Capital Drain

Rick's investment opinion newsletter February, 2011 v.7 no.1

Before printing, think about the environment

Hi Readers,

Once again I've been dithering, delaying writing this letter in the hope that I'll think of something genuinely interesting to say. Nothing special has come to mind, so it's time for me to just write something simple, dull, and short.

In my opinion:

Executive Summary:

- It is still a recovery
- which means interest rates will rise.
- Bonds are a poor choice
- Stocks are debatable
- Dividend stocks seem to be best of an unappetizing menu.
- It's credit-check time again, this time at EQUIFAX

US stocks have had a pretty sprightly recovery. Most of those are nice companies, but the prices reflect high continued growth expectations. If you're holding shares of any of the conspicuous high-fliers, you might consider selling them into this bounce. It is safer to risk gaining a little less rather than risking losing a lot more.

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.

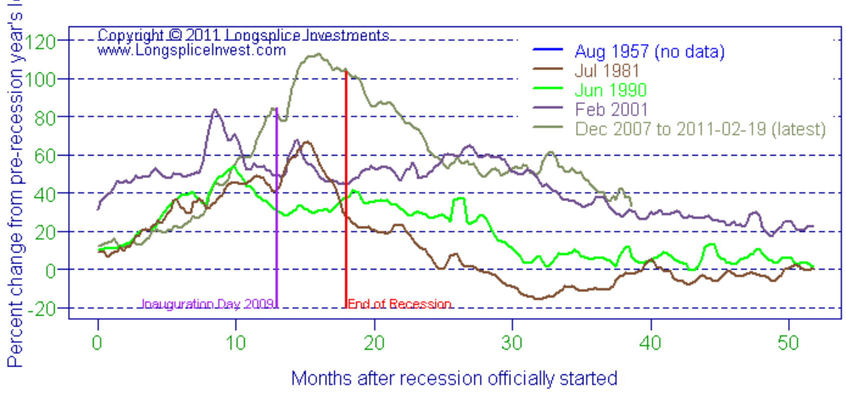
The Details:

The good news is that the economy is definitely expanding, and the recovery looks as if it's gained enough strength to be self-sustaining.

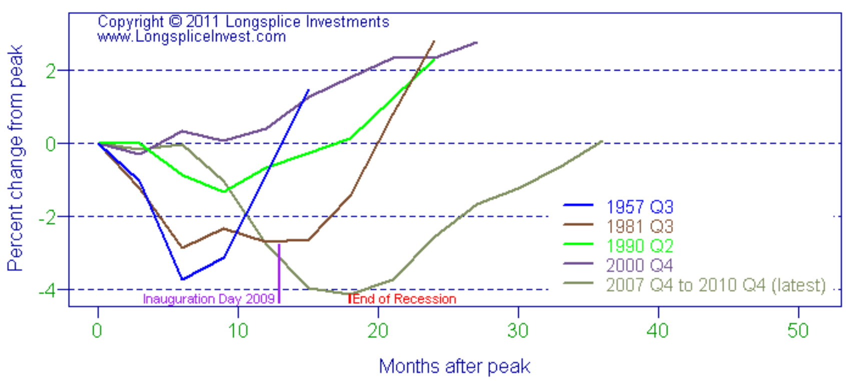
The bad news is that leaves us wondering what the best investments are for the near- to mid-term.

Summarizing the good news, here are the charts I've been using to track the progress of the crisis, recession, and recovery.

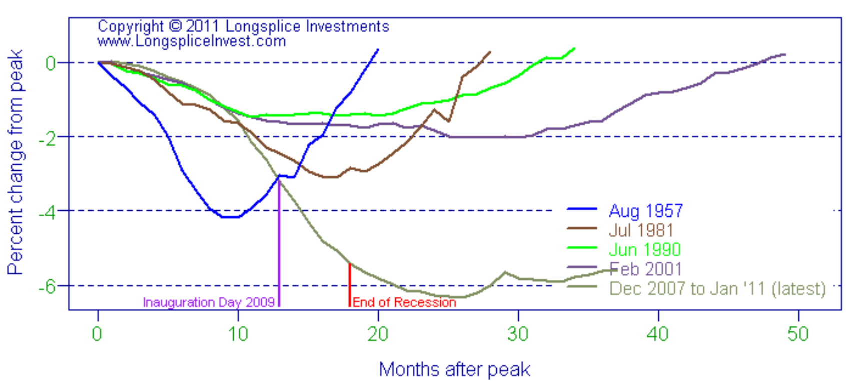
Initial Unemployment Claims Rise and Fall in Five Recessions



