CORE Comments
ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

February 6, 2018

# From Placidity to Turmoil

After more than a year of strong markets and exceptionally calm markets since the November 2016 election, and after a torrid start to 2018 during the first four weeks of January, stock markets took a tumble last week. The tumble became a rout on Monday of this week, before a wild day today. Today the stock market traded in a range of more than four percent, before closing up by 1.7%. Whew!

Bearing directly on the recent selling are the rising levels of bond yields and corresponding declines in bond prices. Treasury bond prices began to fall persistently in December and the slide accelerated recently. Last Friday's monthly employment report showed that wage growth, feeble for years, is now rising comfortably ahead of inflation. This is, of course, a good thing for the US economy and for workers struggling after several years of stagnant wages. However, it increases the likelihood that the Federal Reserve will be able to tighten monetary policy, in the confidence that stimulative policies needed after the financial crisis are no longer necessary. It is rather doubtful that stock markets will enjoy tight monetary policy.

The sustained buying stocks in recent months rendered them susceptible to some selling and the rise in bond yields provided the trigger. By contrast, the economic cycle still favors stocks and provides the impetus for more gains. Rising corporate profits and solid economic growth in America and abroad provide support for stocks. In addition, the recently-enacted tax legislation will likely provide a boost to the economy in general and to corporate profits in particular.

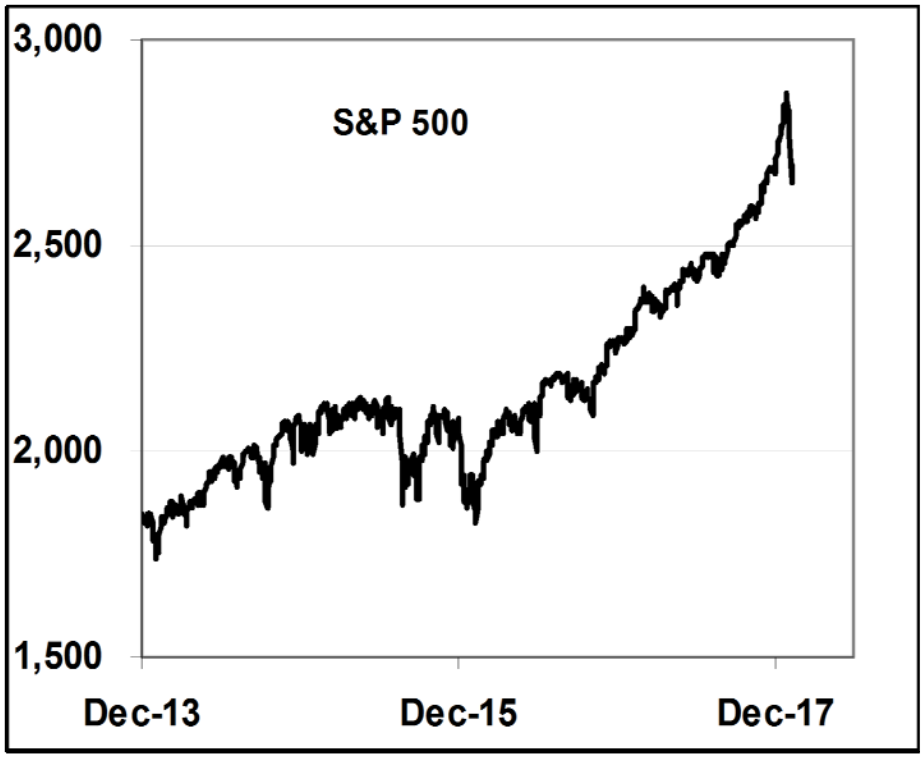
***By***

***Jack Mayberry***

In fact, the rise in bond yields itself restores more normal relationships between the level of those yields and underlying economic growth, inflation levels and stock prices. The actions of central banks since the financial crisis of 2007 to 2009, while necessary and very helpful, pushed bond yields to exceptionally low levels. Indeed, in much of the developed world outside the United States, interest rates have been negative for more than a couple of years. In historical terms, interest rates on the ten-year Treasury bond, the bench-

mark for all the world's fixed-income securities, is still quite low.

The rise in bond yields comes about not because of monetary policy misjudgments or the view that government bonds have become more risky, but because of the of strong global economic growth, rising wages, deregulation and the fiscal stimulus provided by the recent tax legislation. Given the still-low level of bond yields and the favorable economic and fiscal backdrop, it is quite reasonable to remain positive about stock investments.




It is, of course, a fool's game to try to predict financial markets. We make no attempt to do so, but we have what we think are well-considered plans to reduce risk if the market rises from this very recent bout of selling or if it should continue to fall.

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CORE Comments
ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

February 18, 2018

## Interim Remarks

*The sharp and swift decline from late January highs quickly gave way to an equally sharp and swift rally from the early February lows.*

*We abstained from selling equity positions as the markets fell, on the notion that they would soon recover. At the end of the week just passed, we reduced equity investments by a bit, in response to the clear evidence that stock markets have become much more volatile.*

*Big swings up and down lie ahead.*

After my letter from earlier this month, written while stock markets were engulfed with selling, the market had two more sharp declines, then a sharp turn upward. At this week's end, the market notched its sixth successive gain, in a rally that has lifted it by 7.9 percent from its recent low, leaving it 4.9 percent from its late January high and up by 2.2 percent from the end of 2017. The moves down from late January, then back up from the February 9th low have been unusually swift.

Given the favorable conditions I enumerated in my recent letter, including synchronized economic growth around the world, rising corporate profits, and the favorable effects for corporations as a result of the recently-enacted tax legislation, it has seemed likely to me that stocks markets will rise to new highs in 2018. Because of that view, I did not initiate any selling of equity positions in client accounts during the recent sharp decline. However, on Thursday and Friday of the week just ended, as the market pushed higher in its recovery, Core reduced equity positions in client accounts by a modest amount.

This may seem contrary to my view that the stock market will make new highs. We took the action, however, in light of the recent extreme volatility in stock prices. The long quiet period in the stock market that characterized all of 2017 has, in my view, come to its end. I suspect that the in the coming weeks the market will present more episodes of sharp and sudden declines and more of the recent sharp advances. In this volatile environment, we will benefit by holding fewer equities and more cash than were appropriate last year.

