Capital Drain

Rick's investment opinion newsletter March, 2009 v.5 no.1

Before printing, think about the environment

Hi Readers,

Yes, this issue is way overdue. I apologize. I'll try to make it worth the wait.

To put it mildly, it's been an interesting three months since I wrote. The December-January dead bull bounce crested and fell to a new low. Last Thursday the cheerleaders were saying it again: “a new bull market.” Friday and especially Monday the “bull” fell with a thud.

The usual media cheerleaders are seizing on every twinkling star as a new dawn, but most of the actual data is still bad, and the bad period for stock investing is likely to last for a while yet.

So, at long last, here it is. In my opinion:

Executive Summary:

- No, it is not the bottom. Really
- Eyewitness noise & the futility of post-hoc explanations
  - New factory orders up, but it's noise after huge drop prior month
  - Earnings revisions are downward
- Stocks for the long run - oops
- Housing sales up but prices down more
- Banks are still folding
- Corporate debt coming due to re-finance
- credit check time: Experian

Stocks are generally low enough that it's not urgent to sell now if you haven't already. The exceptions are stocks of homebuilders, automotive, and financial companies; those are still in for hard times. If you still have any money left in high-yield (junk) bonds, dump those, as fast as you can. For a while to come cash will be king. Almost everything else is reasonably likely to suffer losses.

Short of that, 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 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 with high P/E ratios.

The Details:

Everyone wants the bottom to arrive. No more stock drops, no more housing drops, no more dead companies, no more lost jobs. Sadly, wanting does not make it so.

We still don't know which banks will survive, how low home prices will fall, or how much the economy will shrink before it reaches a lower equilibrium. Economic busts, just like booms, feed back to reinforce themselves. This one still shows plenty of new bad news which will itself have depressing effects elsewhere.

Incidentally, I wrote a short blog post (Feedback about 'feedback') to clear up some of the mis-used nomenclature of feedback. It discusses the boom/bust economic cycle as an illustrative example.

I heard one 'expert' say we're in a new bull market. That's a pretty good signal for the dead bull's apogee.

More broadly, every day, and on cable TV every few minutes, some expert will tell you why some little factoid means that the whole economic and investing picture has changed. I like to call this "eyewitness noise." Instead of reacting to every little bump of the Brownian Motion noise, the wise investor will step back, ignore rumors, and let the confirmed and settled facts paint the bigger picture.

I'm particularly aghast at the analysts whose live analysis explains "why" the market has done whatever it did that day. These explanations are almost always *post hoc ergo propter hoc* fallacies-- event A happened then event B, so A must have caused B.

Indisputably, there have been some plausibly positive-sounding statistics reported lately. Sadly, the positives they're quoting are marginal. Consumer spending in particular is up slightly, but the previous was down hugely-- that's just noise. Likewise for factory orders. Plot any of these series for a year and play 'spot the uptick.' They're not only small compared to the margin of error, they're negligible compared to the fall.

> "Still a man sees what he wants to see,
> and disregards the rest. La, la, la."[1]

The other reason cited for optimistically piling into stocks is that "PE ratios are low." Well, not in the way that you would like them to be. In a typical recession, as stock prices fall and they're compared to the *preceding* company earnings, the price/earnings (PE) ratios do look pretty low. When you buy a stock, though, you're not buying its past earnings, you're buying its future.

Earnings estimates are essential to future (forward) PE, by definition. Throughout the slowdown, estimates have been getting chopped, regularly, in big chunks, by all the analysts. When the forward estimates are rosy, or even neutral, the

