral Finance tidbit: people do care about 'special' numbers, but not for any substantive reason.

Today I mentioned that the Dow Index is pushing toward matching a previous all-time record level. So what? Adjusted for inflation on the one hand or for re-invested dividends on the other, the equivalent value of the Dow could be lower or higher (respectively) now than at that earlier date. The record Index level is just a number today.

Similarly, the yuan stuck at 8 to the dollar. What's so big a deal about 8? Nothing really. What happens, though, is that as the rate falls 8.01, 8, 7.99, a trader will notice the fall, in a way she wouldn't if it was falling, say, 8.23, 8.22, 8.21.

In short summary, these special numbers are only special to people because they're special to other people. It's a completely circular cause and effect.

These are two examples of the psychological effect called "Anchoring." Some numbers stick in people's minds and become "anchors" or reference points against which other numbers are compared. The anchors can be and often are completely arbitrary. Once established, though, their effect persists.

That's all I've got for today.

If you have any questions, 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 who may be interested.

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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