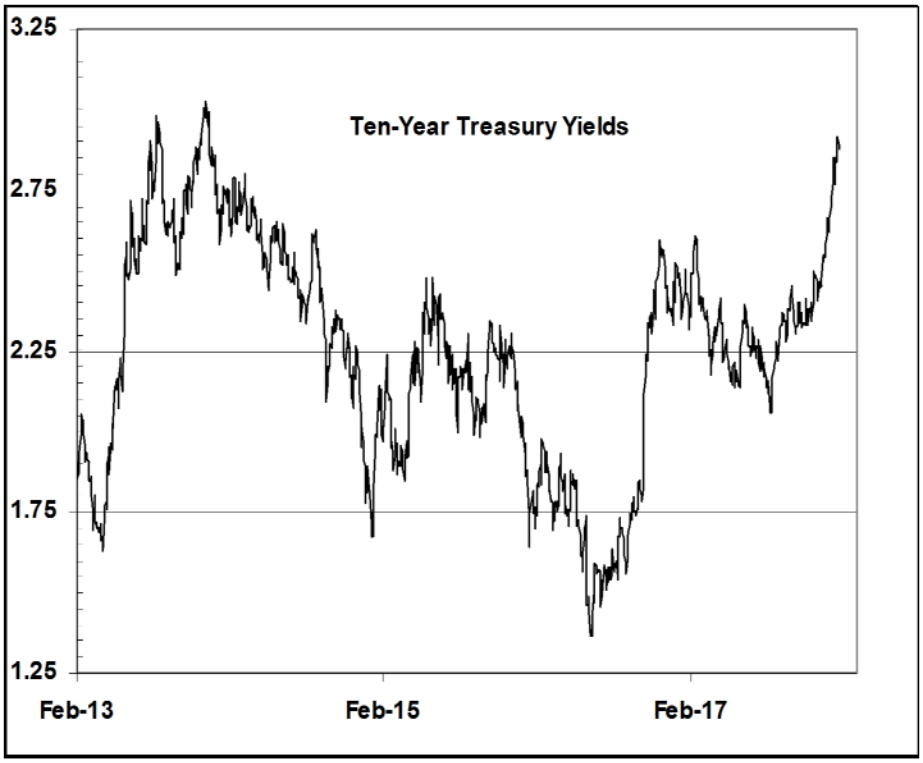
***By***

***Jack Mayberry***

**Bonds.** Apart from these sharp swings in stock markets and probably causing a bit of the recent selling, the US bond market has presented lower bond prices and higher yields. After the ten-year treasury bond, the world's benchmark for fixed income investments, set an historic low in yields at 1.34% in July 2016, yields moved slowly upward until the surprising election in November 2016. With Mr.

*Yields on the ten-year Treasury bond have reached their highest levels in four years and the decades-long bull market in bonds is well and truly finished.*

Trump's victory, bond investors expected inflation and higher federal deficits. Yields jumped from 1.77% at the end of October 2016 to 2.36% immediately after the election. Then, for the next year, the ten -year yield was stable between 2.0% and 2.4%, until December 2017, when bond prices began to fall steadily and yields to rise. Last week, the yield on the ten-year reached 2.93%, its highest in four years. Presumably, this rise in yields and fall in bond prices arises from the Fed's slowly tightening monetary policy, the still-modest increase in inflation, and the expanding US economy.




Because bond yields may rise further and bond prices fall more, we are left with some unappealing investment choices: we can stick with our investments in US bonds while they may fall in price, or we can retain higher money market fund positions, even though these still yield very little. But money market funds will not lose principal value as interest rates rise, while bonds will fall in price in that environment. We expect to keep the proceeds of our recent equity sales in money funds for the time being, perhaps until the rather-clouded prospect for future interest rates becomes clearer.

If you have questions about Core's investments for you, please do not hesitate to contact Margo or me.

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CORE Comments
ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

March 21, 2018

## Volatility Subsides

*Stock markers have become calmer since the turmoil of late January and early February. And, despite political upheaval in Washington, the economy grows apace.*

In our nation's capital, turmoil reigns as Mr. Trump fires his Secretary of State, threatens to fire other high-ranking officials, impels his Attorney General to fire the second-ranking FBI official, forces from office his chief economic advisor and generally sows chaos. Meanwhile, the American economy moves ahead and the recent turmoil in stock markets subsides. It is striking that White House histrionics have so little effect on the economy or financial markets.

As you will remember, the placid advance in stock markets that characterized 2017 and the opening weeks of this year suddenly gave way to swift and sharp selling that brought the market down by 12 percent in ten trading days. Then, within only five days, the market rallied by 8 percent to recover most of those losses. From there, the market has pushed higher; some stock market indices have surpassed their late January highs. Notwithstanding a sharp sell-off on Monday occasioned by news of ill use of Facebook's information about its users, the stock market turmoil has subsided. Given solid economic growth and robust job creation, it seems likely that the US stock market will advance further, at least for coming months. Core's client portfolios retain substantial positions in stocks and will benefit from advancing prices.

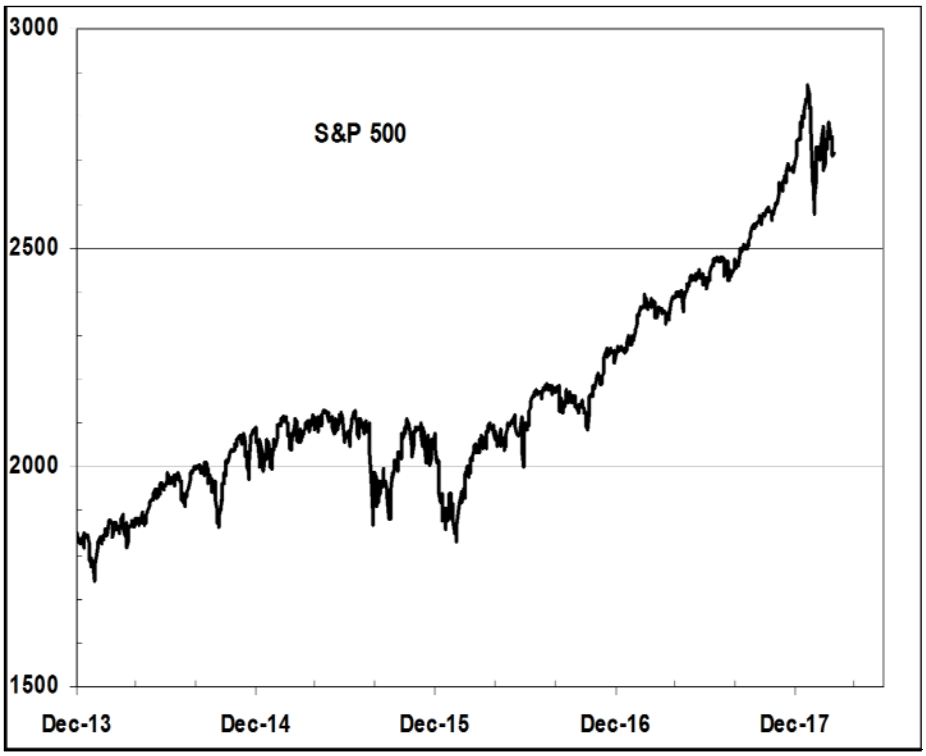
Unusual as the late-January and early-February selling was after the long quiet period of steady stock market gains, it seems likely that we will experience more bouts of selling as things unfold. We have cash in client accounts now and are ready to make further investments at opportune times, especially after further selling squalls. For example, on Monday, we took advantage of weak prices for technology stocks and added to our position in these.