Real GDP Fall and Recovery in Five Recessions



Non-Farm Payroll Employment Fall and Recovery in Five Recessions



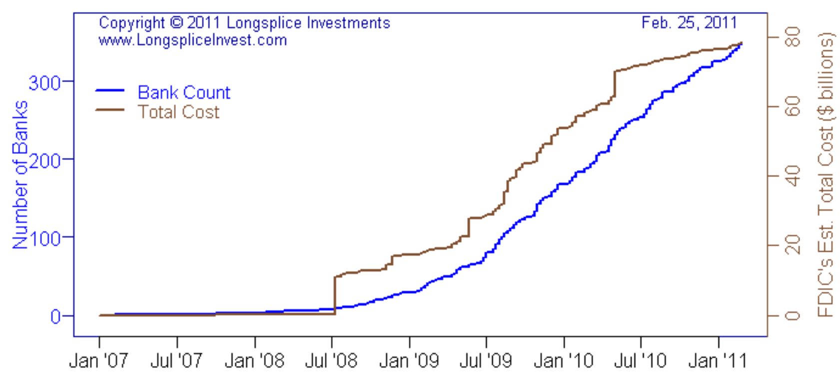
Initial (new) unemployment claims are a leading indicator. That is, they start to rise before a recession is apparent, and they start to fall (improve) while the recession is still getting worse in other ways. It peaked two years ago and is still improving steadily.

GDP has been rising for almost two years, and shows no signs of leveling off. The absolute level is back to its pre-recession mark, although a true "complete recovery" would mean catching up for lost time, or about 10% higher than where it is now. The economy will have to continue its compounding feedback to get to the high growth that will fill the "coulda been" gap.

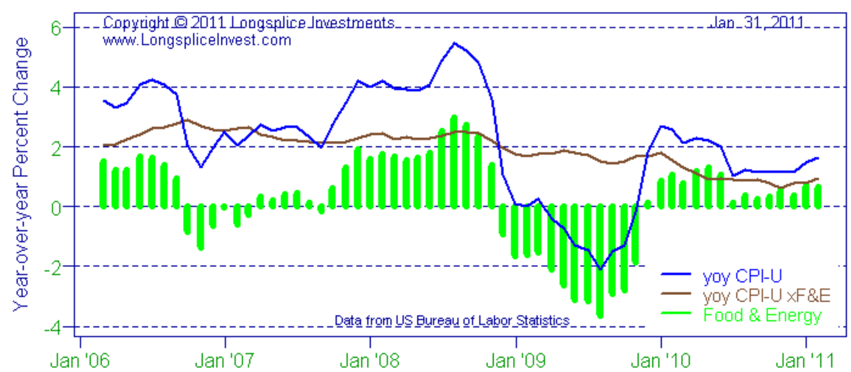
Employment is the indicator that shows just how bad this recession was at its nadir. As an indicator, employment lags, so the bottom came nearly a year after the recession's nominal end. Growth has been slow, but (except for a blip for temporary census-taker hiring) steady.

Private-sector employment growth is quite a bit better than the total shown. The drag on employment now is that governments are still making new payroll cuts. Those cuts are a way for states and cities to balance their beaten-down budgets, but for the overall recovery those cuts are terribly counter-productive. The Obama administration tried to address this by helping local governments keep people in jobs, but the new majority in the House of Representatives has ended that effort, forcing more layoffs. Thanks, guys.