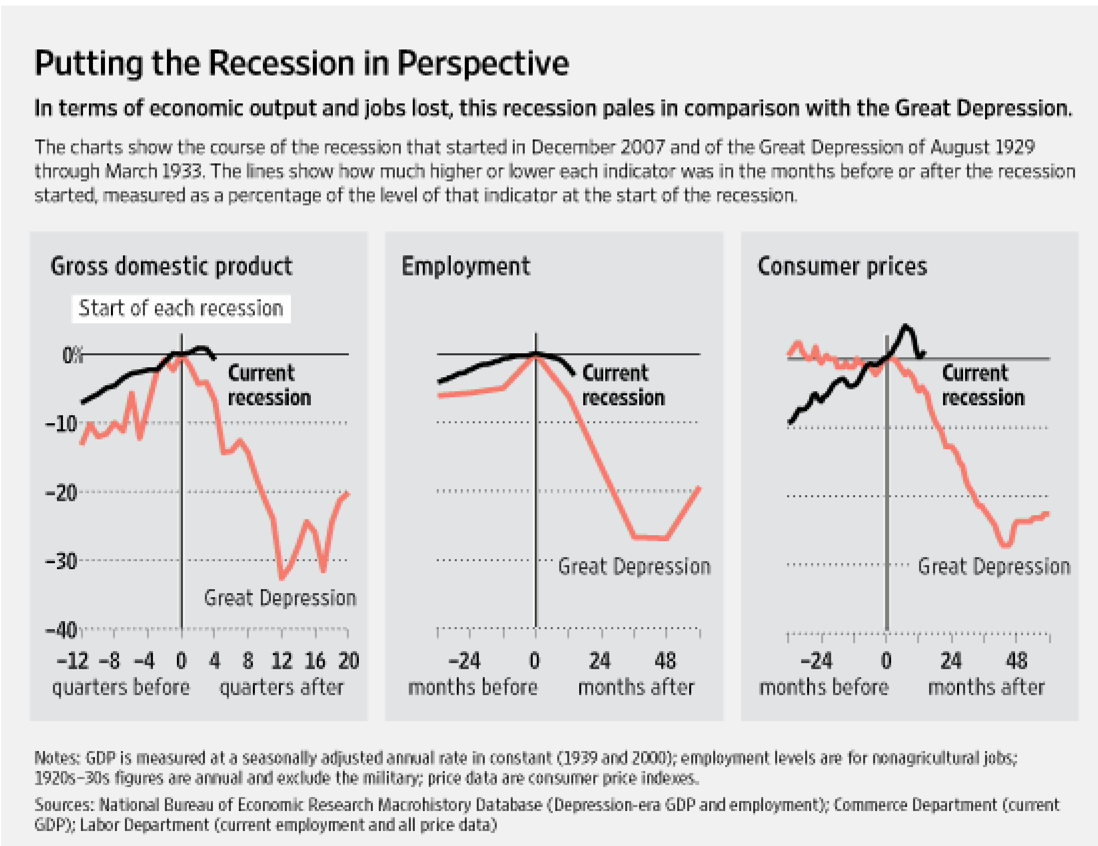
1 Paul Simon, "The Boxer", Columbia Records, 1969.

forward PE can look enticing. As the bad news and reduced hope arrive and estimates are cut, that PE rises unless the stock price falls right along with the estimates.

Eventually the news looking forward will be legitimately more encouraging. That will be the time to look at forward PE and consider buying stocks. Until then, put your money back in your pocket.

That, to repeat, is the take-away investment idea for the moment: **put your money back in your pocket.**

What's the good news? It's not a depression. The current administration is competent to govern. We learned a lot from the mistakes of the Great Depression. We have a chance to pull through this.



[2]

2 Justin Lahart, "How a Modern Depression Might Look -- If the U.S. Gets There," The Wall Street Journal, 30 March 2009, Dow Jones & Company, 30 March 2009 <http://online.wsj.com/article/SB123836938251967565.html>.

Personal Net New Borrowing is negative, for the first time since WWII.[3]

There's been some talk about the "paradox of thrift." In short, when there are scary times like these, people tend to save more and pay down debt, decreasing their spending. Spending less exacerbates a recession; spending more would help to counter a recession. Thus, when a recession causes more saving, it makes the recession worse.

That's the usual story.

The usual answer is "So what?" Individuals should do what's best for themselves because that's what's best for the economy *in the long run*. In fact, American consumers collectively have a horrific amount of debt, and it's in everyone's best interest that they reduce that debt sooner or later. If they choose 'sooner,' so be it.

Another answer is specific to this recession. Most recessions in the modern era have been caused by a lack of demand for purchasing. The usual pattern is that interest rates rise until they hurt, and either companies or households cut back their spending, and GDP tumbles.

This recession is different because it was brought on by lack of lending, particularly by banks and other lenders realizing they need to cut their own lending because it's become too difficult to do their own borrowing. That process is called de-leveraging. GDP is slowing because borrowing became-- not too expensive-- just too difficult, or impossible, to do at any price.

In this case, when consumers save it is helpful: their savings are by definition a bank borrowing from them, and banks need to borrow. When consumers pay down debt, it is helpful: their debt repayments reduce the bank's loans, and banks need to reduce their loans.

In short, never mind the paradoxes, what's good for you ***is*** good for America. Pay down debt and save more.

3 "Flow of Funds Accounts of the United States," 12 March 2009, Board of Governors of the Federal Reserve System, 28 March 2009 <http://www.federalreserve.gov/releases/z1/current/Coded/coded.pdf>.

> "Stocks for the long run" has been weighed in the balance in Baby Boomers' retirement accounts all over the world and has been found wanting. The S&P 500 is now roughly where it was 12 years ago, although earnings in 1997 were higher than those projected for 2009.[4]

The argument was always based on statistics of historical stock market returns, and that alone was enough to make many analysts cringe.

