Capital Drain

Rick's investment opinion newsletter March, 2010 v.6 no.2

Before printing, think about the environment

Hi Readers,

Perhaps I'm over-optimistic, but I think the worst of the miserable bitter storm is over. Certainly, Spring starts this weekend per the calendar, and here in California it's been in full blossom for more than a month. The financial meltdown has run out of negative surprises. The Great Recession did not become the Great Depression II, but has begun a recovery.

Also, we may-- just may-- see an overdue hint of new moderation in the political fighting. Once the health reform bill gets passed and implementation begins, it will be harder for people to miss-represent what the bill actually says. A return to civility is my most tentative prediction, though. We can hope.

Let us begin. In my opinion:

Executive Summary:

- The recession is ending! (Has ended?)
- But the recovery, particularly re-hiring, will take a while.
- Housing will take even longer
- Corporate balloon payments: junk bond re-financings.
- Inflation? I doubt it.
- The paradox: despite the worries, dollar is safety, treasuries are safety
- I like long Treasuries
- It's credit check time: Experian

Stocks have had a pretty sprightly recovery. I think that's the result of too much optimism. If you're holding shares of any of the companies that are still conspicuously losing money, you might consider selling them into this bounce. It is safer to risk gaining a little less rather than risking losing a lot more.

Short of that, this is a good time for investors to be conservative, to be in the best of securities: stick to diversification, value, safety, and call me to chat if you're concerned about anything you're holding.

Above all, as ever, avoid the investments that are at all-time extreme valuations: junk bonds, developing-country bonds, and headline-grabbing stocks with "can't lose" stories and high P/E ratios.

The Details:

> "We have another economic problem which is mixed up in this of too much consumption, too much spending relative to our capacity to invest and to export. It's involved with the financial crisis but in a way it's more difficult than the financial crisis because it reflects the basic structure of the economy." --Paul Volcker, December 11, 2009

The dangerous part of what former Fed Chairman Volker said is not only that the recession has meant that we have collectively spent less, and thus earned less. His bigger point is that we should never have spent so much in the first place, and we are unlikely to spend so much again, as a percentage of our income, for a generation or more.

Therefore the recession is going to be see a worse recovery than usual. Instead of borrowing to spend, we'll be paying back debts instead of spending. To get us back to our pre-crash Gross Domestic Product (GDP) level will not be just a snap back to a pre-crash state, where jobs that were cut will be refilled by people who were laid off. Spending will bounce back to a lower level, and then grow at a more historically normal pace. Job re-creation will see an initial jump, but then will slow.

Where are we in this recession, how bad has it really been, and what can we expect going forward?

To answer, let's look at some key economic variables' behavior during recent recessions. We can see patterns that are common across the recessions, and we can see the magnitude of the current one compared to the others. Finally, we can get an impression of how far along we are in the recession/recovery cycle.

Economists agree that new unemployment insurance claims, reflecting the number of layoffs, starts deteriorating (rising) before there's a noticeable decline in the GDP. The layoffs aren't necessarily a concern at first, as other jobs are still being created, but as they continue to rise they both presage and accelerate the overall drop in the economy.

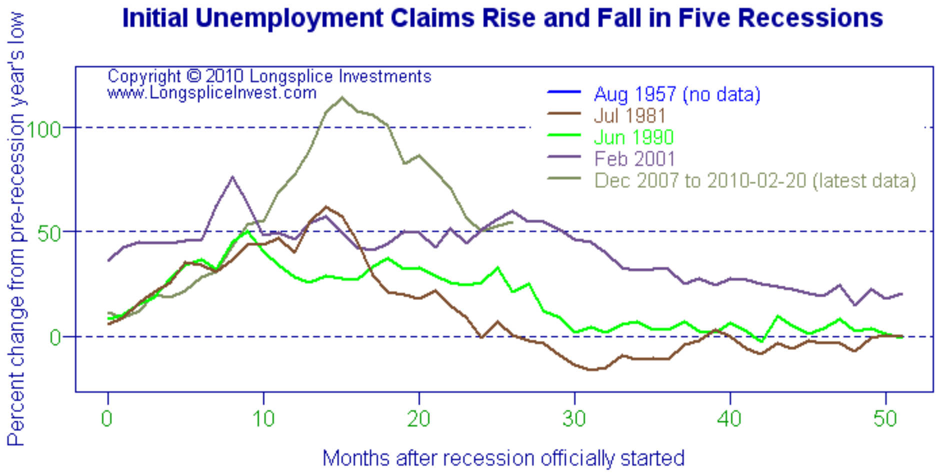
Actual total payroll employment starts to fall sometime after the GDP starts to fall, and continues falling even after GDP starts to rise again. Employers who just had to go through layoffs are not eager to re-hire until they're certain that the new workers are needed.