FDIC Bank Closures



CPI-U Effect of Rising Food & Energy



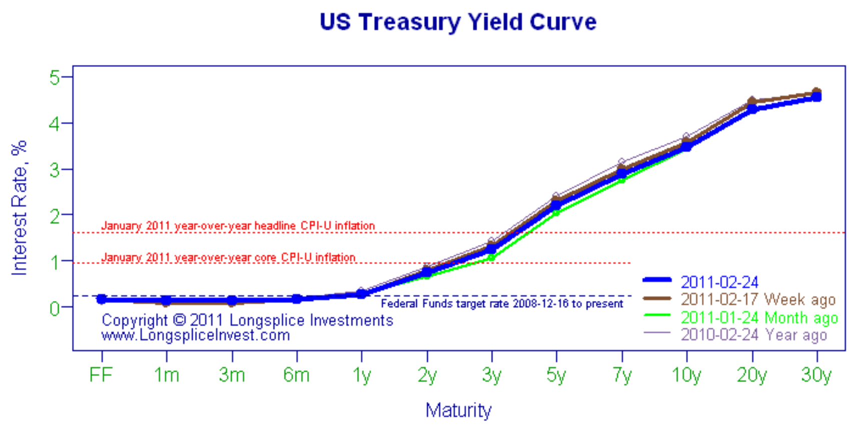
The financial crisis that started the recession is winding down. As the economy improves again, the less-healthy banks are being helped to recover as well. Some of the worst-off banks are still being closed by the FDIC each week, but they are steadily becoming fewer and smaller.

Predictably, the recovery in the US and abroad is causing some increase in inflation, particularly in prices for food and energy. World weather and political crises, more frequent lately than usual, have also raised food and energy prices, although these event-driven rises could be reversed when normal conditions return.

Overall, the current inflation is no big deal, and there's nothing in the data to say it should become a big deal. Some commentators have argued that worldwide government deficit spending and money-supply expansion must cause inflation, but I disagree, for reasons I described in the November 2010 newsletter (pages 4-5).

The money-supply expansion is easily reversible via Quantitative Tightening. The deficit spending is a real problem, in that the debts will have to be repaid over the coming years, but they're not the dire crisis some claim they are. Further, balancing the budget too soon will trip up the economy, causing tax income to shrink further and deficits to balloon, not shrink.

With inflation tame, the Federal Reserve is in no hurry to raise short-term interest rates. Eventually they will raise them, though. Already the market price of longer-term treasuries has returned to a healthy premium well above the current inflation rate.



Where, then, should we invest?

Not in bonds. At some point in this recovery, interest rates will rise, so bonds will begin to have rate-related capital losses. If there's inflation, that will eat into bond's real yields as well. The interest rate rises may be enough to forestall significant inflation increases, or they may not. For our perspective hunting for this season's good investments, bonds lose either way.

I have no interest whatsoever in piling on to the price run-up in gold and other commodities. As I said earlier, I think all the current run-up of prices for food and energy commodities will reverse as the specific supply shocks are resolved. Some industrial commodities have run up on the expectation of high world GDP growth, but I think that's run too far, too. I expect growth, overall, to become more uniform across regions and more moderate. Gold and some of the other precious metals are being driven to bubble-like prices by those expecting high inflation or world collapse. I believe they are over-reacting to current events.

Housing in the US and much of Europe are still a mess, and will be a mess with huge over-supply for quite a while. If you need a house, buy one if you must, but don't think of it as an investment; it is still much cheaper to rent.

What about stocks?

In the October 2010 letter (p. 5) I described why I like the stocks of big, healthy companies with big, healthy dividends. After stock prices have run up I'm less enamored, but I still think this is the best choice available; it's where my money has been and still is. The dividends help keep the price from falling too much, although dividend stock prices can be hurt by inflation/rate increases similarly to the way bonds can be hurt.

The rest of the stock market looks generally too pricy to me. Everyone is really happy to see the recovery, and stock prices have been bid way up as companies have reported huge increases in profits. As the recovery matures, though, those profit increases will moderate, and stock prices will fall due to the disappointment of the irrationally over-optimistic.

This is important.

It's **Credit Check** time again. Once per year per Credit Agency you're allowed to get a free copy of your Credit Report, quickly, online. It's quick and it's free. Do it now!

If you've been following along with my every-four-months pace, you're ready to go to EQUIFAX (again.)

It's easy, and to make it even easier I've taken notes from my own recent visit. You can follow the instructions at http://www.longspliceinvest.com/CapDrain/Equifax.pdf . If you have trouble with the online process, you can fall back to printing and mailing the request form.

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..

Please forward this to any and all friends who are interested. Thanks! If you got this as a forwarded copy, you can get on the list to get your own future copies directly by sending me your email address.

Take care,

Rick

Rick Drain
P.O. Box 5425
Redwood City CA 94063-0425

CapitalDrain@LongspliceInvest.com
www.LongspliceInvest.com

"Our doubts are traitors,
And make us lose the good that we oft might win,
By fearing to attempt."
--W. Shakespeare