Capital Drain

Rick's investment opinion newsletter July, 2011 v.7 no.2

Before printing, think about the environment

Hi Readers,

This letter is really really late going out, even by my recent standards of lateness. I apologize, and I'll get back to a regular schedule.

For those of you who don't mind reading smaller, single-topic messages more frequently, I now have a web log ("blog") where I post some ideas that don't fit well in the newsletter format. To make it even easier, you can **sign up to get the blog posts sent to you by email** automatically, so you never have to check to see what's new.

To sign up, go to www.LongspliceInvest.com/ricksblog and look for the word 'Subscribe'. Or, just phone or send me an email, and I'll put you on the subscriber list.

Some friends and readers have asked for a way to discuss some of my ideas. The blog makes that possible, too. On the same page, you can register, after which you'll be able to add comments to any post or comment.

Naturally, I will continue to **never** share your names or email addresses with anyone.

For anyone who is interested, Longsplice Investments is now on Facebook and Twitter as well.

Now, onward. In my opinion:

Executive Summary:

- The economy is still recovering, but slowly.
- The debt ceiling-- matters, and it doesn't.
- Stimulus vs. deficit reduction vs. tax decrease.
- The stocks I mentioned back in October did pretty well. Time to go?
- It's credit check time: Experian Experian A world of insight

US stocks have risen to remarkable levels considering the state of the economy. 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 rally. 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.

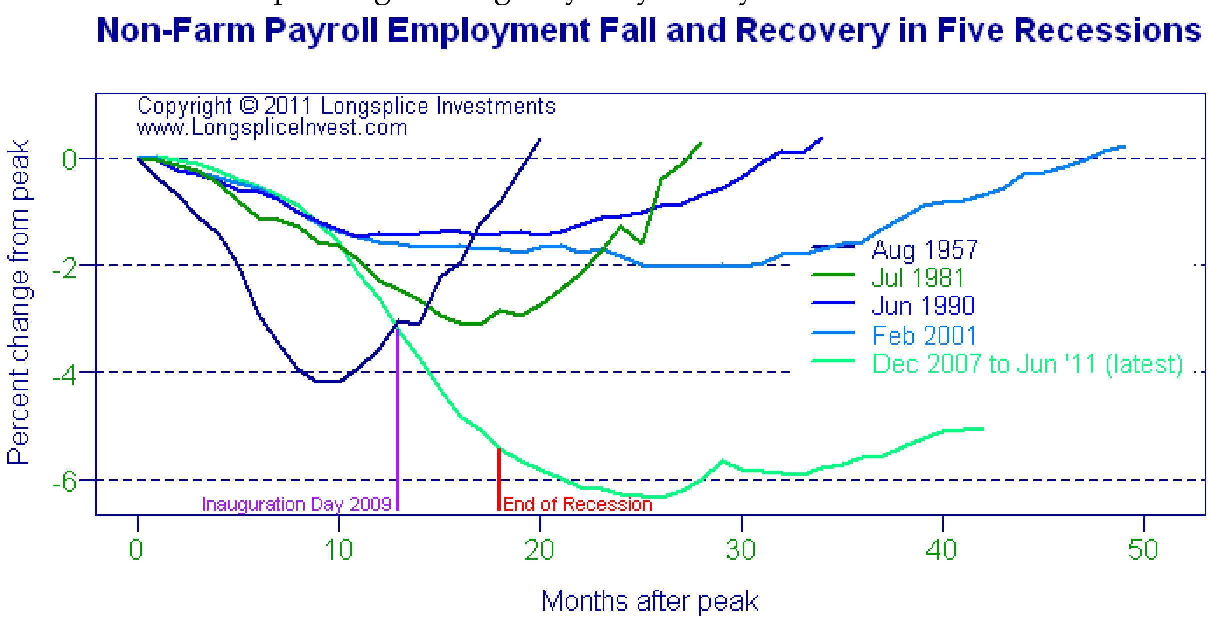
Above all, avoid the investments that are at all-time extreme valuations: junk bonds, developing-country bonds, and headline-grabbing stocks with high P/E ratios.

