

CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

December 26, 2018

Stumbling to the Year's End

Although October and November were a bit grim in the stock market, December has been worse. Indeed, as things stand now, December, usually the best month of the year for stocks, is on track this year to be the worst since December 1931. Not a terribly auspicious year that was, in the depths of the Great Depression. Wave after wave of selling has brought stocks far below the lows of early 2018. The stock market, as measured by the S&P 500 now stands down 13% for the year and 20% from the highs set just three months ago.

Please remember, as you read of the waterfall-like declines that have been unfolding day after day, that, during July, August and September, as the stock market was setting new all-time highs, Core was reducing your equity positions. We have continued to sell in the last three months, as the market itself has been selling off, with the result that at present, a typical managed account holds on about 10% in stocks (in the defensive utilities and consumer staples sectors), some 20% or so in preferred stocks and bonds, and about 70% in money market funds. Thus Core's typical balanced accounts are down just 3% since the market's all time high in September, while the stock market has fallen by 20%. Although there is some variation among individual accounts, those in our regular balanced portfolios are within 0.5% of unchanged for the year to date, while the stock market is down 13%.

It has been said that bull markets do not die of old age; they are killed by the Fed. On Tuesday and Wednesday, the Federal Open Market Committee held its last of eight meetings this year and, to the surprise of none, it raised Fed funds by 0.25% to the range of 2.25% to 2.50%. This is the ninth quarter-point rate increase since the Fed began this series three years ago. At his post-meeting press conference, Jerome Powell, the Fed chair, characterized the US economy as reasonably strong, down-played turbulence in the markets as a factor in the Fed's decision, and said that the Fed's reduction of its balance sheet, now happening at the rate of \$50 billion per month, was on 'autopilot.' This last remark caused the market to sell off very sharply.

In the aftermath of the financial crisis in 2008 and 2009, the Fed, under then chairman Bernanke undertook a series of purchases of government securities and mortgage-back securities to stimulate the economy. The purchases came to be called Quantitative Easing; the Fed's purchases increased the assets on its balance sheet from \$800 billion to more than \$4 trillion. The Fed is now letting these securities run off or actively selling them, so as to decrease the assets on its balance sheet.

How is the Fed 'killing' the bull market? Of course, the increase in the Fed funds rate amounts to monetary tightening, increasing borrowing costs for all newly issued debt. And, in the context of the rapidly expanding federal deficit, the Fed's reducing the assets on its balance sheet is problematic. Last December's tax legislation cut corporate and individual tax rates substantially. The tax cuts were 'unfunded,' that is, there were no offsetting revenue gains for the Treasury. As a result, the deficit increases sharply and the federal government must borrow huge amounts. In November, the federal deficit for the month was a near-record \$205 billion; in the government's cur-

Watching the stock market fall day after day might make for a somewhat doleful holiday season.

Happily, the accounts Core manages have stood aside from the havoc, because our accounts hold very, very little in the way of equities.

So, enjoy the holidays and look forward to a good New Year.

