

CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

October 27, 2018

Wheels Falling Off

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.

By

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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 (unnecessary) fiscal stimulus late in the economic cycle. The result is a rapidly rising federal budget deficit.

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.

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.

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.

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 accommodative 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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