There are two reasons for that. The first is the nature of statistics itself. Those projections of good long-term average returns, being based on a historical sample, have some uncertainty (unknowable amount of sampling error) in their projections. You usually see this expressed as "a 95% confidence interval" or 99%, but rarely more confident than that.

Ninety-nine percent. How do you feel about playing Russian Roulette with a hypothetical revolver with 100 chambers but only one bullet? That would at least make most people nervous, and very few financial analysts would recommend "Oh, go ahead, spin and squeeze one off. Empty chambers for the long run!"

A statistical argument *always* has a chance of reality being different from the projection.

The other problem with the argument is that projections of real-world processes based on history have the inherent assumption of "all else being equal." Obviously, if something big and bad happens that never happened before, it will screw up your projections. More subtly, humans learn, they have fads, they forget, they get confused. History can only predict the future most of the time, and in general.

In the history of the capital markets, the past 30 years were quite different from the hundred years before. Investors became more likely to trust that "the market" would ferret out the true value of companies. This was called an "efficient market." In an efficient market, you could just buy a broad stock index and you'd be OK.

Unfortunately, the Efficient Market Theory was formulated by looking at the prior hundred years of data. Back then, most investors mistrusted stocks, or thought of them as a (possibly rigged) crapshoot. Public pensions and private life savings went much more into (banks or) bonds, and only good bonds at that.

The investors who remained in stocks and other risky assets were professionals, and they tended to look at a company very carefully before buying its shares or bonds. This was a market of Warren Buffets, or at least of people who tried as hard as they could to do what he does. With all that scrutiny, overly-risky investments did tend to be found out and shunned. Not always, but usually. That, in fact, tended to produce a pretty darned efficient market, but it depended on the prices being determined by sharp-eyed competitive analysis.

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4 John Mauldin, "While Rome Burns," Thoughts From The Frontline blog, 20 February 2009, InvestorsInsight, 20 February 2009 <http://www.investorsinsight.com/blogs/thoughts_from_the_frontline/archive/2009/02/20/while-rome-burns.aspx>.

The “stocks for the long run” era meant that a lot of money was put into the stock market-- without analysis, just faith in efficiency. More money was coming in “unguided” and a *lot* more money was coming in overall. Pensions and individuals were no longer scared of stocks, but made them the centerpiece of their long-term savings. As this unguided money poured in, the effect on prices of the decisions of the remaining sharp-eyed analysts was reduced. The market became less efficient.

It seems like a cross between physical science's “Uncertainty Principle” and diplomacy's “Trust But Verify.” As long as people mistrusted the market, it was pretty trustworthy. When they trusted too much, the market deserved the trust much less.

> Housing economist Thomas Lawler implores builders to "stop building." He and others argue that effectively setting a floor for home prices will prolong the pain because it will keep supply and demand out of sync.
>
> "The government does not have the tools to rewrite the laws of supply and demand," said Harvard University economist Edward Glaeser. "By artificially increasing prices, we are encouraging more building."[5]

New home prices are constrained by “existing home” resale prices. Resale prices are being defined by foreclosure sales, of which there's no shortage even here on the Peninsula, and some even in Manhattan. Nationwide and in most urban areas, most of the resales are foreclosure sales, so the median resale price is a foreclosure price. Unhurried sales get good prices IF there's something essential about the house that can't be found in the foreclosure inventory. New home inventory is more than a year's sales. Likewise for used homes, but that's just the visible inventory; people who are holding back homes they'd love to sell at better prices abound.

One laughable aspect of the 'home sales are improving' articles lately is that they're reporting units sold, not dollar value sold. Almost any other industry you see reports the dollars.