The Details:

The **US economy is grinding toward recovery**, but slowly, frustratingly and in daily life imperceptibly slowly. It helps that the rest of the world economy is doing better.

A private economic analysis company called The Conference Board publishes monthly economic indicators. Two of those are the Leading Economic Indicator (LEI) and the Concurrent E.I. (CEI). As the names imply, the LEI describes what's likely to happen soon, and the CEI describes what's happening now. Both of those are rising, still at the same rate as they have for the past two years. That's good; continued growth is good. The Conference Board are notoriously touchy about anyone re-publishing their graphs or even processed re-graphed data, but you can see their latest report online.

In short, profits of big companies are way up because world trade is up. Smaller and local companies are not doing as well. Domestic hiring, in particular, is anemic, so domestic consumer spending is rising only very slowly.



The chart shows the problem in a nutshell: the drop in employment was far deeper than in any recession since the Great Depression. As is typical, employment continued to fall even after the recession was technically over. Since the bottom, the rate of improvement has been very very slow, even compared to the "jobless" recovery of the 2000s. This is not promising.

Meanwhile, the **Federal Debt Ceiling** is in center-stage in Washington. Although the ceiling has been raised 74 times since March 1962, including nine times during the G.W. Bush administration,[1] Congressional Republicans are using this as a lever to try to force huge concessions.

Just to be clear, a raised ceiling does not authorize any new spending. It simply authorizes the Treasury to sell bonds as necessary to pay for the spending that Congress has already called for in its regular budgeting. Arguably, it's redundant. If Congress had wanted to stay under the ceiling, they should have passed a smaller budget, or via increased taxes a more balanced one.

Technically, without a raised ceiling, the Federal Government will run out of cash soon and will have to prioritize its spending to match its tax income. That would be extremely disruptive for the country. On the other hand, many legal scholars argue that the President has Constitutional authority[2] to do what he needs to do to execute the budget, including borrowing. Others disagree. One wag described this Plan B as "So I saved the economy. So sue me."

One way or another, I think the sharp divisions between the mainstream (center and left) and the far right will keep Washington uncomfortable for months, but I don't think it will be allowed to cause a financial meltdown.

For what it's worth, the Treasury Bond market has been remarkably nonchalant. If anyone should be extra-nervous, they should, but they're not. Bond interest rates are remarkably low.

Don't get me wrong, the public debt matters. However, it's not the only thing that matters.

> "Though not in a forceful way yet, Federal Reserve Chairman Ben Bernanke has already been [advising against deficits]. He has issued several warnings to Congress that, unless it moves to cut the budget deficit, the economy could suffer via higher long-term interest rates.
>
> **With the recovery losing momentum, Mr. Bernanke and** his deputy-designate, **Janet Yellen, have been** making an even stronger point recently. They are now **signaling the Fed would welcome more spending and less taxes in the short term to stimulate the economy**, but only if accompanied by a credible and specific commitment to reduce the deficit later. "[3] (emphasis mine)

1 Jeanne Sahadi, "Debt ceiling FAQs: What you need to know", CNNMoney, 18 May 2011, Cable News Network, 27 Jul 2011, <http://money.cnn.com/2011/01/03/news/economy/debt_ceiling_faqs/index.htm>.

2 "Constitutionality of the debt ceiling", Wikipedia.org, 27 Jul 2011, The Wikimedia Foundation, 27 Jul 2011, <http://en.wikipedia.org/wiki/2011_U.S._debt_ceiling_crisis#Constitutionality_of_the_debt_ceiling>.

Economists, from the Federal Reserve to the business press, are trying to make the point that fiscal (government spending) stimulus plays a crucial part in re-invigorating a stalled economy.