***By***

***Jack Mayberry***

**Bonds and the Federal Reserve.** This week, the Fed is holding its first meeting of the Federal Open Market Committee under Jerome Powell, its new chairman. The uniform expectation is that Fed funds, the short-term interest rate that the Fed directly controls, will be raised by one-quarter percent, to a target range of 1.50 percent to 1.75%. The present view is that this will be the first of three or

four such quarter point increases in short-term rates in 2018. After the FOMC meeting, Mr. Powell will hold a press conference today in which he will have the opportunity to express the Fed's plans and the direction of monetary policy. It seems likely that Mr. Powell's remarks will express continuity with the policies the Fed set in motion during Janet Yellen's tenure as Fed Chair. Mr. Powell's recent Congressional testimony, while couched in terms less academic than those of his (academic) predecessors, did not indicate radical changes in direction of Fed policy. Apart from the question of how rapidly and by how much the Fed will raise short-term interest rates is the matter of the pace of decreasing the Fed's enormous balance sheet.




At present, the Fed holds Treasury securities and mortgage-backed assets of some $4 trillion, up from the $800 billion held before the financial crisis. The Fed's actions to reduce the level of these holdings will have real consequences for the prices and yields of all bonds. Given that Congress recently enacted a substantial reduction in taxes and plans significantly greater government spending, the Federal deficit will become much larger and much more government borrowing will be necessary. The combination of greater Treasury borrowing and the reduction in the Fed's Treasury holdings can certainly cause bond yields to rise and bond prices to fall.

For thirty years from the 1980s, bond prices rose and yields fell; we are probably now in early stages of a reversal of that long-term trend. We and many others will carefully attend to Mr. Powell's comments on these matters. For our part, Core has sold its long-term bond positions and replaced them with short-term securities and cash, against this risk of higher yields and lower bond prices.

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CORE Comments
ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

June 3, 2018

# Italy, Money Funds, Rising Short-Term Rates

*The rise in short-term interest rates, occasioned by the Fed's slow process of raising the Fed funds rate, has made money market funds a viable investment. For years after the financial crisis, money funds yielded essentially nothing. Now the yield is roughly equal to the rate of inflation and those yields are rising.*

***By***

***Jack Mayberry***

I wrote most of what follows in the letter below a week ago and was on the point of sending it when the latest drama in Italy's long history of unstable governments shook financial markets around the world. A rather brief and somewhat ill-informed synopsis: In its March elections, the rather strange Five Star party and the far-right Northern League party won, between them, fifty percent of the vote and allied to form the new government. Italy's president, whose duty it is to approve ministers of new governments, refused to permit the man nominated to be finance minister, because he is outspokenly opposed to the Euro. Although many Europeans and others in the West were discomfited by the notion that these two rather unusual parties would be forming Italy's government, the prospect of an immediate new election, after the impasse with the finance minister, was even more alarming. It was feared that the two parties would likely gain more support under these circumstances.

Markets around the world fell very sharply on Tuesday, especially in Europe, as this drama unfolded. Then came a resolution on Wednesday among the two parties and the president, leading to a relief rally. Meanwhile, in Spain, the long-serving prime minister, Mariano Rajoy, lost a parliamentary vote of no confidence, leading to the appointment of the Socialist party's Pedro Sanchez. The week ended calmly enough, but geo-political risk made itself clear. It is generally the case the markets ignore events that would appear to be unsettling to investors. We got a reminder last week that political events can have harsh consequences. We have not heard the last from Italy and Spain.

**Short-term interest rates and money market funds.** After a turbulent period in late January and February, stocks have drifted fairly quietly in recent months, gaining a bit of ground but still standing below the highs set in January. Our president, with his typical impulsiveness and upending of long-standing agreements, practices and alliances, has caused instances of short-term dizziness in stock markets, but, for better or worse, the world and investors seem to have become inured to Trump chaos. By contrast, action in short-term bond markets has been striking. Yields on the two-year treasury have climbed steadily for the last year, from around 1.25% a year ago to 2.50% now. This reflects ongoing Federal funds rate increases by the Federal Reserve and the prospects for more ahead At its meeting later this month, the Fed is likely to raise Fed funds by another 0.25% increase from the current 1.75%.

This increase in short rates has consequences for the broad economy and the markets. Among other things, it has caused the dollar to rise against major foreign currencies, after its depreciation from January 2017 to January 2018. The increase in Fed funds has lead to a corresponding increase in money-market

funds, at least those pegged to short-term rates. (More on this latter point below.) Financial conditions generally have become slightly tighter over this last year. This so-far modest tightening of financial conditions may presage conditions that can have an adverse effects on the economy. After several years with inflationary pressure non-existent, US inflation is slowly moving up and now stands near 2%, which the Fed considers an appropriate level. Because money funds are now offering a decent yield and with higher rates ahead, we can once again treat money fund holdings as a viable investment position.

**Schwab's money fund decisions.** In the years after the financial crisis, during which the Fed cut rates essentially to 0%, companies like Schwab that issue and maintain money-market funds found themselves in a losing position. Such companies maintained the fixed dollar price of their money-market funds, but had to bear the costs of operating them and could pay a yield only infinitesimally above 0%. In the last year, with the modest, but steady increases, money-market funds can pay the companies like Schwab their costs in managing them, and still pay a decent yield to investors. For example, one of Schwab's principal money funds now yields 1.74% and it pays Schwab 0.39% for its management of the fund. Thus, fund sponsors and the investors both make money now. Investors will earn more, as the Fed continues to raise rates.

Schwab has decided to keep the benefits of rising interest rates to itself. For a couple of years, it has required that all new accounts accept a Schwab Bank managed fund as its 'sweep' money fund. (A 'sweep' fund is one that automatically receives all proceeds of securities sales and other money kept in 'cash.') The Schwab Bank sweep fund pays 0.15% per annum. Schwab has no plans to raise that payout, even as the Fed continues to raise rates. Within a few weeks, Schwab will transfer to its Schwab Bank sweep fund the money market fund balances for all Schwab accounts. I have had extensive conversations with Schwab executives about this. They admit it is contrary to their customer's interests and contrary to Schwab's longstanding practice. But, Schwab makes no apologies and is adamant about sticking with the new policy and capturing for itself the benefits of rising interest rates.

