

CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

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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.

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.

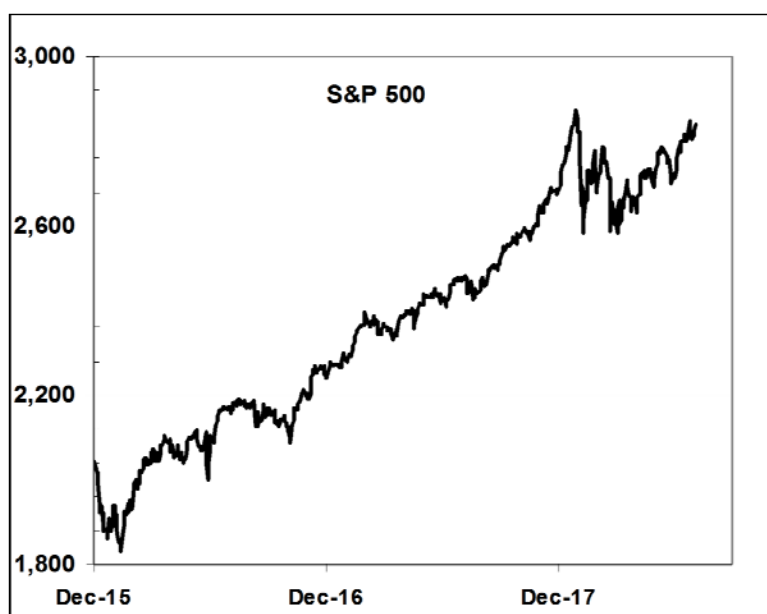
Reasons for caution. That's the good news. Against this backdrop, I have become more cautious about prospects for further stock market gains. Core has reduced equity positions in client portfolios because of what I take to be increasing risks. Here are some troublesome ones: Oil prices and short-term 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-

By

Jack Mayberry

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 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.



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.

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 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.

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