Capital Drain

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Hi Readers,

Well, another fun-filled month has flown by. I hope it was as good and productive for you as it was for me.

Without further ado, let's go. In my opinion:

Executive Summary:

I suppose I dragged my heels a bit hoping I would think of something actually new to say. Instead, it's mostly the same old stuff. The only difference, and I suppose this is good, is that what I've been saying seems to be still true, which is (tentatively) like saying it was a good prediction.

The economy is slowing significantly, although the cheerleaders have been out in force to try to convince you otherwise.

Expect inflation to be higher than expected, and the Federal Funds rate to be high to match.

A paradoxical conflict has emerged between the US stock and bond markets.

Housing is visibly sliding, and will likely continue sliding for a surprisingly long time.

The dollar is sliding again, too, compared to almost all currencies and therefore gold prices are rising again, too.

Behavioral Finance: what's the most dangerous thing you can see in your data? A hint of what you want to see.

> As before, 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.

These are **risky 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 Chinese bank IPOs.

Sure, Google is doing great. 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!" One day the market will wake up and Google won't be the darling any more. Until then, the price may continue to rise. After then, it will drop quite a bit.

The Details:

In August, I described how the Leading Economic Indicators have been falling, predicting a slowdown, for quite a while. I also reiterated that last December and again in February I pointed out that the inverted yield curve is a pretty good predictor of a coming recession. (If you're curious, you can see those and other old letters at http://www.ricks-cafe.net/CapitalDrain.html .) Well, now the concurrent (latest actual) indicators are showing a slowdown definitely happening, and a recession quite possibly imminent.

And yet, the Dow Jones Industrials Average (DJIA) hit a record high. What gives?

It's definitely not like all of the financial community sees happy days ahead. The bond market, via the low long-term interest rates, is signaling that a slowdown will put a damper on inflation, and thus beget much lower short-term rates, starting pretty soon.

The stock market continues to party like it's only sunshine from here.

Well, not really. The cheerleaders have been hyping that "the market" has been setting records. The DJIA is far from being the market. It is, in fact, the small handful of the biggest, most stable companies, and therefore the ones you would most want to own if you had to own stock in a downturn. The other, broader, indices are also up, but by much less, and to nowhere near record levels.

Further, not all of the 30 DJIA stocks are up. Fewer than half are up, and some of that other half are down substantially for the year. Of the ones that are up, not a single one is at its own individual record high level. The record high for the DJIAverage is largely an artifact of the Averaging process.

The Market Cheerleader summary to square all this is: the economy slows just a little, inflation evaporates, the Federal Reserve pulls the bottom out from under short rates, GDP surges, stocks rise, bonds rise (interest rates fall) and Everyone Lives Happily Ever After.

That may turn out not to be the case.

Even with the slowing economy, inflation may be surprisingly persistent. For a year we've been told to ignore energy costs and look only at Core inflation. Now, though, even though energy costs are going back down somewhat, the core inflation rate is still rising. Why? Partly because the rapid rise in the price of energy and raw materials is now showing up in the price of everything else. Partly because some market participants are no longer ignoring inflation but are raising prices that previously they had held down. Partly because the long-term fall of the dollar has made imports more expensive.

As I said last month, I think the Fed is going to look at inflation more than GDP growth in deciding when to cut interest rates. That may take more time and a slower economy than many people are expecting. If that's true, the likely outcome in the near term is that bonds will fall (rates rise) and stocks will fall too.

Oh, and don't get too comfy with the falling energy prices, either. We're in the seasonal lull between the Driving Season and the Heating Season. Energy prices could well start bouncing back up as soon as the weather turns cold.

We've now disposed of the illusion that housing prices can only go up. They're falling, some places more than others, but across the board falling. Further, as Soros would put it, real estate is a very reflexive market. That is, what direction it will go depends very much on what direction people expect it to go. That creates a tendency for many people to jump into the market when it's rising, increasing the rise, but also for people to jump out of the market when it's falling, increasing the fall.

It's true that many homeowners can stay in their current houses and wait out the slump. However, many leveraged "investors" (speculators), plus the new-housing developer giants, will be increasingly eager to sell their inventory of houses for what they can get quickly. That will drive the market prices down for everyone.

The dollar is sliding again, too, compared to almost all currencies and therefore gold prices are rising again, too. That may continue for a long time and a surprisingly large change in relative values.

In the stock, bond, housing, and foreign exchange markets, some people have been and still are claiming that everything is rosy, even as more and more un-rosy data come out. Some of them will probably still be clinging to their beliefs until their last supporting datum collapses. This is known as Confirmation Bias: we see the portion of the picture that agrees with what we want to believe. There's more discussion of this in last November's letter. Everyone is subject to Confirmation Bias to some extent, but you can spare yourself some of the worst effects as long as you always remember that you're subject to it, and remind yourself to also look for the data that disagrees with your view. That can be annoying and stress-inducing, but it can make you happier in the long run.

As I said last month, this is a great time to take profits in stocks or long bonds, and move to short high-quality bonds or TIPS, and maybe more just a little bit more overseas.

It's time (past time) to wrap this up and hit 'Send'.

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