**The work-around.** Schwab continues to manage several 'normal' money-market funds, by which I mean funds that purchase short-term commercial paper and government securities, and, after normal expenses, pass on the investment income to its investors. The one I refer above, Schwab Value Advantage Money Fund, symbol swvxx, is one such fund. We are able to purchase this fund for Core's clients so that our clients will receive the benefits of the rising short-term yields. We have begun this practice. We make our estimate of the short-term cash needs for given accounts of our clients, and use the excess to purchase swvxx. By this, we will achieve for our clients most of the benefits of rising rates they would expect if Schwab had not decided upon its new policy.

**A caveat.** We are aware of the client accounts from which regular distributions are made and those against which clients write checks from time to time. We intend to maintain sufficient cash in the Schwab Bank sweep fund to fund those distributions. However, we request that you contact us if you write a check of an unusual amount against an account that we manage, so that we may assure that funds are available in the sweep account to fund the check payment. The risk is that an unexpected check may give rise to a debit balance on which Schwab will impose somewhat high margin interest rates, or that the check will not be paid. If you have questions about any of this, please contact us.

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CORE Comments
ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

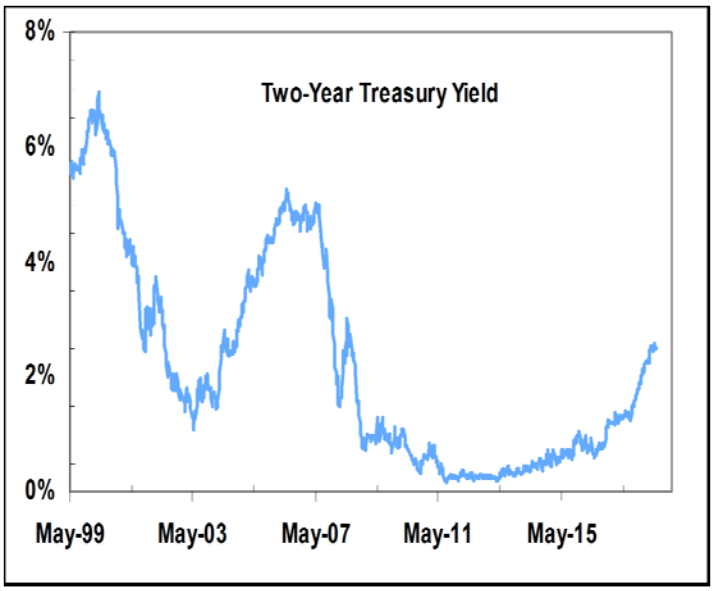
June 30, 2018

# Politics Intrude

*President Trump's recent actions and threats relating to tariffs on imported goods and other trade restraints cause selling in financial markets. After a first year in office when the administration's actions were generally deemed friendly to markets, things have turned darker.*

Having expressed my personal views about our president just after the election and a few times since, I have generally abstained from further such comments in my letters. After all, these *Core Comments* are meant to discuss investments and the economy. No one pays Core to read my political commentary. And, as it happened, in the first year of Mr. Trump's administration, the actions of his administration and those of Congress, both houses of which are controlled by Republicans, were deemed salutary by many investors.

Despite the adverse effects of the tax legislation on residents of New York, California and New Jersey, subject to substantial property taxes and state income taxes, stock markets seemed to like tax 'reform' and bank deregulation. The US stock market responded positively: there was a strong correlation between stock prices in the latter part of 2017 (they rallied) with the increasing likelihood of the tax changes that were enacted in December. (Of course, we must remember that correlation is not causation.)




Recently, however, things have been changing. In his campaign and since, Mr. Trump has complained that the trade regime among most important nations disfavored US interests. That these trade agreements were largely designed by the United States and, in large part, benefit America, our president seems to ignore. Over recent months, he has threatened various tariff increases with Europe, China, Canada and elsewhere. As quickly as some were announced, they were withdrawn, usually for reasons left unexplained. Accordingly, the threats and proposed tariffs were mostly ignored by financial markets, on the notion that this was largely bluster, not actual policy.

***By***

***Jack Mayberry***

However, tariffs on steel and aluminum were imposed and European countries retaliated by imposing tariffs on certain US goods. After tariffs on Chinese imports were imposed, the Chinese announced reciprocal trade restraints. Upon which, our president ordered even greater restrains against China. Quite recently, Harley Davidson, the motorcycle manufacturer, announced that it would have to move manufacture of its motorcycles destined for export to Europe to overseas facilities to avoid the European tariff. A US steel manufacturers trade association filed litigation on Wednesday challenging the administration's tariffs on steel imports. On Friday, General Motors reported that the tariffs would be likely to cost GM jobs in the US. In short,

the administration's efforts to impose tariffs and restrain trade are meeting opposition from US companies and are depressing the US stock market.

Thus, despite my wishing to avoid writing about politics, the effects of recent and threatened actions directly impinge upon investments; discussion is now timely.

*America's economic success and the vibrancy of financial markets here has been built on a foundation of respect for civil rights and civil liberties, the many global organizations founded at the instigation of the US after the Second World War, and the extraordinary web of world-wide alliances among nations that the US has fostered.*

*The administration appears to decry this history and to read it as failure.*

**Civil rights and civil liberties.** Tariffs and other trade restraints put into focus the ways in which the incumbent administration attacks the foundations of American policies of the post-World War II period. Stepping back to look at things from a longer perspective is relevant to present US policies. I studied at the Yale Law School in the 1970s. In retrospect, the 1970s appear to mark the high-water mark of the recognition, the expansion, and the realization of civil rights and civil liberties in this country. I do not mean the social or actual apogee of such rights and liberties--we have seen great advances since then in our society. Consider, for example, the acceptance of gay marriage. But that decade indisputably represents the point at which the embodiment of those notions into constitutionally-prescribed law reached its unchallenged high point. When I was a student then attending my many courses on constitutional law, I thought--naively, it turns out--that the long arc of social justice would keep its upward ascent.

In 1976, while I was at Yale, the Supreme Court rendered its first opinion limiting federal laws that imposed restraints on campaign contributions in *Buckley vs. Valeo*, 424 U.S. 1 (1976). Neither my fellow students nor our eminent professors recognized what a milestone was *Buckley vs. Valeo.* But we know now whence came *Citizens United vs. Federal Election Commission,* 558 U.S. 10 (2010) and *McCutcheon v. Federal Election Commission,* 572 U.S. ___ (2014), both of which cases significantly limited restraints on corporate funding of election campaigns. Bought and paid for, one might say about our elections.

**A functioning government.** Apart from the judiciary, in the 1970s we observed the effective functioning of Congress and the Fourth Estate--the press--in upholding the governance institutions of our country. President Nixon sought to cover-up a burglary of Democratic Party offices during his 1972 presidential campaign. We need not rehearse Watergate history here, except to note that Congress, the federal courts, and the press, led by the New York Times and the Washington Post, ultimately did their duties as our Framers had intended. Our country's institutions were strengthened by Watergate and by what I refer to as the long arc of social and political justice. Until....

