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

August 30, 2020

New Highs in the S&P 500…
...Mean What?

The S&P 500 has recently set a new all time high. Its valuation is utterly divorced from the weak economic conditions around the world and from depressed profits of the companies that comprise the index.

Core's investments have well exceeded returns from stocks.

Contrary to my expectations, put forth several times in *Core Comments* this year, the stock market, as measured by the S&P 500 index, has recovered fully from its February and March losses and gone on to set new all-time highs. The utter collapse in the economy through the second quarter of this year appears to have mattered little. The epic fall in corporate earnings has caused little consternation. As it happens, the four titanic tech companies, Apple, Amazon, Microsoft and Google (properly known as Alphabet), have benefitted enormously from the work-from-home and shop-from-home life that the Coronavirus brought. Each of these companies has a capitalization of more than one trillion dollars--Apple just reached two trillion--and a disproportionate amount of the S&P's gain is a result of the growth of these four.

The S&P 500 is a capitalization-weighted index, meaning that the value of the S&P is determined by the capitalization--the product of a company's total shares outstanding times the price of each share--of its components. Thus, the biggest companies count the most. Other stock indices are constructed differently or comprised differently. These others tell a different story: whereas the S&P 500 has exceeded its previous, pre-Coronavirus February high by about 3%, the so-called 'equal-weighted S&P 500,' by which all companies, big and small, have the same weight, is down by 5% from that February high. The Russell 2000, the best-known index of small US companies, is down by about 7% from that high.

Where do stocks go from here after the enormous advance from the late March lows? Impossible to say. But, by any number of analyses, tech stocks and the market as a whole are more overvalued now than at the peak before the dot.com bubble burst in 2000. We will continue to look elsewhere to invest the capital we oversee.

The investments we hold have served us very well for the last year and more. Whereas the S&P is up by 8.6% this year, Core's accounts in the aggregate have gained 18.5% net of fees paid to Core and have avoided the wild rides down and up. (Variation in returns exists among different accounts.) Recently, I have made a couple of changes in our investments: I have reduced our positions in our very profitable investment in long-term US Treasury bonds by a quarter. (Recall that in March, I first made a reduction in this large investment.) I have become more doubtful that the yield on long Treasuries will fall further and that prices will rise further. (Prices and yields on bonds move inversely.) Prices and yields have been largely stagnant since late March; it is a precaution to reduce this still large position against the possibility of adverse price moves.

By

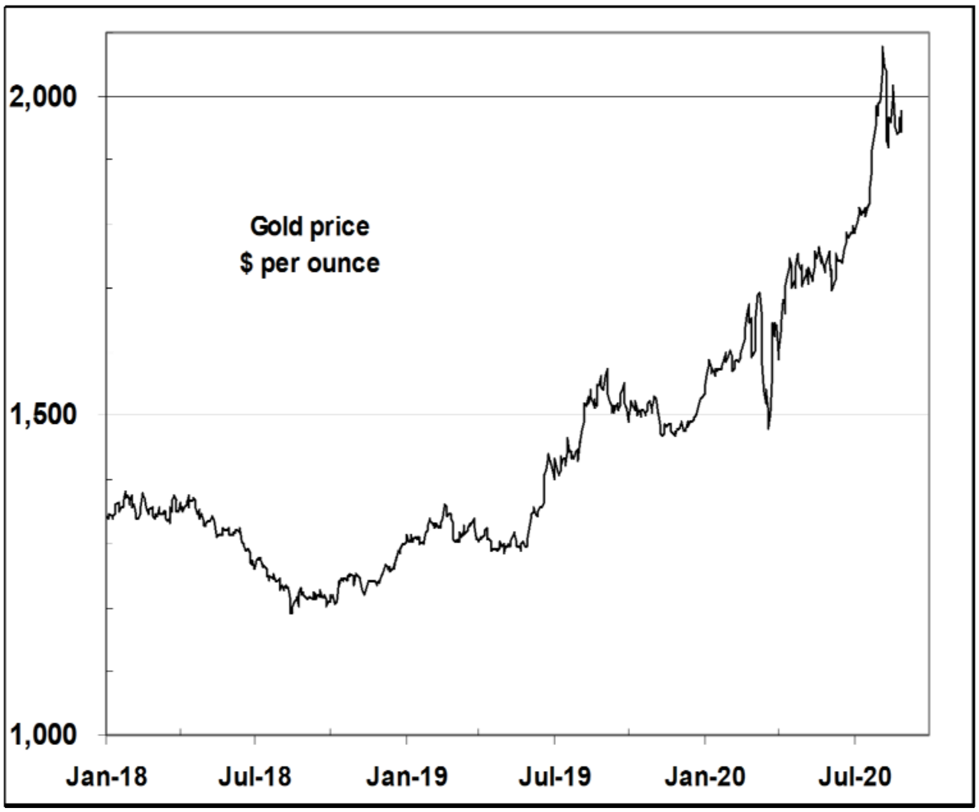
Jack Mayberry

The Coronavirus has caused a collapse in demand and a concomitant slowing of the economy. Tax revenues have fallen while spending by the federal government to support people and businesses has soared.

The United States has become increasingly indebted. One result has been an increase in gold's price.

Our other large investment in the last year and more has been gold, the price of which has continued to move higher. In early August, gold set a new all-time high at more than $2000 per ounce. (The nearby chart shows its gains since the beginning of 2018.) My assessment is that gold prices move higher from here. Hence, with some of the proceeds of the sale of long-term Treasuries, I purchased a position for us in a large gold mining company, Barrick Gold Corporation. Its cost of production of the gold it mines is about $1100 per ounce; as gold prices rise, its profits rise faster.

There are two important reasons to expect higher gold prices: The first is that the response by the world's rich countries to the pandemic has been to increase government spending to support unemployed and underemployed workers and to help businesses at risk of failure from the collapse in demand. This response--and there is probably more to come--has increased government borrowing significantly and has weakened the fiscal position of these governments. Apart from the 2017 tax cut, tax revenues in America have fallen again this year while spending has increased. Because currencies--the US dollar and the others--are all calls on the financial strength of their governments, weakening fiscal positions undercut the value of their currencies. Gold is no country's liability; its gains partly reflect weaknesses of currencies.



If you give a farmer a dollar bill to buy a bunch of carrots, you get a bunch of carrots and the farmer gets a promise from the United States. From a logical point of view, that promise becomes less secure as the United States becomes more indebted. Unlike the explosion of US federal indebtedness, there is no discernable increase in the amount of gold being mined.

The second reason to expect higher gold prices has to do with the carrying cost of gold. Gold pays neither interest nor dividends, while it imposes storage costs upon it owner. By contrast, bonds and money market funds (usually) pay interest. One has to pay to own gold, but one (usually) receives payments as an owner of bonds. These days, however, some $15 trillion of bonds have a negative yield: one has to pay Germany for the privilege of lending money to it. Although the United States does not have negative yields now and probably will not in the foreseeable future, US money market funds pay essentially nothing. The Fed promises to keep short-term rates at or near zero for at least a few years to come. In these market conditions, gold's modest carrying costs do not loom too large. Gold prices are going higher; gold mining stock prices are going higher.

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CORE ASSET MANAGEMENT

PO Box 1629
108 Caledonia Street
Sausalito, California 94966
(415) 332-2000 • (800) 451-2240
fax (415) 332-2151
www.coreasset.com
info@coreasset.com