

Capital Drain

Rick's investment opinion newsletter

November/December, 2008

v.4 no.8



Before printing, think about the environment

Hi Readers,

This has been an unusually busy two months for the economy, and for me personally. The next few months will likely be similar. In the interest of getting this out without further delay, I'll keep it short. This will be mostly "what to consider doing," and not so much "what the heck is going on here?"

In my opinion:

Executive Summary:

- Everyone agrees it's a recession, and a bad one.
- Sure, the market is down, but is it cheap?
 - If it's cheap, does that make it a good buy?
 - No. Just wait.
- January is often weird: Again, just wait.
- All that bailout money; why is it not creating an inflation threat?
- Financial institutions are still de-leveraging.
- Buy local, high-labor-content. Tip your waitress.

This is different from my previous few years of summary:

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

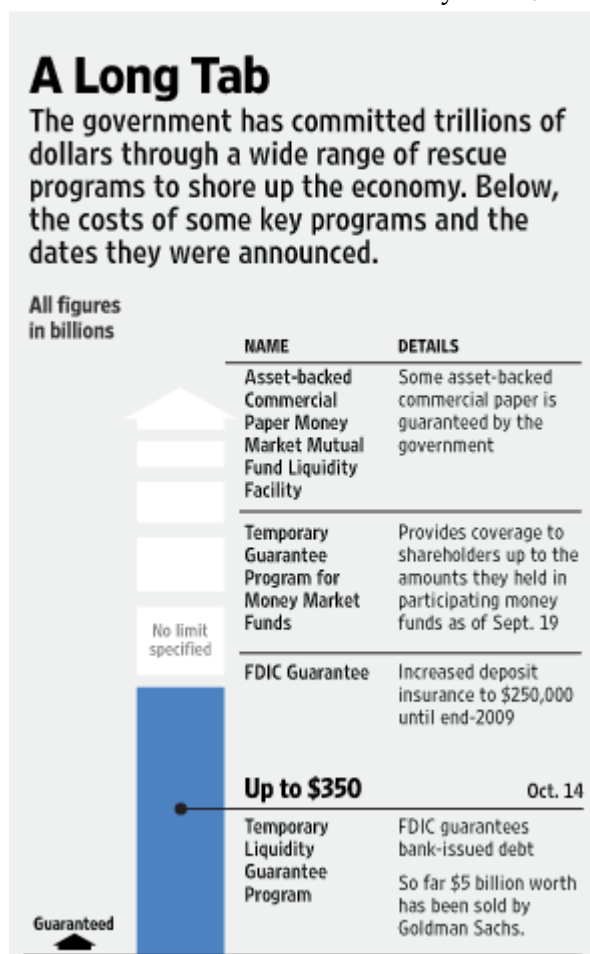
Short of that, this is a good time for investors to be conservative, to be in the best of securities: stick to value, to safety, to short maturities (for debt), and call me to chat if you're concerned about anything you're holding.

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:

It's "a recession with adjectives," Martin Feldstein, a member of the NBER group that announced the downturn, said in a Bloomberg Television interview yesterday [Dec. 9, 2008]. "A deep recession, a long recession, a damaging recession."¹

As I suspected last January², the recession started a year ago, in December. The big tax-rebate stimulus package did a good job of boosting buying during the Spring, but the effect wore off very quickly. The Fall quarter-- the run-up to Christmas, a boom time for retailers-- is very slow, so the coming quarter-end will be the worst one



yet.
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You may have read that Warren Buffet has started buying stocks. Does that mean you should? I don't think so.