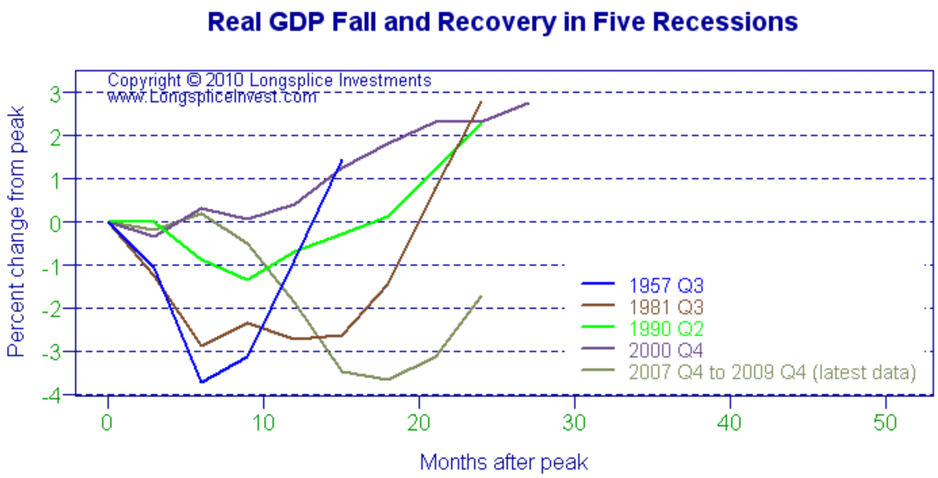
In the recovery, the order of the improvements is the same.

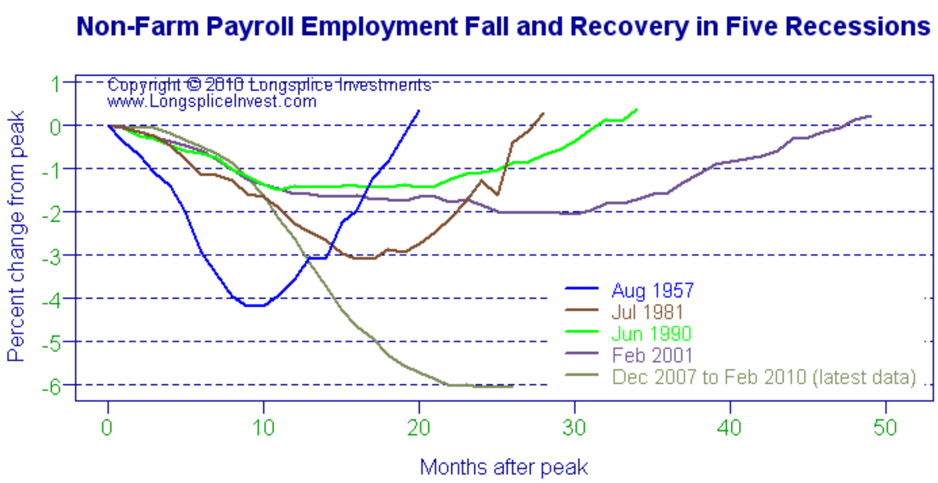
A comparison of economic variables during the five deepest recessions since 1950:

Below, we see new unemployment claims, GDP, and total employment for the same five recessions on the same time scale. These charts have been normalized; the data has been scaled so that different recessions are easy to compare as a percentage change from the start of the downturn.

I couldn't find data for the unemployment claims for the '57 recession, but I've included the year in that chart's legend so the three charts will be easy to compare.







[1]

Clearly, the current recession is the deepest of the five in every aspect, and looks likely to become the longest.

We can take comfort that two of the variables are now improving, and the third, the total employment, seems to be flattening out.

Note that the previous longest recovery, from the recession started in Feb. 2001, featured what we then called the "Jobless Recovery," long and sloooooooow. Further, in the 2001 recession the GDP barely slipped at all, as recessions go, but the Employment was still badly hurt four years later.

Overall, though, the present data is encouraging. New unemployment claims are clearly declining. GDP has improved for two quarters in a row. Total employment is no longer falling.

1 Data come from the US Department of Commerce Bureau of Labor Statistics (Employment) and Bureau of Economic Analysis (GDP), and the US Department of Labor Employment and Training Administration (Claims). "Thank you" to William J. Polley, Assistant Professor of Economics at Western Illinois University for providing the idea of comparing Employment.

The pundits have already started calling this another jobless recovery. I think that's just because they like the term. The recovery only just started. In our previous examples, employment didn't start rising until 3-25 months after GDP bottomed.

For what it's worth, I think that when the official date of the end of the recession is determined, it will have been in November or December of last year. Some commentators are saying it ended at the end of last June.

Housing's recovery will take longer. First off, let's note that 'housing recovery' can mean at least two things to different people: a recovery in existing home selling prices, or a recovery in new home construction.

House prices are starting to firm up in some prime areas like downtown San Francisco, while still falling fast in some of the most overbuilt areas like peripheral Las Vegas. In fits and starts, the firming-up will likely continue, but it probably won't (realistically shouldn't) go back to the pre-crash appreciation rates.

New home construction will be very slow for a long long time. I don't have the citation handy, but I saw that there are around one million unoccupied homes in the country. Some of those will be re-filled with renters as people get jobs again and move out of their cars or parents' basements. Others were never sold by their builders in the first place, or sold to speculators. That quantity won't be filled until the natural growth of US households (demand) catches up with supply.

