Capital Drain

Rick's investment opinion newsletter January, 2008 v.4 no.1

Before printing, think about the environment

Hi Readers,

I've been dragging my heels about writing this month's letter, hoping to think of some sort of unified thematic presentation rather than a laundry list of investment vignettes and trivia.

Certainly it's been a busy, interesting six weeks since I last wrote. I should at least offer some comments on the big news items.

How's this for a theme: Ooops.

OK, here it is. In my opinion:

Executive Summary:

- Credit market epitaph: told ya.
- Taking a real estate walk: http://www.youwalkaway.com
- Recession + Inflation re-hash
- I would ***NOT*** buy the dips

As I've written 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 and Exchange Traded Funds (ETFs)), reflecting the distribution of world economic activity.

This is a good time for investors to be conservative, to be in the best of securities: stick to value, to safety, to short maturities (for debt), and emphasize **capital preservation rather than capital gains**. Developed-nation and blue-chip company bonds give a good chance for safety.

Above all, avoid the investments that are at all-time extreme valuations: junk bonds, developing-country bonds, and headline-grabbing stocks with high P/E ratios.

The Details:

"I told you I was sick."
-epitaph from a headstone in the Key West cemetery

The international-- and especially the American-- credit system is in big trouble, which is far from over.

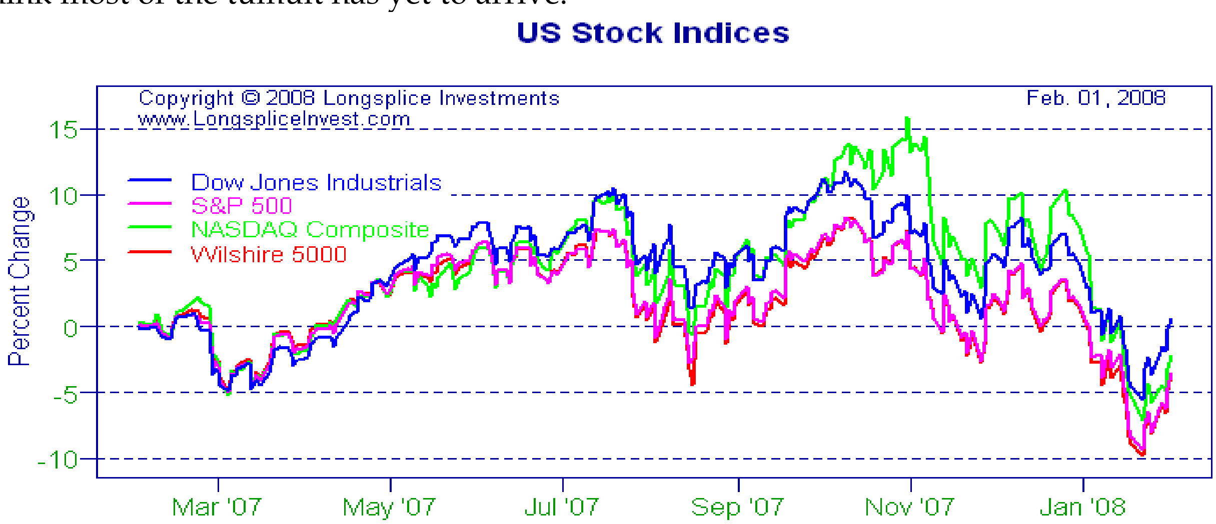
We've seen some big events lately: huge emergency loans to the banking systems around the world, failing banks requiring rescue in Germany (IKB), England (Northern Rock), and the US (Countrywide et al.), and a record-setting rapid drop of the Federal Funds target interest rate to approximately the rate of inflation.

Reporters like to call it the Sub-prime crisis, but it is much more than that. It is a lending crisis, part of which funded a housing bubble.

The excessive risk of the lending of the past several years is gathering force like an avalanche. The first little rolling snowball was when the sub-prime home mortgage foreclosure rate rose enough that bonds made from collected mortgages defaulted. That little snowball grew quickly, and dislodged more snow as it went. More than just sub-prime loans are defaulting; all sorts of real estate loans are showing stress. More than just mortgages are defaulting; some junk bonds are in trouble, and the inability to get new junk bonds is sweeping some weak companies into the avalanche.

Derivatives created from risky bonds were supposed to be riskless-- but the theory was applied too aggressively and plenty of risk remains. Insurance for risky bonds was supposed to be available in the form of Credit Default Swaps (CDS) and some credit-guarantee banks-- but the "insurers" didn't all set aside enough money to pay off claims, or even close to enough, so some of the insurance buyers still have a lot more risk than they want or can tolerate, and many of the insurers are doomed.

And yet, the stock markets, including the financial companies most at risk from this mess, rallied last week. An interest rate cut, a few days with no unambiguous bad news, and many investors seem to think it's over, that the avalanche has stopped. I think most of the tumult has yet to arrive.



Meanwhile, the real estate market slides from bad to worse. All the cheery assurances that real estate doesn't drop, or not much, or not nationwide, etc., were done in by the bubble mentality.

Excess demand-- lots of people who got loans they couldn't really afford-- goosed the housing industry to create excess supply-- lots of houses with no qualified buyers. At the current rate of sales, it would take a year to sell all the houses currently on the market. But wait, there's more! Even though 1% of house owners nationwide have already defaulted, the wave of adjustable rate resets that is still to come implies that at least that many more foreclosures are coming. That's more supply. Amazingly, homebuilders are still building-- they borrowed to buy land, and now have to build and sell for no profit just to get cash to pay the banks. That's more supply.

