



Capital Drain

Rick's investment opinion newsletter

December, 2011

v.7 no.6



Before printing, think about the environment

Hi Readers,

Since I last wrote, there was quite a bit of news that could have made a big difference in the investing environment, but thus far none of it has. My choices for investments for an uncertain era are unchanged.

For the last letter of the year I'll just summarize and note a few news items that could still be unexploded bombs.

In my opinion:

Executive Summary:

- Known Knowns:
 - Slow and steady won the race: Solid stocks with solid dividends.
- I think that will continue, as the recovery continues SLOWLY
- Known Unknowns:
 - North Korean politics
 - Chinese economic balance
 - European United Confusion
- Unknown Unknowns
 - Duh, we don't know. That's the point. There WILL be surprises.
- Unknown Knowns
 - I still haven't figured out what could be in this category, aside from recognition that we're not omniscient. Hints are welcome.

Many US companies are surprisingly doing well, but the prices reflect high continued growth expectations. If you're holding shares of any of the conspicuous high-fliers, especially the "hot" new tech IPOs, you might consider selling into this renewed bounce. Better to risk a little less gain rather than a lot more loss.

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 (or no E).

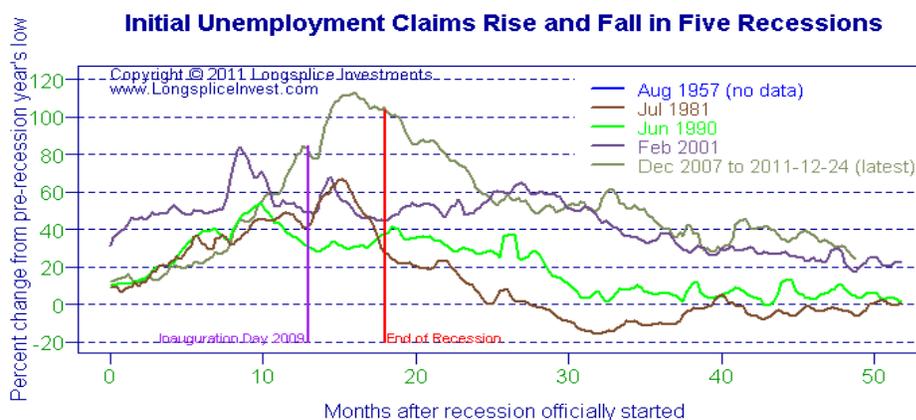
The Details:

First and most important, I want to point out that **Donald Rumsfeld was NOT the first person to use that “unknown unknowns” formulation.** Not by a long shot.

Prior uses range from a 1984 Air University Review (US Air Force) paper to the 13th Century Persian-Tajik poet Ibn Yamin.¹ That Rummy's purported authorship could be assumed and cited unchallenged for so many years makes me fear that there are no longer any competent literate editors in the world press. The reporter at the press conference might not be expected to be well-read but somewhere in the information digestive tract someone ought to have recognized the phrase and said so. Pass the word. Thanks.

The end of the year brought a helpful little run-up in stocks, so the capital gain plus dividend return for the portfolio I talked about back in [October 2010](#) (bottom of p. 5) is up to a bit over 10% for the year. A few hotshots with exotic portfolios did better, of course, but a lot of others died like flies. I am happy with 10% and a year of sleeping peacefully.

I expect the US recovery to continue, slowly.

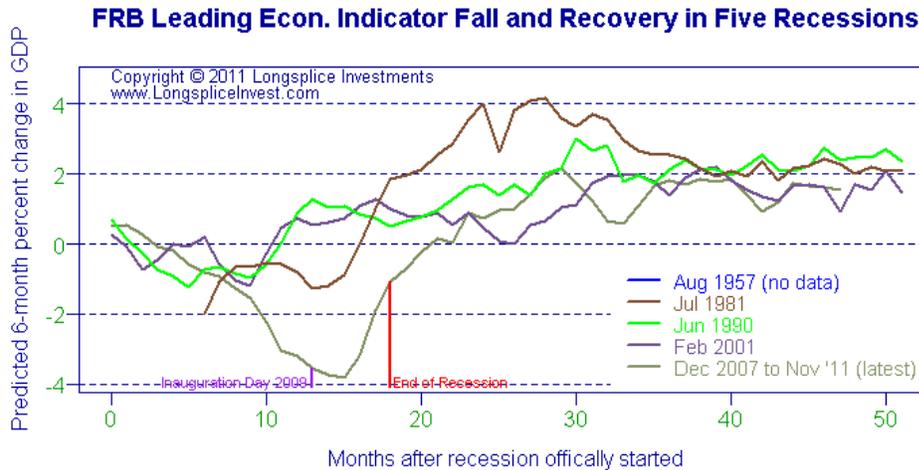


The big (60%-ish) driver of GDP is consumer spending. The driver of consumer spending is having money. The driver of having money is having jobs. You knew that.