By

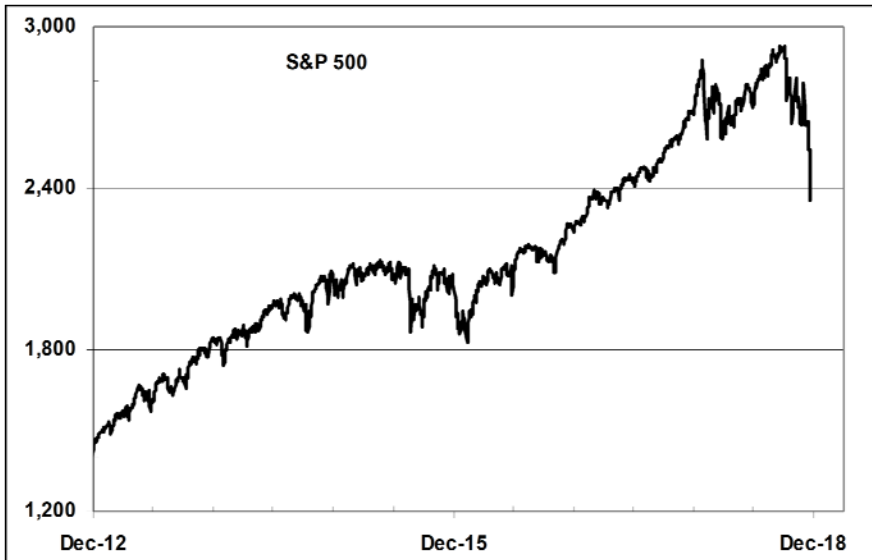
Jack Mayberry

Because of tax cuts and spending increases, the federal budget deficit is on its way to \$1 trillion in this fiscal year. The Fed is raising rates and shrinking its balance sheet.

Not too surprising that stocks and bonds both fall in price.

rent fiscal year, the deficit will exceed \$1 trillion. Thus the federal government must borrow a huge amount each week, at a time when China and Japan, the biggest foreign holders of US government debt, have cut their purchases; indeed, China has been a net seller recently. The tax and the spending legislation that followed were counter-cyclical. Years into an economic expansion, there should be a federal surplus, not tax cuts that increase the deficit by hundreds of billions of dollars each year.

That the Fed itself is reducing its assets now, in contrast to its years of securities purchases during Quantitative Easing, removes it as a buyer of Treasury bonds. In short, the Fed is tightening monetary conditions and exacerbating the liquidity issues that face the stock market. As one observer pointed out, the Fed has never, until now, tightened monetary policy in the circumstances that now obtain, namely falling stocks, falling bonds, falling commodities and falling credit. The Fed is probably trying to ‘normalize’ monetary conditions, by raising the Fed funds rate and decreasing the assets on its balance sheet, so that it will have the tools at hand to combat the next recession.



Stocks are not alone in falling: As we near the end of 2018, government and corporate bond markets both show losses for the year, as do commodities and residential real estate. This will be the first year since 1994 that money market funds have returned more than both stocks and bonds. And it is the first year since 1969 that cash returns have been positive, while returns for stocks, bonds, and commodities have been negative.

Remarkably, since October 5, when the 10 year Treasury bond yielded 3.25%, that yield fell by 50 basis points to 2.75% last week, and the price of the 10-year rose. This is remarkable in

the context of the much greater supply of Treasuries being sold by the government to fund the huge budget deficit. In normal circumstances, greater federal government borrowing would raise rates, not lower them so sharply. The only explanation is that demand for credit by private companies is falling sharply. This is strong evidence that the economy is slowing--and gives a bit of a lie to Mr. Powell's rosy scenario.

Trump Unbound. In the first year of Mr. Trump's administration, his actions were seen as supportive of the markets, including the tax cuts of last December and the cutting of federal regulations affecting banks and big industrial companies. Although the former may well increase the risks of another financial crisis and although the latter damage our environment and our health, they both, especially with the sharp cuts in corporate taxes, have boosted corporate profits. Mr. Trump's wrecking-ball instincts were, to a degree, contained by a handful of his appointees, including Defense Secretary Mattis, Secretary of State Tillerson, National Security Adviser McMaster, and Chief of Staff Kelly. By the end of this month, all four will have resigned or been fired. It has been reported that these 'adults' have sought to restrain Mr. Trump's impulses to tear apart America's seventy-year web of alliances and multilateral institutions like NATO, the World Bank. With the departure of these four voices for maintaining the leading role of the United States in the world, Mr. Trump may feel himself able to act without restraint and to continue to cozy up to autocrats and adversaries, including Putin, Kim Jong-un, and Saudi Prince Salman, and Turkey's president Erdogan.

We leave for yourselves and others consideration of the political consequences of all this, to make the point that Mr. Trump's behavior and his actions have deleterious economic and financial market consequences. The time is long past when Mr. Trump was helping markets or the economy.

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