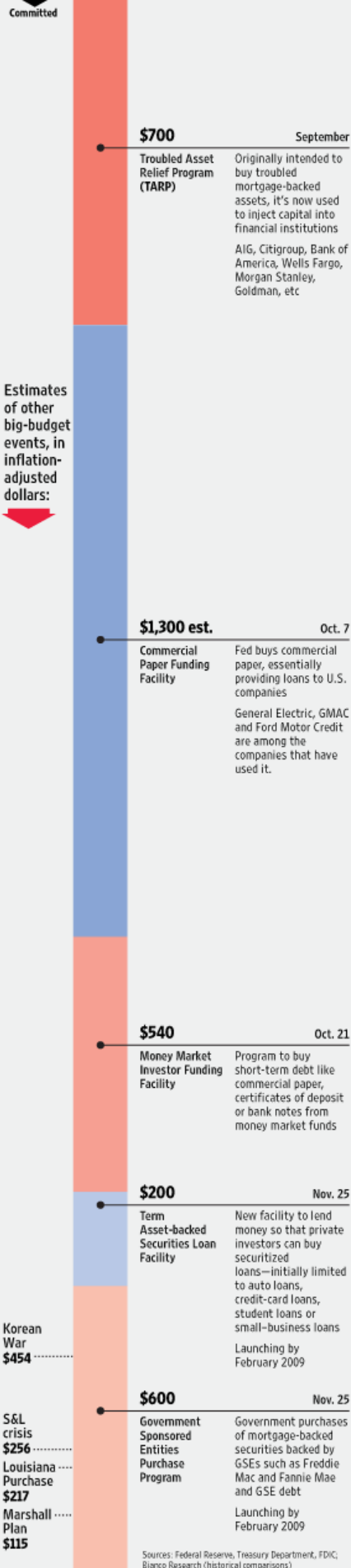
Buffet isn't like you and me. He's one of the world's best stock pickers; note that he only bought shares in a few select companies, not the whole market. Also, he has a lot of cash, so he can get good deals. Finally, he wouldn't miss a meal, and his grandkids would still go to college, even if these latest investments completely go bust.

Some surprising companies have already fallen: K-B Toys, a toymaker, filed for liquidation before Christmas. Pilgrim's Pride, a chicken farmer, filed Dec. 1. Eight more banks have been taken over by the FDIC since I last wrote, totaling 25 this year.

The stock markets are way down, and they may even be cheap. That does not mean they're a good deal that you should jump on. There is plenty of bad news yet to come, and no confident prediction of when the economy will bottom, so the markets

1 Shobhana Chandra and Andy Burt, "Worsening Spending Slump Paces 'Scary' U.S. Recession," Bloomberg L.P., 10 Dec 2008 <<http://www.bloomberg.com/apps/news?pid=20601103&sid=ado8P..GctC4&refer=us>>.
 2 http://www.longspliceinvest.com/CapDrain/CapDrain_v4n1.pdf , page 3
 3 Jon Hilsenrath and Deborah Solomon, "Mortgage Rates Fall as U.S. Expands Rescue," The Wall Street Journal, 26 Nov 2008, <<http://online.wsj.com/article/SB122761978389056335.html>>.

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could keep falling. Just wait. As I said before, don't do any buying until there is some actual good news.

Further, the year-end is a weird time for stock prices. Portfolio managers everywhere pretty-up their reported portfolios by selling their dog investments (which have already fallen, so there's no benefit to the fund investor) and buying the miracle Teflon stocks that have done well (already). Also, in January there's a lot of re-positioning, and a LOT of wishful thinking. As you saw at the end of this past January, a faith-based rally can fall apart pretty quickly when the news stays bad. Just wait; the time for buying will come. There is no advantage to being too early.

All those big numbers down the left side of the pages have been a summary of the money thrown into the battle to save the financial system from collapse. So far, no collapse. That's nice.

But what about the arguments we've heard for years about the inflationary danger of the Fed creating money too fast? Isn't the Big Bailout a massive creation of money?

First of all, what actually causes inflation is too much money chasing too few goods. For there to be too much money chasing, you need three things together:

1. Increasing money supply. (Yes, we have this.)
2. Banks willing to lend money. (No.)
3. Consumers willing to spend money. (No.)