Happily, for several weeks now we've seen the number of new unemployment claims decrease. The raw numbers bounce up and down from week to week, so the chart here shows a four-week moving average. As you can see, the level is nearly back down to the corresponding levels from the Bush “jobless” recovery. That's not great, but it could be worse considering how very much worse this recession was.

¹ “There are known knowns,” Wikipedia.org, 15 Dec 2011, Wikimedia Foundation Inc., 31 Dec 2011 <http://en.wikipedia.org/wiki/Unknown_unknown>.

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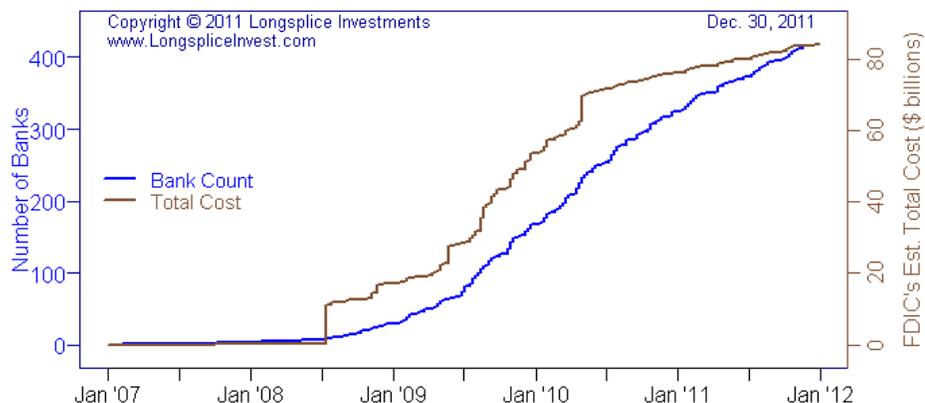
New claims are just one of the data series that are referred to as “leading indicators” because they start moving up or down months before GDP starts moving up or down. The Conference Board has a widely-cited

Index of Leading Economic Indicators (LEI) which has been rising quite cheerily for several years since the bottom of the recession. I (and all other non-subscribers) am expressly forbidden from quoting the numbers to you, but [you can see them here](#).

I *am* allowed to show you a similar LEI data series from the Philadelphia Federal Reserve Bank, above. It is encouraging. Values above zero means the LEI is growing, ie, GDP will very likely be growing months from the date of the datum. Higher above zero means higher expected growth.

FDIC Bank Closures

More good news comes via the FDIC. They've only had to take over two small newly-failed banks in the past six weeks. A year ago, banks were failing at a rate of about four per week, and each of those banks



was on average two or three times as large. A healthier banking system is both a sign of a healthier economy and an important contributor to accelerating growth.

Sweet! So what could possibly go wrong? You had to ask.

With the death of North Korea's Kim Jong Il, there is the chance for a nuclear-armed failed state with a huge and competent army to go crazy. Thus far all has been quiet, with the funeral and the elevation of Kim's son going according to protocol. Perhaps it will stay quiet. If, however, there are factions within the army with strong differences of opinion, then we have to wait for one of the 'out' factions to make its

move. If nothing happens for a year or two, then we can relax and go back to thinking of North Korea as batshit crazy but predictable within limits.

China has been a huge success story for more than a decade, but some of the success was built on shaky foundations. Inflation there is very high. There's actually a shortage of labor of the sort that are smart enough and industrious enough to (formally illegally) move from the interior to the coastal industrial cities. The percentage of GDP that's been spent on new factories is suspiciously high, because it's not clear that those factories will ever be able to get workers or markets for profitable products. Without profits, the loans that built the factories will fail, taking some of the lending banks with them. The rise of the Yuan (a.k.a. Ren Min Bi) relative to world currencies has been inevitable, and increases the pressure on the profitability of China's exporters. The non-bank (debatably legal) banking sector grew enormously in the boom, just as ours did here, and it could burst suddenly and catastrophically with little formal warning, just as ours did here. An ailing Chinese economy would be trouble for the world, and for us. Much is made of the fact that we import a lot of goods from China. Less is made of the fact that we also *export* a lot of goods and services *to* them. Their recession would crimp our exports.

You've probably read or viewed/heard a lot about the problems in Europe and the Euro currency zone. Those problems are real, and definitely not yet solved. On the current path Europe is headed for a long period of stagnation. With a little bad luck, it could become a recession. As with China, any bad news there will hurt our economy at least a little. Simple stagnation there decreases our potential growth rate, at best.

Also, in November we'll have a major US election day. The President, all the House of Representatives, and roughly a third of the Senate will be up for grabs, along with most State-level Executive and Legislative and some Judiciary posts. There has been enough turmoil in the past few years that many many surprises could come between now and the end of the vote-counting (and re-counting). For what it's worth, on average stocks rise in election years. Not always, but usually.

I wish you all a healthy, happy, and prosperous New Year. We'll see what we get.



It's time to proofread and email this to you. After that I can finish my coffee, drive to where dozens of friends are gathering, and switch to champagne.

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



A collection of fine industrial Boilerplate, but true:

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