**Global institutions for peace and economic well-being.** After the Second World War, when Europe and Japan were largely destroyed by the successive global wars of the first half of the twentieth century, the United States, undamaged and in rude health, created a system of organizations to link the developed nations into self-reinforcing arrangements that fostered economic development of the war-torn regions and linked the countries so as to end the cycle of nation-state violence that gave rise to the wars of the nineteenth and the early decades of the twentieth centuries. The European Coal and Steel Community, the predecessor to the European Union, formed itself in 1951 while the ashes of the war were still warm. NATO, the United Nations, the World Bank, the International Monetary Fund and America's treaties and alliances with scores and scores of nations brought about extraordinary things: the economic resurgence of the western European nations and Japan, peace within the 'free nations' of Europe, the containment of the Soviet empire, and its ultimate collapse in 1989.

In these years after the Second World War, the United States pursued its own misadventures, in Iran, in Viet Nam and elsewhere. But during these misadventures, it maintained its alliances and the institutions it created and, as importantly, it stood for the values of civil liberties and civil rights. It advocated for such rights and liberties around the world and, in a faulting but forward-looking way, it pushed ahead the system of rights and of democratic government.

*The charts on the first and last pages of this letter illustrate the actions of the Federal Reserve in raising short-term interest rates and the possible onset of the next recession and bear market.*

*The yields on the Treasury's two -year note gives a read on expectations of the Fed's actions with short-term rates. In the financial crisis and deep recession of 2008 to 2009, the Fed slashed short rates to zero and, until a couple of years ago, it kept short rates there. Recently the Fed has raised short rates every three months; two more are planned for this year. But two-year yields remain far below the levels reached in the late 1990s and before the Great Recession.*

*The yield curve chart on the next page shows that the spread between the 10 year and the 2 year Treasury yields shrinks toward zero. This happened just before the recessions and bear markets of 2000 to 2002 and 2008 to 2009. The 'inversion' of the yield curve, that is, when short-term interest rates become higher than long-term rates is a fair harbinger of recession. We are not there yet, but we're approaching.*

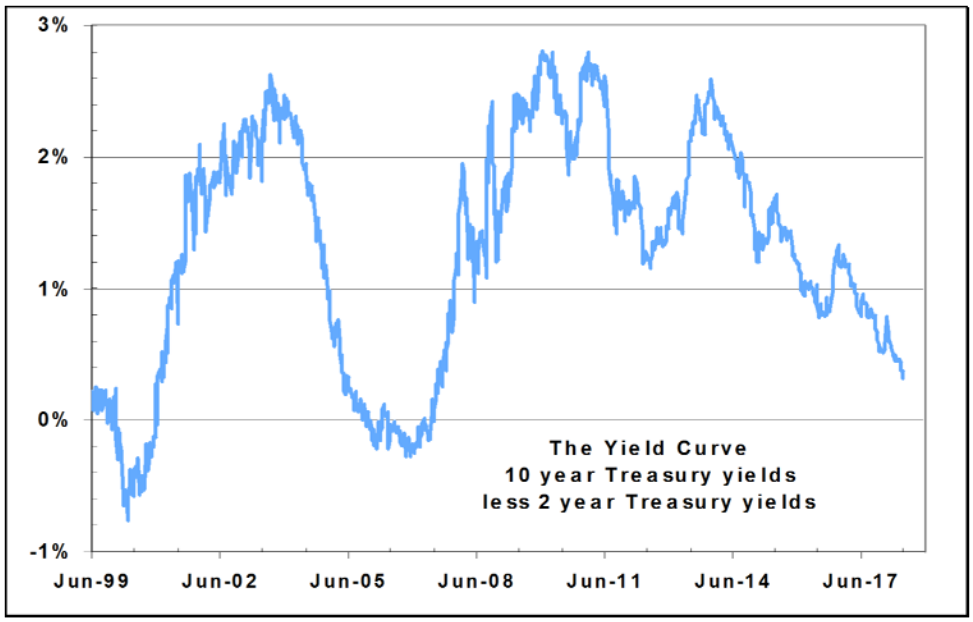
**The relationship to investment matters.** I am not discussing history or politics here. Instead I am trying to portray, in short form, the framework for the economic strength of the United States and for the vibrancy of its financial markets in the decades following the Second World War. The rule of law and the certainty of enforcement of contracts in America have attracted an untold amount of custom to our country. This custom, this business has brought economic activity here to an extent difficult to measure, but certainly enormous. Our present administration appears to have determined that pulling apart carefully-fostered alliances and the institutions that our country created will 'make America great again' and put 'America first.' Maybe. But our present administration does not explain how its actions will make America again great and first. Most of us did not notice America's fall from greatness, but enough voters did.

**Shredding alliances, fawning on dictators, separating children from parents.** After leaving early from a G7 meeting in Canada to attend his meeting with Kim Jung Un, our president delivered himself of a harsh criticism of his host in Canada, Justin Trudeau, and refused to have the US join the declaration at the end of the annual meeting of this important group of nations. Upon return from the Singapore meeting with North Korea's dictator, when he declared that North Korea is no longer a threat to the United States, our president seems to have turned his attention to asylum applicants from Mexico and Central America, complaining of the 'infestation' of America by such migrants. 'Infestation' is, at best, a loaded term, as we have learned from the 1930s and recently in the powerful graphic novel by Art Spiegelman called Maus. While in the business of separating incoming asylum applicants and illegal immigrants from their children, our president has decided to that a trade war with Europe and China is the best way to achieve the 'greatness' that he promises.

Financial markets are notable for lack of moral scruples and for dis-interest in the institutions and practices that have sustained financial markets in America, Western Europe and Japan over the last seven decades. Without discussing the day-to-day of all this, suffice it to say that threatened and actual tariffs and other trade restraints impel those countries targeted for these restraints themselves to impose their own tit-for-tat retaliatory measures. Thus arise consequences adverse to our country and to the rest of the world. If companies and people, here and in China, Europe, and elsewhere, could be sure that the public threats were merely the early staking-out of positions in a bargaining process, well and good. However, our president does not provide such clarity. As his process goes on, including the tariffs, the embrace of dictators, and the encouragement of anti-immigration zeal, one can be forgiven for wondering whether Mr. Trump's real target might be the destruction of American institutions of government, the Western alliance and the liberal ideals upon which these are based.