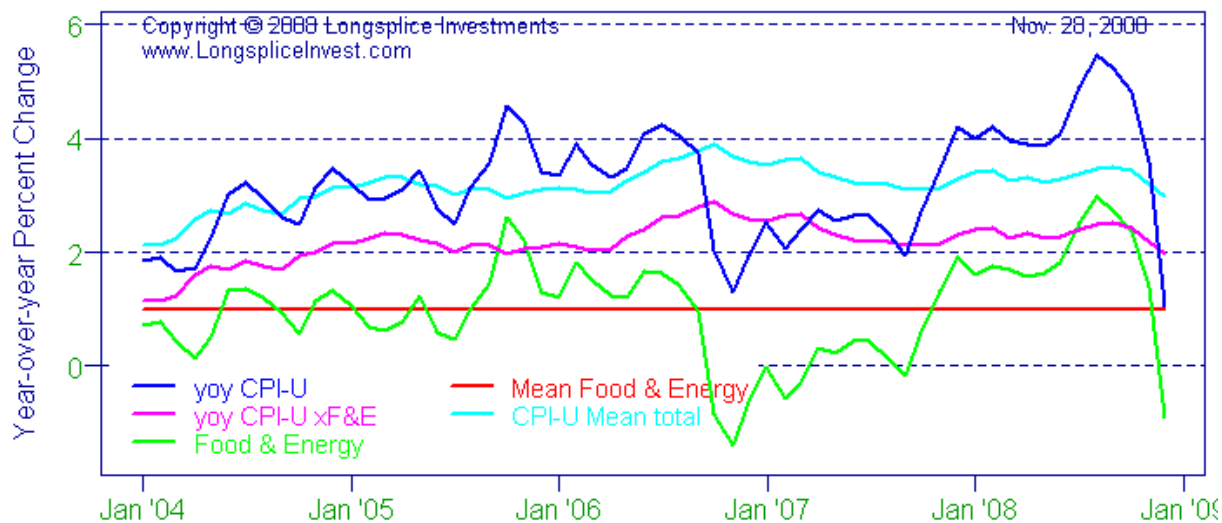
All the money the Fed has "given away" these past few months has actually been lent. As it gets paid back, the new money will be un-created. As long as the Fed can decrease factor #1 to balance the eventual increases in factors #2 and #3, then inflation is not likely.

For the moment, consumers are beginning to rediscover frugality, and banks are beginning to rediscover prudence.

Consumers, and all the manufacturers, wholesalers, retailers, etc., who are intermediate consumers of raw materials and shipping, have cut back their spending quite a bit. Even as the price of gas has fallen, the

quantity of gas being used has stayed low. As that ripples through the economy, inflation is clearly falling, at least for the now. We'll see how far it falls before consumption and inflation begin rising again.

CPI-U with Average Food & Energy



Meanwhile, banks are not only not lending more, they're doing everything they can to lend less. That's because everything they lend is borrowed from somewhere else; they make their money by borrowing cheap and lending at higher rates. Borrowing cheap is much harder today than it was a few years ago. Thus, banks are de-leveraging: they're getting repaid as quickly as they can, so that they can repay what they borrowed. New lending is a secondary priority at best.

“If you mark to market today, the banking system is bankrupt,”
[David] Tobin said. “So what do you do? You try to keep it going as best you can.”⁴

In the midst of all this, what can you do? First, don't be part of the problem. Get back to the financial basics: Pay off your credit cards; fully fund your 401-k; save a little for a rainy day; don't invest in risky high-flying fad stocks.

What else? I know it sounds tacky, like when we were told to go shopping after 9/11, but what a recessionary economy needs is spending. Responsible spending, to be sure, but spending. If you have a secure job, and you have some money to spare, the small businesses in your community need you. Local, high-labor-content spending is most effective. It's a great time, for example, to have some painting or repairs done around the house, or restore some order to the shrubs taking over the yard.

Above all, this is not the time to be cheap with the people who have a lot less than you do. Tip your waitress.

4 Mark Pittman and Bob Ivry, “U.S. Pledges Top \$7.7 Trillion to Ease Frozen Credit,” Bloomberg.com, 24 Nov 2008 <<http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a5PxZ0NcDI4o>>.



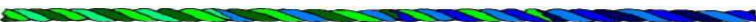
It's time to check the spelling and ship this to you.

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 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



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