Do you recall all those home-buyers who got themselves in trouble by getting mortgages with balloon payments, meaning that in five or seven years the entire balance would be due? They were counting on price appreciation to make it easy to re-finance. There was a lot of tut-tut-ing about how silly and unsophisticated they had been, once the crash started.

However, they have a lot of company, literally a lot of companies which took out relatively short-term loans knowing that they would have to re-finance before their profits had grown to where they could pay the loans back. These now threaten the banks who lent the money.

> A “wall” of junk debt maturing in the next four years will increase the risk of corporate defaults in the U.S., according to Bank of America Merrill Lynch.
>
> More than $600 billion of high-yield bonds and loans are due to be repaid between 2012 and 2014, New York-based analysts Oleg Melentyev and Mike Cho wrote in a note to clients. Almost 90 percent of loans outstanding mature in the next five years, compared with an average of 36 percent between 2005 and 2009, according to the report. Debt maturities are “a point of particular concern in our view, given that primary loan issuance remains challenged by declining bank lending,” the analysts said. [2]

In other words, the banks and the economy have another shoe yet to drop. The partially offsetting good news is that this shoe is recognized and expected, so dealing with it will be less chaotic than the earlier default wave.

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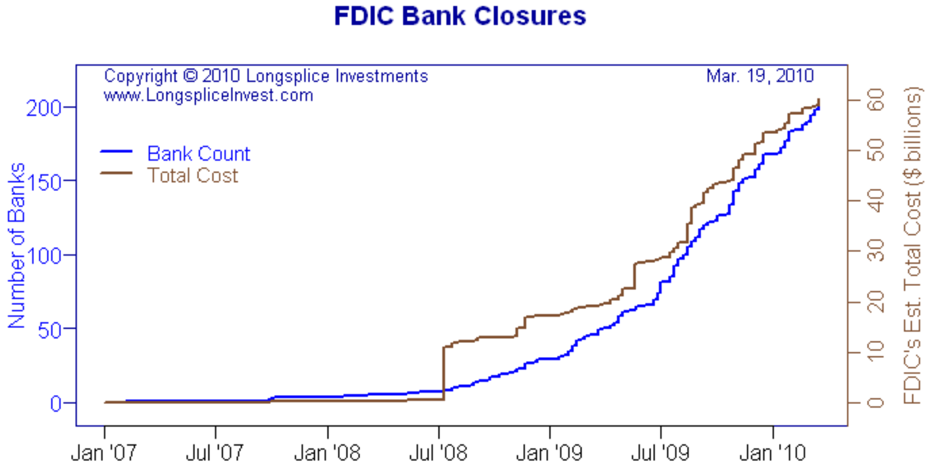
2 Karen Eeuwens, " Junk Debt ‘Wall’ to Trigger U.S. Defaults, Bank of America Says," Bloomberg.com, 24 Feb 2010, <http://www.bloomberg.com/apps/news?pid=20601103&sid=akI.38vS3OlA>.

It's not as if the banks really need new trouble, either. The FDIC is still taking over several busted banks every week. Since 2007, they've now had to seize and re-structure more than 200 banks at a cost to their Deposit Insurance Fund of more than $60 Billion.



What to do now?

Many analysts are concerned that all the government rescue financing will cause inflation. As I described in more detail in newsletters in January 2010 (middle of page 3) and April 2009 (bottom of page 4), I doubt it.

Further, some analysts have predicted the imminent crash of the dollar and the end of its status as the world's reserve currency. Again, I doubt it, partly because the dollar's situation isn't really all that bad, and partly because there really isn't a credible substitute. The dollar is the least safe currency, except for all the others. The Euro had a bit of a stumble over Greece, and in particular, the Chinese Yuan isn't even freely convertible. Rumors that the Chinese could stop buying our Treasury debt are greatly exaggerated. I'll write more about that in April's letter.

In short, despite all the worries in this country and around the world, I think the best store of value available is US dollars, invested in long-term US Treasury Bonds.

As I've said, I'm suspicious that stocks have, in general, risen more and faster than is justified by the economic recovery we'll get in the next year or two. Money market funds pay, typically, something like a tenth of a percent interest, well below our already low and falling inflation rate.

At Friday's (3/19) close, 10-year bonds were yielding 3.68%, and 30-year bonds were yielding 4.58%.

Warning: if inflation does go up, or if long-term interest rates rise for any other reason, these long bonds will drop in price, causing a capital loss. The balancing point is: how likely is that rate rise, and will the accumulated high yield be greater than the capital loss? The longer the bond, the greater the loss if interest rates rise. For me, though, for my money, the 30-year Treasury bonds look like the best investment available for now. Mutual funds such as Vanguard's VUSTX, Fidelity's FLBIX, or T.Rowe Price's PRULX are convenient ways to invest.

It's **Credit Check** time again.

Why? Identity theft has become a big big business, with professional thieves maturing into a 'thinking, adaptive enemy' as Gen. McChrystal described a different scourge. Your best bet for protecting yourself is to keep an eye on all your financial accounts, watching for suspicious activity.

How? 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. Experian A world of insight

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 .

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.

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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