*The chart below shows the narrowing difference between yields on two-year and ten-year Treasuries. The markets tell us that economic weakening lies ahead. Recessions typically following 'inverted yield curves. Then come bear markets. These may not be too far away.*

**Financial markets respond.** One thing is clear: Mr. Market does not like the escalating threats and retaliatory measures. It is worth remembering that the very confident buying that marked the beginning of the new year in January gave way to intense selling in late January and early February. Although the US stock market has traded fairly quietly since then, within a range just below the late January highs, it has failed to set new highs. This is despite remarkably robust corporate earnings, the likes of which are rarely seen at this stage in the economic cycle. December's corporate tax cuts have been characterized as a 'sugar high' that will soon wear off as we roll toward upcoming corporate earnings reports. More than one respected economist doubts the sustainability of the very recent increase in corporate profits and questions the likelihood of continued strong economic growth in the second half of this year.




One might also consider the Smoot-Hawley legislation of 1930 that raised tariffs on imported goods and invited commensurate retaliation by America's trading partners. Smoot-Hawley is widely seen to have exacerbated the economic depression of the 1930s. Has Mr. Trump or have his advisers considered this quite prominent historical example of the effects of raising tariffs?

**Core's actions.** Of course, the outcome of all this is quite uncertain. A new set of tariff threats or of accommodations may happen at any moment. There is, one reads, discord within the administration on this question. What are Mr. Trump's views? That's what matters. Caution is in order. It is a long time since the 2009 bottom in the US economy and the stock market.

**The yield curve flattens.** As the Fed continues its steady increases in short -term interest rates, fears for the sustainability of American economic expansion grow. Such fears tend to depress long-term interest rates with the result that the difference between short rates and long rates shrinks toward zero, particularly now, when short-term rates rise. This feature, referred to as a 'flattening' yield curve, augurs poorly for the economy; indeed, an 'inverted' yield curve—the situation that obtains when long-term rates are lower than short-term rates—is a fair harbinger of recession and of a bear market in stocks. The graph on this page demonstrates where things stand at present. Not a favorable prognosis.

Core has reduced some foreign stock investments and bought some amount of US small company stocks. Small companies do not have much business overseas; thus are somewhat unaffected by appreciation of the dollar and by threatened new tariffs At present, we have a more defensive position in your portfolios than for a long time.

CORE Comments

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CORE Comments
ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

August 6, 2018

# Economic and Market Warning Signs

## And Margo Leardini

*The economy is strong, corporate profits have been rising markedly, and the US stock market has largely recovered from its January and February sell off.*

*But risks to the economy and to markets are rising. Oil prices and short-term interest rates have risen sharply, while copper has fallen in price. These factors have preceded recent recessions. The Fed is tightening monetary conditions while the housing market signals weakening in mortgage applications, sales and prices of homes.*

***By***

***Jack Mayberry***

**Margo** joined Core early in 2005 and has been a mainstay of our activities ever since. Earlier this year, she told me that she planned to leave Core and resume working in education. Margo had been working at Dominican College in Marin before coming to Core and, indeed, she returns there next month. I cannot say enough good things about Margo; she has been extremely helpful to me over these years and, unsurprisingly, we have been in touch almost daily over this period of years. She has always been a pleasure to work with and always very effective in her work. I have been told by many clients over the years how helpful Margo has been in handling their matters. I get a sense of how highly regarded Margo is by clients when I answer Core's phone and hear the disappointment that Margo is not the person speaking for Core.

Over these recent months, Margo and I have worked jointly to handle things as she takes her leave. Core will be quite ready to keep things rolling along smoothly. In her usual helpful way, Margo has offered to be available to help as needed after August 31, but I will not take her up on her kind offer except in unexpected and unusual matters.

**Stocks and the economy.** The US stock market continues to rise modestly. It is close to the all-time highs set early in January, but has yet to surpass those highs. The US economy is strong--witness the recent estimate for second quarter growth--and corporate earnings have risen markedly, as announced after the first quarter and now, after the second quarter. Last week's employment report for July was another strong one; growth in jobs this year has been steady and powerful enough to pull formerly-discouraged job seekers back to the jobs market.

**Reasons for caution.** That's the good news. Against this backdrop, I have become more cautious about prospects for further stock market gains. Core has reduced equity positions in client portfolios because of what I take to be increasing risks. Here are some troublesome ones: Oil prices and short-term interest rates have risen substantially in the last year, exactly as occurred just prior to the last three recessions. Copper prices have fallen by nearly twenty percent since early June. Because of its widespread use in many, many aspects of the economy, copper's sharp decline presages economic weakness. The Fed is raising short-term rates with determination and is allowing the assets on its balance sheet to run off as the securities it holds mature. Recall that the Fed's enormous purchases of government bonds and other securities, which came to be called 'quantitative easing,' caused its assets to increase from about $800 billion to $4 trillion. Now the process is going in reverse. The Fed is almost certain to try to raise short rates by at least one percent more; only the onset of a recession will slow it down. The years'-long tail wind that the Fed provided to financial markets has become a head wind. To use the old meta-

phor, the Fed's job is to take away the punch bowl as the party gets lively. The punch bowl is no longer on the table.

*Last December's tax law has not stimulated the economy. It has merely shifted revenues from the US Treasury to corporations and their owners.*

The housing market is another point of increasing weakness, one that has a very big effect on the US economy. Mortgage applications are declining, the pace of home sales is slowing, and, in some important markets, home prices are weakening. The Fed has not discussed these matters in its recent statements, but they offer a warning signal now.

*The steady ascent in US stocks came to an end in January. A slow recovery in stock prices has not yet brought prices to new highs. The recovery now faces headwinds.*

**The tax legislation.** As for the gains in corporate profits cited above, note that much of the gain derives from the December tax law changes. Recall that one of the significant tax 'reforms' was a large decrease in taxes levied on corporate profits. As a justification for cutting corporate rates, the administration and the Republicans in Congress pointed out that America's rate of tax on corporations, at 35%, was far higher than the rates in other developed countries. The supposed result of the high tax rate was the failure of US corporations to invest sufficiently in plant and equipment, depressing, it was said, the potential to create new corporate jobs. Lowering the corporate tax rate would spur capital investment and job creation. Advocates of the tax cut neglected to point out that the myriad corporate tax deductions embedded in our tax code made the rate of tax actually paid on operating earnings by US corporations entirely in line with those of other countries and far, far less than the headline 35% rate.


Indeed, the lower tax rate has increased corporate after-tax profits quite significantly, but pre-tax or operating profits have not increased by anything like the increase in after-tax profits. Moreover, it appears that much of the money saved by cutting corporate taxes has been used to fund payments to shareholders via dividends and increased stock repurchases, rather than new business investments. This should not be terribly surprising, in that corporations have had very substantial earnings for the last several years and have generally been able to afford any business development the companies wished to make. The real effects of the tax cuts have been to enrich the owners of corporations and to deprive the federal government of needed funds. (Although we are all owners of public corporations and, in that way, benefit from the higher profits, we will pay the price as citizens of our weaker country.) The federal budget deficit is rising sharply, after falling steadily during the last six years of Mr. Obama's administration.