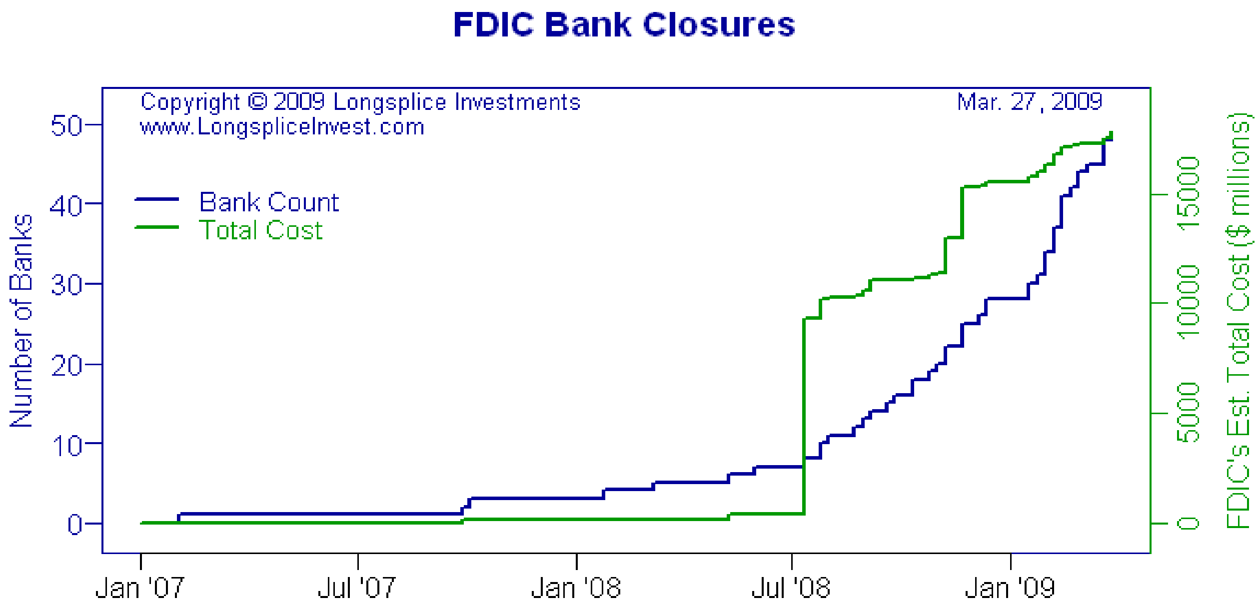
Lower price means higher sales. That's axiomatic, not 'good news.'

Since prices are still dropping by bigger percentages than unit sales are increasing, price elasticity is still < 1 and actual sales dollar volume is dropping. When %price decrease <= %unit sales increase, THEN you're looking at a bottom. The elasticity is actually quite low, like 0.3. Either prices have to drop a lot, or there has to be some miracle increase in willing able buyers.

It's not making the papers much anymore, but banks are still failing and being taken over by the FDIC regularly and often. New ones get announced almost every Friday. The FDIC does the takeovers on Friday so they can have the bank open again

5 Nick Timiaos, “Home Builders Make Plea for Federal Aid: Critics Warn That Propping Up Housing Demand Will Only Prolong Market's Woes,” The Wall Street Journal, 24 November 2008, Dow Jones & Company, 24 November 2008 <http://online.wsj.com/article/SB122748520112251743.html>.

for depositors, typically as a new part of an existing healthy bank, the following Monday.



The big jump in total cost in July 2008 was Indy Mac.

Why are new banks being added still? Is it just a matter of finding the ones that were already mortally wounded? No. New banks are being felled by new bad debts nationwide caused by de-leveraging and recession.

There are a lot of companies that borrowed relatively short-term money for long-payoff investments. Even if those investments (new factory, new product line, etc.) pay off as expected, the plan from day one was that they'd need to be refinanced. Those refinancings are coming up, the banks won't be so keen to lend on any but the best, and some companies will get stomped.

Likewise there's a wave of consumer charge card delinquencies and negligible hope for roll-overs, consolidation loans, etc. In addition to the harm to the lending banks, at a minimum that's a recipe for reduced spending; it probably also adds to home foreclosures.

Final thoughts:

I've added some new charts on the 'Econ charts' page: a weekly update of the FDIC bank closures, unemployment patterns of recessions, and comparative bear market tracks.

Oh, and Geithner's plan is still a question, not an answer. How many of the remaining banks are busted?

Eventually I understood that the strength of the dollar was due not to people choosing to hold dollars but to their inability to maintain or roll over their dollar obligations. In a very real sense the strength of the dollar, like the fever associated with sickness, was a measure of the disruption of the financial system.[6]

It's **Credit Check** time again. Once per year per Credit Agency, you're allowed to get a free copy of your Credit Report. If you've been following along with my every-four-months pace, you're ready to revisit Experian.

It's easy. I've taken notes from my own recent visit, so you can follow the instructions at www.longspliceinvest.com/CapDrain/Experian.pdf .

It's time to check the spelling and ship this to you.

If you have any questions, please write or phone. If you want to read more, the company web site has archived editions of this letter, lots of charts, and links to other interesting sites. There's also a web log where I discuss the process and progress of starting the mutual fund, along with occasional economic or investing thoughts..

Feel free to forward this to any friends who may be interested.

Take care,

Rick

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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

6 George Soros, “The game changer,” The Financial Times, 28 January 2009 <http://www.ft.com/cms/s/0/49b1654a-ed60-11dd-bd60-0000779fd2ac.html>.