

CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

October 3, 2019

Slowly, Inexorably Toward Recession

In the financial markets, the recent action has, in large part, been a continuation of the way things have been unfolding for months. There will come--as always happens--sharp changes. Before considering what lies ahead, a brief account of what has been happening: In the bond market, the recent high in yield and low in price of the world's benchmark bond, the ten-year US Treasury bond, was reached on October 5, 2018, when the yield on the ten-year reached 3.248%. From there, the yield has fallen, with some modest interruptions, to reach 1.536% as of October 3, 2019. Because yields and prices move inversely, the price of the ten-year Treasury has appreciated markedly over this last year.

Meanwhile, the stock market declined very sharply--by 20%—in the fourth quarter of 2018, then rallied strongly from its Christmas Eve low through the first four months of this year, essentially recovering the losses from the end of 2018 sell off. Since the spring, the US stock market, as measured by the S&P 500 index, as made a few tiny new highs, although, as I write, the S&P has essentially achieved only very modest gains in the last twelve months, about 2% including dividends, while long-term US Treasuries have gained more than 25% with interest payments in the same period. The chart on the next page illustrates this.

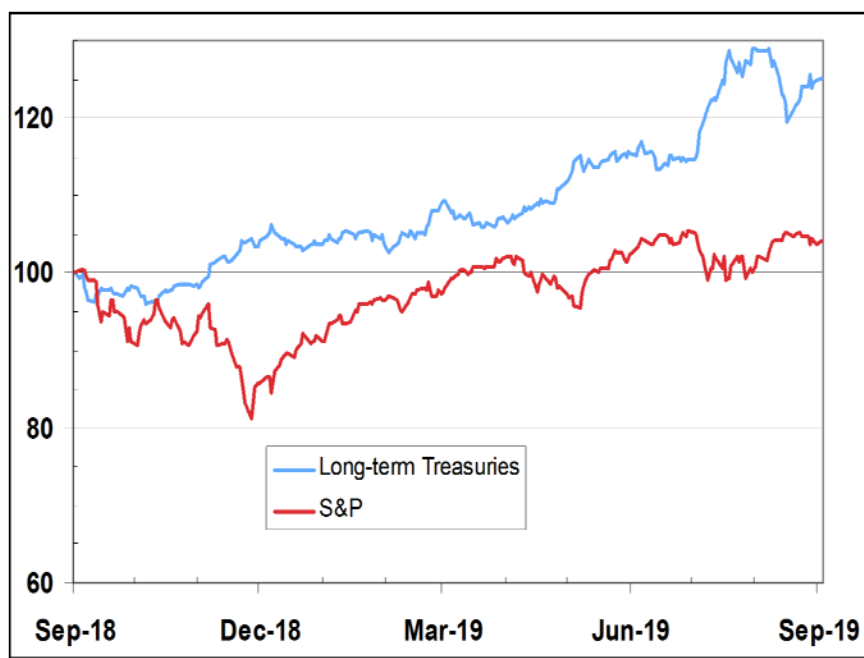
What does this mean? During the first quarter of 2019, while the S&P rose by 13%, corporate earnings of the S&P fell. In the second quarter, the S&P rose a bit more, but, once again, corporate profits fell. In the third quarter, just ended, profits fell once again, but the S&P made nominal new highs in price. What gives? It is likely that stock investors expected—quite rightly, as it turns out—that the Federal Reserve and other major central banks would, once again, loosen monetary policy for the benefit of the economy and for the benefit of investors. The Fed has indeed loosened monetary policy, but only after having over-tightened policy in 2018. The Fed's actions are well known and long recognized to operate with considerable time lags. Thus, the overly tight policies of 2018 have still not shown their full negative effects on the economy. The effects of the only-recently begun monetary easing will not be realized for many, many months. Until then, conditions will weaken.

By

Jack Mayberry

Corporate profits have fallen, in part, because the US and the rest of the global economy has been weakening throughout this year. Although we have probably not begun an economic recession in America, we are likely near the cusp of one. The bond market in a clear and straightforward way bears this out. Bond yields fall and bond prices rise because there are more savings looking for investment than there is demand for credit. Supply of money exceeds demand for credit. This suggests that economies are weakening; this weakening is borne

The chart below shows the returns in the US stock market as measured by the S&P 500 index with dividends reinvested and compares that to the returns from the long-term Treasury bond fund, including interest payments, in which we invest. Both are rebased to 100 as of September 30, 2018, to make the comparison easy to see. The chart goes to September 30, 2019, and leaves off the first three days of this month in which US stocks fell sharply while Treasuries continued to rise in price.



out in the economic statistics published on an ongoing basis. The major central banks all have taken steps recently to loosen monetary policy. Central bankers read the economic reports; they are acting to ameliorate this weakness.

A problem facing central bankers is that their traditional tool to stimulate the economy—the lowering of interest rates—has uncertain effect in this era when interest rates are historically low and, in many cases, negative. The United States and Britain are the only major developed economies in which government bonds have a positive yield and their yields can hardly be deemed robust. It is questionable whether still lower interest rates will cause economies to emerge from the doldrums. We shall see.

What lies ahead? This is trickier: it is one thing to describe the past and quite another to forecast the future. But, here goes: My view is that economic weakening will continue; economies are not poised to expand sharply. As noted above, corporate profits have been weakening this year. Unsurprisingly, US gross domestic income, that is, corporate and personal income, has been contracting this year. While gross income was falling in the second quarter of 2019, individual spending was increasing. The increased spending has to have been funded by increased borrowing, including more credit card debt. The rate of individual savings declined in that quarter. This is not really sustainable, of course. So, as income declines, it is reasonable to expect less growth in consumer spending. That will be reflected in weaker gross domestic product, declines in employment, and a return to higher rates of saving.

The bond market is anticipating just such an outcome as Treasury bond prices rise. My expectation is that bonds will continue to rise in price and that stock prices will fall. I have been wrong in my predictions in the past--as has everyone else offering financial market predictions. I may be wrong now, as well. But, based on my view, I intend to maintain the large positions Core's clients hold in long-term US treasuries and to maintain a fair amount of cash. If geopolitical events--including the serious disputes between the US and China, Iranian attacks on Saudi oil properties, impeachment events, North Korean nuclear bomb and ballistic missile development and many, many more--should disrupt markets, these disruptions can only add to the uneasiness in markets already reflected by higher price volatility and significantly higher gold prices. (Core has reasonably large and quite profitable gold positions for its clients.) Core continues to avoid stock market investments, given our view the lower stock prices loom.

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We will retain ample positions in money market funds, even though cash yields very little, because of the risk and the ever-larger swings in prices. Indeed, given the sharp increase in bond prices this year, one must recognize that risk in holding long-term Treasuries is higher than a year ago. Caution and alertness are always useful in investing. The more so now than usually.

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