**Tariffs and trade** are political problems that threaten the economy and financial markets. The trade wars that Mr. Trump has begun and threatens to intensify cannot end well. All economic research and historical experience show that higher tariffs on goods and services depress economic activity and raise costs to consumers. These ill-favored economic effects are highly correlated with lower prices for stocks. We have observed in the last year several episodes of angst in stock markets as Mr. Trump's sabre rattling about tariffs has brought swift declines to stock markets.

As a result, Core has been slowly increasing the portion of safe assets in the accounts we supervise. These 'safe' assets include money market funds, bond funds and funds holding preferred stocks. The portion of risk assets--in our case, the various equity-oriented investments we hold--has decreased. Last week, we sold another stock position; the process is likely to continue.

CORE Comments

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CORE Comments
ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

September 21, 2018

## Selling too Soon???

*New highs in the US stock market have been achieved this week. The rest of the world lags far behind and there are growing signs of economic weakness. Caution is useful now.*

For some months, Core has been engaged in an ongoing process of lowering risk in our clients' equity-oriented portfolios, on the view that economic growth is weakening and that stock and bond markets face price declines in the period ahead. As you may be aware, the primary measure of the US stock market, the S&P 500 index made a new high in late August, again yesterday. Today it set a new intra-day high, before closing slightly lower on the day. By this measure, it appears that Core may be selling too early. However, given the impossibility of timing the stock market and selling at the top, our view is that selling too soon is better than selling too late.

Although we observe the recent new highs in the S&P 500, there are any number of negative aspects to the behavior of the stock market. For example, (a) the stock markets in the rest of the world are still some 15% below the January highs, (b) more than one half of the total gain in the S&P in 2018 comes from just six stocks, including Amazon, Apple and Microsoft, while the other 494 stocks in the S&P 500 have gained a mere 3%, and (c) the recent new highs in the S&P have accompanied by much weaker participation. That is, many fewer stocks are rising and more are falling this time than in January and more stocks are setting new 52 week lows in price than are setting new 52 week highs. Narrow advances like this one, led by a handful of very large growth stocks, are a sign of a market making a final top in price.

Another feature of market action that seems to confirm the notion that we are in the last inning of a long baseball game is that defensive industry groups are now leading the advance, while the formerly strong cyclical industry groups are in decline. In the recent few months, defensive sectors like consumer staples (i.e., groceries, gasoline and the like), health care, utilities and telecoms are rising, while the sectors that advance in early stages of economic and stock market advances, like industrial stocks, basic materials, financials and technology stocks are faltering. Among the portfolio changes we have been making since mid June is the selling of cyclicals and the buying of defensives. Thus, we have sold the industrials, bank stocks, and half our tech stocks in favor of consumer staples, small company stocks, health care and utilities.

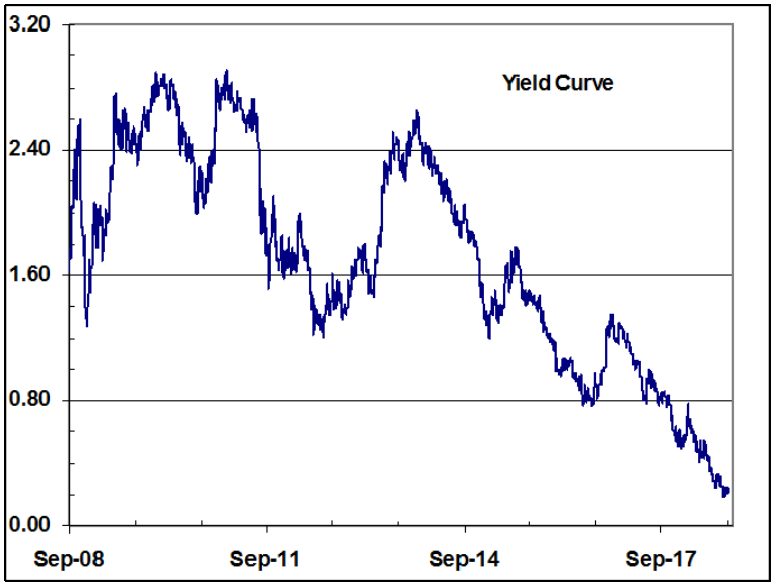
Apart from selling the cyclicals and buying the defensives with the proceeds, we have sold some equity positions outright and have roughly doubled holdings in cash, bonds and preferred stocks. This 'de-risking' of clients' portfolios is a process; a process that may continue as we evaluate changes in the economy, the actions of the Federal Reserve and the political dynamics, including the Trump administration's imposition of tariffs and trade wars—or 'skirmishes, as Jamie Dimon puts it.

***By***

***Jack Mayberry***

**The Federal Reserve's** governors meet next week and are almost certain to raise short-term rates by another one quarter of a percent. It seems quite likely that another rate rise will follow at the December meeting. More are likely in 2019. Concurrently, the Fed is allowing the total assets on its balance sheet--the nearly four trillion dollars of government bonds and other securities it holds--to shrink as it undoes some of the effects of the bond-buying program--Quantitative Easing--it undertook in the aftermath of the financial crisis. Slowly the Fed tightens monetary policy. The typical outcomes of Fed tightening are recession and a bear market in stocks. In the thirteen cycles of tightening of monetary policy since the Second World War, a recession developed ten times. We may be some distance from recession and from a bear market, but we are much closer to the end of this economic expansion and bull market in stocks than we are to its beginning in 2009.

**Inflation.** Among other things that will keep the Fed on its monetary tightening course is inflation. The steady increase in employment coupled with the reasonably strong economy have given rise to the unusual situation in which there are more job openings than people seeking work. Indeed, so tight is the labor market that more than all of the net new jobs created in the last three months have been filled by those without more than a high school education. This unfilled demand for labor is finally, albeit rather slowly, pushing up wages. The so far still modest wage 'inflation' is very likely to push up prices of goods and services with it. The long period of subdued inflation, indeed at levels considered dangerously low by the Fed and many economists, appears to be coming to an end. At the same time, the burst of economic growth in the second quarter of this year is already subsiding. Is the dreaded 'stagflation' at hand? (The horrible term was coined in the seventies to describe the combination of high inflation and stagnant economic activity that characterized the latter part of that decade.)