Now demand is shrinking as only the best borrowers can get loans. It's going to take a year or more for supply to shrink to near balance, causing more price drops.

Sign of the times: there's a web site offering services to help you efficiently default on your mortgage: http://www.youwalkaway.com

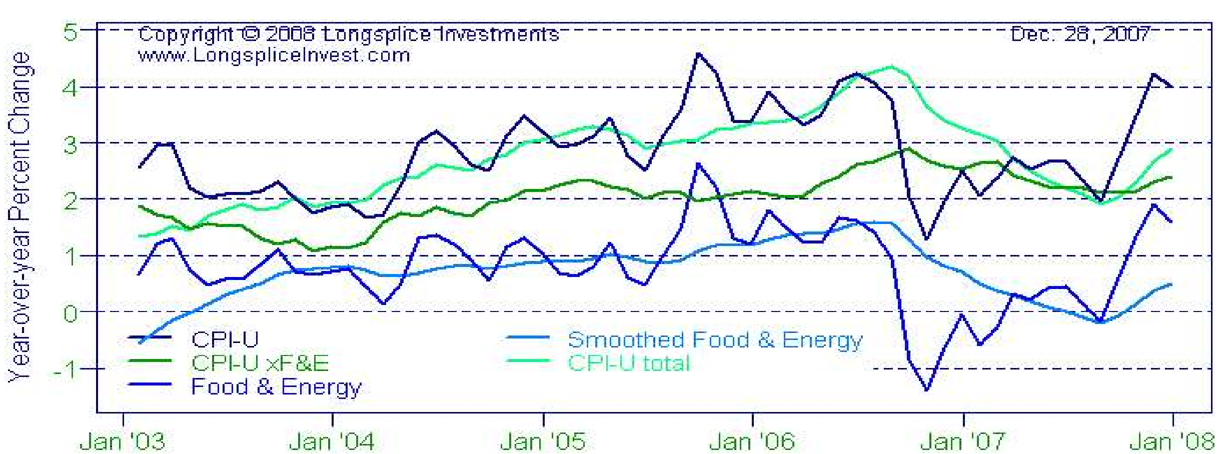
The US government Bureau of Economic Analysis just announced that real GDP in the 4th quarter increased at an annual rate of just 0.6%, as contrasted with 4.9% in the 3rd quarter. Think back: October seemed normal, November actually had a lot of Christmas shopping and so on... so how bad did December have to be in order to make the quarterly total so low? My guess is that when the official dates for this **recession** are set, the start will be pegged as December, 2007.

OK, but that's why the Fed cut rates so much, and Washington will probably hand out $150 billion soon, so everything is OK now, right? No, not right.

Rate cuts take about a year, plus or minus half a year, to have an effect on the economy. The government stimulus checks won't even be printed until June. That's plenty of time for things to get worse before they get better.

Meanwhile **inflation** is not going away, because at best it's going to take the recession running for a while to reduce the demand price pressure. Food and energy are still big contributors, and Core inflation is drifting upwards:

CPI-U with Smoothed Food & Energy



(See www.LongspliceInvest.com/econCharts.shtml for a detailed explanation)

Falling economy, rising inflation: that's stagflation, happening now. It's not as bad as it was in the late 1970s, but it's not trivial, either. It will be unpleasant.

So, all this cheery news... makes ya wanna run out and buy stocks, right? Many people did just that last week.

I would definitely ***NOT*** "buy the dips." In a bull market, you can make money by buying when stocks have just dropped, and riding the likely bounce back up. Right now, though (review the bottom of page 2), the most recent dip took the US stock market indices to 12-month losses of 5-10%. The current bounce is bringing it back to "just" a 12-month loss of 3-4%, with the Dow Industrials breaking even (Woohoo!). The trend the past 3 months is clearly downward.

Some traders speak of trying to "catch a falling knife." The analogy suggests that if you try to "catch" an investment while the price is falling, you could get hurt. Your timing could be off, the knife could keep falling, and it could cut you as it passes. Why not just wait for the knife to hit the floor and come to rest, then pick it up?

You needn't be in a hurry. You can afford to wait to see how long this little rally lasts before you think about buying. Meanwhile, keep your money someplace safe.

I mentioned last month that if I had to pick just one investment to make before being marooned on the proverbial desert island, I'd pick German government bonds. I think that was a good pick then, and a better one now.

Why?

- The recent rate cut puts ever more downward pressure on the dollar. Therefore: invest in non-dollar assets.
- Our recession and our financial storm may well spread, at least in milder form. Therefore: bonds are likely to outperform stocks for a bit.
- Bonds (highest quality only) are boring but safe. Live adventurously-- later.

Realistically, buying individual bonds is cumbersome, and Germany isn't the only attractive issuer.

The mutual funds BEGBX and PFBDX hold high-quality worldwide bonds. PSAFX is similar but holds very short-term bonds, making it nearly a diversified overseas money market fund. Note that all of their price histories look funky in December because they paid big dividends. If you adjust for that, they've all been steady gainers. I think they will continue to be.

Finally, the Exchange Traded Fund BWX holds developed-country treasury bonds. Be careful of BWX, though: it's not very heavily traded, so some parts of the day the bid-ask spread is wide. Don't use market orders (where you don't specify a price) but specify a price between the bid and ask, then just be patient.

May all your adventures be good ones.

It’s time to send this on its way to you.

If you have any questions, please write or phone. If you want to read more, I’ve got a web site (see URL below) with archived editions of this letter and some links to other interesting sites. There's also a weblog where I discuss the process and progress of starting the mutual fund.

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