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

February 1, 2020

Priced for Perfection...
...in an Imperfect World

The sudden emergence of Coronavirus is very disruptive to China's economy. Long-term consequences are impossible to assess at this time.

The investment response so far has been to sell stocks and flock to 'safe-haven' investments like Treasury bonds and gold. This response is entirely rational and very beneficial to Core's portfolios.

By

Jack Mayberry

In the last several days, the ever-spreading Coronavirus dominates the news and the activity in financial markets. In the news, we learn of its day-to-day increasing infections and deaths. We learn of the attempts to contain it and to find the means to cure its victims or, at least, to slow its spread. Major US airlines have stopped flights into and out of China; other nations acted sooner than the US. We read of the isolation of those who may have been exposed to it. Only epidemiologists have anything useful to say on these matters and one reads that some of them declare that it is too early to make meaningful predictions.

Despite not really knowing what may happen next with all this, economists and investment firms have begun to estimate the likely effects on global and US economic activity. The isolation of large cities in China, the cancellation of travel to and from China is certain to restrain China's economic activity; this just after we learn that China's economic growth was slower in the year just ended than in any year in the last twenty-nine. Goldman Sachs, the American investment bank, on Friday projected that the effect on the US economy would be to decrease (already weak) economic growth by 0.4 percent in the first quarter of this new year.

The reaction in financial markets has been utterly reasonable. Stocks have fallen fairly sharply while the safe-haven assets like US Treasury bonds, gold, the Japanese yen and the Swiss franc, have all risen markedly. As we have written in previous letters, Core's investments for its clients have been limited to bonds (mostly long-term US Treasuries), gold and money market funds. We have avoided stock investments on the notion that prices for stocks were too high when measured by the risk they present. Thus, as things have unfolded recently, the accounts of Core's clients have appreciated: long-term US Treasuries, our largest investment, have gained some 7.7% this month, while gold has appreciated by 4.5% and achieved its highest price since 2013.

Priced for perfection. The stock market rose by a more than 25% in 2019 and, until news of the Coronavirus emerged, it had risen by another 3% in the first weeks of January. As discussed in previous letters, the rather remarkable rally has taken place while corporate profits have fallen in each of the four quarters of 2019. And, as also discussed, the price appreciation has gone on while the US economy has been weakening.

The rally in the last quarter of 2019 was powered by the Federal Reserve, which had cut Fed funds rates three times in 2019 and, more importantly, had commenced, in early October, another huge round of buying securities. This was undertaken, as we are told, to put right the repo market, by which banks lend to

Stock markets, particularly in the United States, have been priced for perfection.

Unfortunately, the world is an imperfect place.

each other overnight. Buying of Treasury bills has exceeded $300 billion so far and continues at the rate of $60 billion per month. The Fed is at pains to say that this is not a further round of Quantitative Easing--the securities buying that it and other major central banks undertook in the aftermath of the financial crisis. However, the flood of new money into the system, at a time when private credit demand from companies and households is weak, finds it way into asset markets.

Whether the rally in stocks was induced by the Fed or not, the effect has been to increase valuations to remarkably high--one might say dangerous--levels. The ratio of stock prices to underlying corporate earnings--the price to earnings ratio--has risen markedly. Ditto the ratio of price to corporate net assets--the price to book value ratio. Such measures have approached those that occurred just prior to the bursting of the so-called dot.com bubble in 2000 and 2001. Given that there is no obvious likelihood that economic activity in the US and in other developed countries will rise from today's somnambulant levels, it is hard to justify such high valuations.

Thus, one can say that the stock market has been priced for perfection. The disturbances early in January when the US assassinated Iran's General Soleimani gave a brief foretaste of how stock markets could be disturbed by external events. The Coronavirus matter is showing us in a more pronounced way how our imperfect world can throw up obstacles to a stock market priced for perfection.

What about highly priced bonds and gold? May similar points be made in arguing that Treasury bonds and gold, having themselves appreciated so much, are priced for perfection? Of course, and one can read these arguments every day. The difference is that the increase in Treasury bond prices (and the concomitant decrease in their yields) is grounded in economic realities. These include slowing economic growth, persistently low inflation with increasing deflationary pressure, and the excess of savings over the demand for credit. As for gold, how can one measure its value? The decline in interest rates on sovereign debt in these recent years means much. Gold pays no interest and costs money to store safely. The carrying costs and absence of interest payments become less significant when we note that the ten-year German *bund*, the safest security issued in Europe, offers a yield today of -0.438%. In August of 2019, more than $15 trillion bonds traded with a negative yield. We are approaching that level again in this new year.

If one wants security, that is, a safe investment that will assure you of the return <u>of</u> your capital, you may look to German *bunds*. But, if you buy them, you are assured to lose money because of the negative yield. In this world, the carrying costs of gold do not loom terribly large. As prickly situations arise, *e.g.*, a nasty, rapidly spreading virus; a belligerent, missile-testing autocrat in North Korea; or an angry developing nuclear power in Tehran, gold and long-term US Treasury bonds look quite appealing.

At present the world dicey enough to incline me to invest for safety and to realize the gains that will continue to arise in Treasures. The slowing economy and the world of excess savings is one that enhances the value of long-term US Treasuries. Declining corporate profits present a situation too parlous to dump money in the 'priced-for-perfection' US stock market. When the stock market does, in time, return to more attractive levels, Core will be buyer of stocks for its clients. The time may come soon or it may come late, but it will come. The economic cycle has not been repealed and stock valuations--as with many things--do revert to the mean. Let us be patient and sell our Treasuries when they become too expensive. Let us buy stocks when they become attractive in price.

CORE Comments

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