The nearby chart shows the yield curve over the last decade, specifically the difference between the yield on the ten-year treasury bond and that of the two-year treasury note, expressed in basis points or hundredths of a percentage point. (For example, if the yield on the 10-year note is 3.00%and that of the 2-year is 2.00%, the difference is one percent or 100 basis points.) Normally, the yield on the 10-year exceeds by a comfortable margin that of the 2-year. When the yield on the 10-year falls below that of the 2-year, it is referred to as an inverted yield curve or a negative term spread. It suggests that economic weakness is at hand. As can be seen, the difference has been falling steadily for three years and is near to zero. As stated in a recent paper by the Federal Reserve Bank of San Francisco, "[e]very US recession in the past 60 years was preceded by a negative term spread, that is, an inverted yield curve. Furthermore, a negative term spread was always followed by an economic slowdown and, except for one time, by a recession." As the Fed continues its raising of short-term interest rates, the yield on the 2-year note is almost certain to rise, making an inverted yield curve more likely. Should a recession come, the next bear market in stocks is highly likely to accompany it.

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CORE Comments
ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

October 27, 2018

# Wheels Falling Off

*Concerted selling in October has carried stock prices sharply lower.*

*Because Core had been reducing equity holdings in portfolios we manage while the stock market was making new highs in September, the losses in Core's portfolios are quite modest.*

*Last year's tax cut and the early 2018 federal spending increases have provided (unneeded) fiscal stimulus late in the economic cycle. The result is a rapidly rising federal budget deficit.*

***By***

***Jack Mayberry***

One is tempted to recall the title of the last letter in this series--Selling too Soon???--and call this one Selling too Late??? A striking decline in stocks so far in October has been unsettling, to say the least, for those who think this the strongest possible economy and the strongest of bull markets. The very sharp bouts of selling on most days, interspersed with days of robust recoveries, signal a change in the markets. Recall that 2017 was a one-way street of higher stock prices and one marked by very low volatility (or swings in prices). January of this year continued the process until late in the month when the market fell suddenly and deeply. For the next weeks, selling and large price swings continued until the beginning of April when things settled down and the market again began to advance. After this settling down, the market, as measured by the S&P 500 index, made new highs in August and September. Then came October, during which the market, as of yesterday's low, has fallen by 10.6% from its late September high.

**A modest 'correction' or** the beginning of a meaningful decline? The latter, I think. Despite the high growth in the second quarter of this year at 4.2%, growth subsided in the quarter just ended to 3.5%. The end of 2017 tax cut, coupled with substantially increased federal spending as enacted shortly thereafter, gave rise to higher growth, but the underlying growth rate of about 2% is what we will likely see in coming quarters as the initial effects of the strange fiscal policy fade. Meanwhile, though, sharply lower taxes combined with increased federal spending give rise to higher federal deficits and the need for more borrowing by the US Treasury to fund the government's operations.

It is quite unusual (and quite unnecessary) to engage in fiscal stimulus by cutting taxes and increasing spending in the ninth year of an economic expansion during which unemployment has fallen to decades-low levels. But there we have it. In the US fiscal year just ended--the US is on a September 30 fiscal year --the federal deficit was $779 billion (3.9% of Gross Domestic Product, GDP) as against a deficit of $666 billion last year (3.5% of GDP). Given the higher rate of spending and lower gathering of revenue, the federal deficit for the year just beginning is likely to be $1 trillion or more than 5% of GDP. One wonders why, with a strong economy late in the cycle, Congress and the administration found it necessary to juice things with tax cuts and increased spending. In the period late in the 1990s economic expansion, the US federal budget was in surplus and in 2007, prior to the recession and financial crisis, the budget deficit was a modest $162 billion.

**How do we fund our federal deficit?** The United States has been for a long time the most credit-worthy borrower in the world and, given that the US dol-

*Funding the much higher US federal budget deficit will be trickier as Mr. Trump attacks China, previously the biggest buyer of US debt. It appears that China is somewhat less interested now in lending money to the United States. We should not be surprised.*

lar is the world's reserve currency, there has been no lack of lenders to fund US debt. This may be changing. China and Japan are our largest creditors, each holding more than $1 trillion of US bonds and notes. In recent months, for reasons not hard to imagine, China has withdrawn from Treasury debt auctions and has not increased its holdings of US debt. Foreign buyers now hold 41% of US Federal debt, down from 50% five years ago and the lowest percentage in 15 years. Can this be China's silent retaliation against Mr. Trump's anti-China policies? Every week, the US auctions a good deal of new bills, notes and bonds to replace those maturing and to fund new spending. In recent weeks the bid-to-cover ratio—the offers to buy as compared to what is on sale—has fallen. This indicates that, as the US needs to borrow more, the demand for its debt is falling. Even for those of us who studied Greek and Latin in college rather than economics, it is easy to understand the disjunction between supply and demand.

*The problems facing financial markets are daunting: The Fed is tightening monetary policy, China is in a deep bear market, tariffs and other trade barriers are rising, inflation is rising, Italy presents big problems to Europe.*

*Caution is the watchword.*

**What else is amiss?** Let us list some: The Fed is tightening monetary policy by raising interest rates and selling Treasury securities it purchased during and after the financial crisis. Other major central banks are nearing the end of their own accomodative monetary policies. China is in a major bear market and its economic growth slows. The US administration is intent on raising tariffs and other trade barriers. Inflation is rising, both in wages (a good thing for those who work), in goods and in services. Despite Mr. Trump's complaints, the Fed must tighten monetary conditions. Italy's debt presents huge problems for Europe and, unlike Greece several years ago, Italy is too big to be bailed out. As written in previous notes, the internal conditions of the stock market are far weaker than in January, the last time the US market fell sharply. This time, the economic background is nothing like as robust. Although GDP rose by 4.2% in the second quarter, that likely represented the 'sugar high' of unneeded fiscal stimulus. Important sectors of the US economy are weakening sharply, notably the housing market. As the stock market falls, the sectors that are doing reasonably well are the most defensive, e.g., utilities and consumer staples (groceries and gasoline), while cyclical sectors, including technology, are falling sharply.

**Core's actions.** As discussed before, we altered portfolios months ago, shifting equity holdings to defensive sectors and away from cyclicals. Then we began to sell equity positions outright and move to cash. As 2018 began, the portfolios we supervise held about 70% or more in equities. By September 30th, as the market was making new all-time highs, we had cut equity positions to a bit more than 50%. As of yesterday's close, having continued selling in October, we had cut equity positions to about 25%. As a result, although Core's accounts have lost money in October, the losses are less than one third the losses in the US stock market. It is easy to imagine, particularly after a session like Thursday's, when the S&P rose by 1.9%, that the selling this month is a modest aberration in the years-long bull market. Most market participants seem to believe that, as shown in various surveys. Doubtful.

Predictions about future stock market prices are futile. It is far easier to be wrong than to be right in such things. At this stage, caution is in order. Risks are high; the Fed is taking away the punch bowl, as is its duty. Best to await more insistent rounds of panic selling than we have yet observed. There is little money to be made while we are on the sidelines, but there is less to lose as we stand patiently watching. Like yourselves, I have learned from the bear markets of the last thirty years. Let us put hard-won learning to good use.

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