Even former Fed Chairman Greenspan, who many consider more free-market and anti-government-involvement than Bernanke, agreed. Greenspan's unprecedented public comments in favor of the Bush tax cuts helped get them passed. He's changed his mind:

> "Greenspan responded more bluntly when asked about remarks he made recently to Bloomberg Television in support of allowing the Bush tax cuts to expire. "Look, I'm very much in favor of tax cuts, but not with borrowed money," he said, adding that such an approach would prove "disastrous."
>
> Asked whether he agreed with some Republicans' argument that tax cuts pay for themselves, Greenspan responded, "No, I do not."" [4]

Part of the argument in Congress hinges on whether tax cuts or stimulus payments are more effective for re-invigorating an economy.

As a favorite MBA professor used to love to say, "It depends." Seriously, details matter.

The classic post-WWII recession has been caused by a over-strong economy, in which the country's buying power exceeded its production, causing inflation. The Fed would typically raise the interest rates to cool things off a little. In that environment, stimulus spending would be counter-productive; the point is to de-stimulate the economy a bit. At the same time, in this case tax cuts (permanent or nominally temporary) for investors would be good-- it would encourage them to invest in new productive capacity (ie, factories), putting the production/consumption interplay back into balance. With more production ready, interest rates could fall, consumption could resume, and inflation would be tame. Happy Fed, happy public.

This most recent recession, however, was different. It was a financial crash, not a Fed-induced slowdown. The key difference is that consumption fell all on its own in a vicious cycle: over-indebted people stopped spending, over-indebted companies stopped spending or failed, and even healthy companies had to lay people off to match lower sales. In this case, what is holding back the economy is pure lack of demand, lack of consumers. Giving tax breaks of investors won't help, because there isn't a need for new investment. There is a need for more, more confident, consumers, which means a need for more jobs. The government can help, via stimulus programs:

> "Why not use government policy to directly create jobs— labor-intensive service jobs in fields like education, public health and safety,

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3 Luca di Leo, "'Fiscal Science' Touted To Strengthen Policy ," WSJ, 28 Aug 2010, Dow Jones, 28 Aug 2010, <http://online.wsj.com/article/SB10001424052748703669004575457551290469506.html>.

4 Jessica Holzer, "Greenspan: A 'Quasi-Recession'," WSJ, 1 Aug 2010, Dow Jones, 11 Aug 2010, <http://blogs.wsj.com/economics/2010/08/01/greenspan-a-quasi-recession/?mod=djemRTE_h>.

urban infrastructure maintenance, youth programs, elder care, conservation, arts and letters, and scientific research?

Would this be an effective use of resources? From the standpoint of economic theory, government expenditures in such areas often provide benefits that are not being produced by the market economy. Take New York subway stations, for example. Cleaning and painting them in a period of severe austerity can easily be neglected. Yet the long-term benefit to businesses from an appealing mass transit system is enormous. (This is an example of an "externality," which the market economy, left to its own devices, will neglect.) "[5]

It's not a "one size fits all" world, and the hard-core cut tax, cut government thinkers are in an era they don't fit. They're welcome to come back after the recovery, and a) make specific proposals about what government programs the public would be happier without, and b) cut taxes AFTER the budget is balanced and the debt reduced.

Back in October's newsletter (p. 5, bottom) , I mentioned a handful of **stocks I liked**. These were strong companies, paying good healthy dividends. Since then, even after the stock jitters this past week, those companies have appreciated about 15%, in addition to paying about 3.5% (annualized) dividends. That's been pretty good, actually better appreciation than I expected.

I am concerned, now, that the markets have been too optimistic. Even if we get through the debt ceiling kerfuffle with no disaster, growth in the economy will be slow, and growth in profits will probably be much slower than they were over the past three quarters. I'm looking at selling those stocks, even though I have no good idea where to invest next. Sometimes avoiding losses is the closest you can come to a gain. There may be a stock market bounce back up after the debt debacle decision. I'll probably sell then.

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

Why? Identity theft has become a big big business, with professional thieves adapting daily. 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 .

5 Robert J. Shiller, "What Would Roosevelt Do?," WSJ, 31 July 2010, 11 August 2010, <http://www.nytimes.com/2010/08/01/business/01view.html>.

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

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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