CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

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A Placid Year Passes the Halfway Mark

Modest but constructive progress continues in the markets. Despite our volatile and disruptive president, alarming and dangerous actions of North Korea, and the confounding inability of the Congress to make legislative progress, the US stock market has moved forward in an undisturbed way. This week, it reached new highs again. And in Europe and Japan, where Core has significant stock investments for clients, stock markets have been also been strong, indeed, stronger than the US market. In the US, corporate profits grow at a decent pace, while the economy moves forward at an unexciting but steady rate. Similarly favorable conditions obtain in Europe and Japan.

Stock markets in the US, in Europe and in Japan have grown steadily this year. Political disturbances and the absence of promised, pro-growth policies from the Trump administration and the Republican Congress have not disturbed financial markets.

The dollar and the euro. To us, the surprise this year has been the weakness of the dollar against both the euro and the yen. The US dollar continued to strengthen in second half of last year, largely because the Federal Reserve was beginning (ever so gradually) to raise short-term interest rates while the European Central Bank (ECB) and the Bank of Japan (BoJ) were engaged in massive programs of quantitative easing (QE) and seemingly a very long time away from any tightening of monetary policy. This quite reasonably and directly caused US interest rates (low though they be in historical terms) to rise a bit and almost to assure that US rates would be meaningfully higher than those in Japan and Europe for a long time to come. Higher rates in the US attract capital to dollar securities and draw capital from the low-interest rate regions of Europe and Japan. Thus the dollar appreciates in value against those currencies.

The US dollar has fallen, particularly against the euro. Subdued inflation trends in the US have caused many to expect that the tighter monetary policy by the Fed will be slower than the Fed suggests.

Without too much conviction, we think the Fed will keep to its course and the dollar will strengthen again.

Not so this year. The euro fell to $1.04 late in 2016--a huge decline from the $1.40 to $1.60 range that prevailed a few years ago. But this year, the euro has strengthened to $1.16. The view seems to be that with sustainable economic growth across the Europe, the ECB will in a short time begin its own normalization of monetary policy, raising short-term rates and slowing its bond-buying program. To my mind, the strength of the euro is unlikely to last. Despite low inflation in the US, the Federal Reserve will likely continue its gentle rate-raising process and will probably begin to reduce its huge mountain of securities purchased in its own quantitative easing exercise. In my view, it will be quite a long time before the ECB begins monetary tightening. Hence, US interest rates on short- and on long-term securities will rise while European rates remain vanishingly low. The result will be a stronger dollar and a weaker Euro.

By

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America First. This was the slogan Mr. Trump used successfully in his campaign; his policies since taking office are often framed with that term. It is puzzling, to put it mildly, to consider the isolation of Mr. Trump in the recent G20 meetings in Hamburg and to wonder how his policies and conduct advance the America First project. Mr. Trump has withdrawn the United States from leadership of the world, leadership nurtured by all presidents of both parties since the end of the Second World War. He sunders the broad and deep web of alliances that America has developed and nurtured over decades and diminishes the standing of the country with his impetuous behavior and malign rants against women and the press.

While campaigning, Mr. Trump breezily promised that his administration would undertake policies that would raise America's economic growth rate (GDP) to 4%. For a long number of years, America's GDP has been well below that; since the Great Recession ended, it has been about 2%. Economists rolled their eyes with Trump's 4% prediction. In his budget outline and projections for the next ten years, his Treasury Department predicts 3% growth, by which America's federal deficit would be reduced to zero. The bipartisan Congressional budget office, duty bound to analyze it, predicts the deficit will stabilize at about $700 billion per year, whereas it has been $450 billion in the last twelve months, remarking that, because details about possible policies are unavailable, it cannot analyze "their macroeconomic effects or the budgetary feedback that would result from those effects."

Trump administrations projections of more rapid economic growth seem more like political puffery that reality-based economic modeling.

As discussed in previous letters, the hoped for policy changes--tax 'reform' and infrastructure spending, among others--have languished in the chaotic beginning months of the administration, marked by its unwelcome and unsuccessful efforts to 'repeal and replace Obamacare.' Thus, stimulus to growth is on hold while the administration considers (and threatens) policies that will likely cause growth to slow. Consider the economy-slowing effects of imposing tariffs on steel; consider the effects of Mr. Trump's wall and renegotiation of NAFTA, the North American Free Trade Agreement.

Monetary policies of the major central banks have provided a very good deal of support for bonds and stocks. In the coming years, there is every possibility that central banks will tighten monetary policies. Tighter policies will be headwinds for the markets.

Central Bank Assets. Since 2009, the Federal Reserve and the other major central banks have engaged in unprecedented monetary policies, including QE by which the central banks buy enormous quantities of bonds. There is serious disagreement about the extent to which QE has supported the real economy. We need not address that matter here. What is beyond dispute is that QE has had an enormously positive effect on the market for bonds and for stocks around the world. Bond prices and stock prices have reached historic highs in developed countries. The S&P 500 has appreciated by 57% from its highs in October 2007 before the financial crisis and by 272% from its lows in 2009 in the depths of that calamity.

This is well and good. But what happens in the years ahead as the central banks try to 'normalize' their monetary policies by raising short-term interest rates (as the Fed has already begun) and by reducing the assets on their balance sheets. In total, the four principal central banks, the Fed, the ECB, the BoJ, and the Bank of England, hold some $14 trillion of assets, up from about $4 trillion in 2007, before the crisis. For the Fed, the numbers are $800 billion in 2007 to $4.5 trillion now. The Fed has begun to write and speak about how it intends--slowly and gently--to reduce its balance sheet.

Tightening of central bank monetary policies, already underway by the Fed with its four increases in the fed funds rate, is very consequential. Abrupt changes can certainly be expected to cause turbulence; we saw this in May 2013 when then Fed Chair Ben Bernanke first discussed reducing ('tapering') the rate at which it would continue to buy government securities. The 'taper tantrum,' as it came to be called, caused a sharp bout of selling in bonds. Tighter monetary policy is still some way off in time and its consequences do not loom before us now. In time, though--perhaps in a year or two--we can expect central banks to begin the reversal of the ultra-loose, ultra-accommodative monetary policies that have characterized the post financial-crisis era. A new world will then be upon us.

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