

CORE Comments

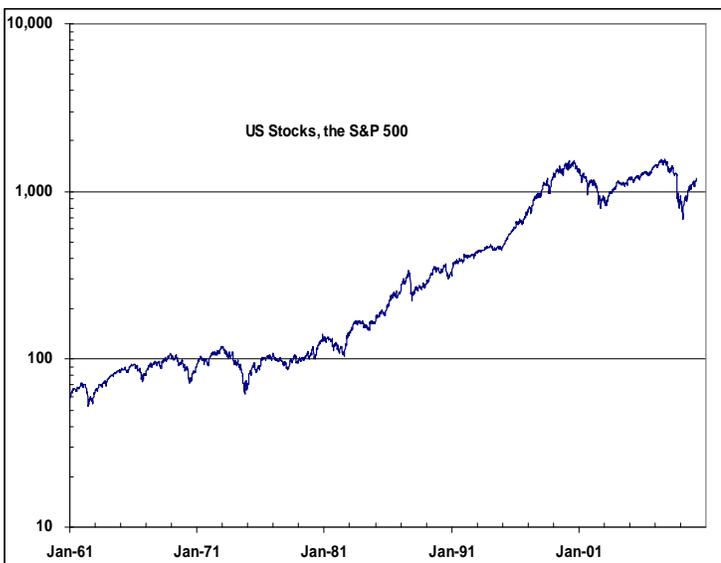
ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

April 7, 2010

Structural Changes and the Cyclical Bull Market

The long-term, logarithmic-scale chart of the S&P 500 shows the 'secular' bull market of the '80s and the '90s. Did a new long-term bear market begin in 2000?

The financial crisis and recession have made lasting changes in the ways that people and companies and governments act, changes that may become manifest over the next decade and more. These changes will have long-lasting effects on investments, requiring Core to adjust its practices to align the capital we manage with the new reality. Without discussing the nature of the changes in a detailed way, I wish to touch on some of the issues and point to changes we have made in our investments. Within the long-period changes, our investments must be consistent with the still-young cyclical bull market that began in March of last year. This letter will attempt to describe the interplay between the long-term and the cyclical forces.



De-leveraging in the private sector. The crisis followed a decades-long process of increasing indebtedness in the world. At least since the early 1980s, the private sector--people and companies--took on more debt, as credit became easier to access and lending standards fell. The final wave of the process involved huge increases in mortgage debt in the United States and many other countries in the developed world, along within the unsustainably large increase in house prices. Much of the world's economic activity since the early 1980s derived from borrowed money. When home prices began to fall in 2007 and mortgage-backed securities lost value, the global financial crisis was on, with the nasty features we remember so well. One immediate consequence was the effort by the private sector to reduce debt, to 'de-leverage'. A good part of the de-leveraging is accomplished by saving more and spending less, which process may go on for years. As companies and individuals clean up their balance sheets and reduce indebtedness, the lower rate of spending may result in

slower rates of economic growth than in years past. In particular this is likely to be the case in the developed economies of Europe, Japan and North America.

By

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As an investment matter, we might expect that the United States will be generating a larger portion of its income from export activities and a smaller portion from consumer spending. Indeed, it is entirely possible that Asian consumers in the rapidly developing economies will be saving somewhat less and spending more, providing a counterbalance to the reduced spending and increased saving in America.

As the consumer sector of the United States becomes proportionally smaller than before, and

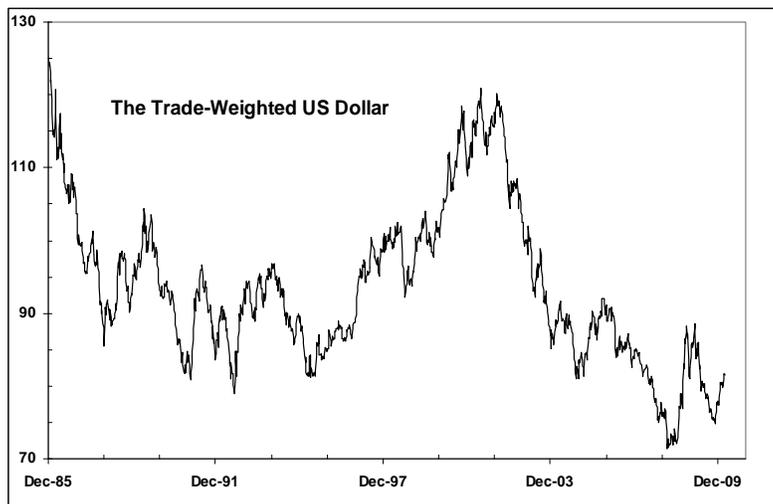
The crisis with the Greece and the euro marked the beginning of an upturn in the value of the dollar against its major trading partners.

For the sake of US exports, US policy makers would prefer an 'orderly' decline in the dollar's value. At present, China and the United States are expending a good deal of diplomatic energy around questions of the exchange rate between the dollar and the renminbi. The United States (and most other countries) want China to allow its currency to appreciate.

the export sector somewhat larger, the investment focus shifts toward those sectors in which productivity gains are greater. US economic growth will increasingly depend upon higher productivity. For a number of years, the productivity of the US labor force (the quantity of goods and services produced per unit of labor) has grown at a much faster pace than in Japan and Europe. This is the most reliable source of growth for the United States.

To the extent Americans increase their savings, so will grow the demand for high-grade fixed-income investments. We may expect this to favor high-grade bonds and the stocks of financially strong companies with relatively high and growing dividends.

Increased debt in the public sector. As economies contracted very severely in the second half of 2008 and the early part of 2009, and the world tottered at the brink of financial and banking system collapse, the public sector--governments and central banks--stepped forward to preserve the banking system and to forestall depression. Governments vastly increased their levels of spending for unemployed workers and in projects to stimulate economic activity. The increased spending took place against the backdrop of collapsing tax revenues, so that public deficits soared. Meanwhile central banks and the public treasuries took on a huge range of housing and banking-related assets, to support the collapsing financial system. Thus, as the private sector has been de-leveraging and reducing debt, the public sector has increased its debt and its deficit spending. It is almost certainly the case that, if governments had been unwilling to increase deficit spending and to take on dodgy mortgage-related assets, the global recession would have been far worse, and the human suffering from the financial crisis and recession would have been much, much greater than it has been.



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However useful and however well-intentioned has been the public sector response to the crisis, the world now finds itself in the situation in which some governments have far exceeded the amount of spending and borrowing their economies can support. Greece is one of these; we addressed its slowly unfolding and somewhat insuperable problems in our last letter. Some other countries do not face a crisis now, even those with very high deficit spending. The United States is one of these. However, problems for America and others lie ahead, because future payments which the country has promised to make may well exceed its funding capacity. The analysis involves consideration of a country's present outstanding debt, the so-called 'structural deficit' (including the projected costs that arise from unfunded future obligations), economic growth rates, and demographic balance. A favorable demographic balance is one with lots of young working people and not too many old, retired folks. The United States has had a far better demographic balance than Western European countries and Japan, in significant part because of fairly open immigration policies that encourage young, ambitious, hardworking people to come to the United States. To the extent the somewhat ugly anti-immigration politics of the last decade and more slows the flow of immigrants, our demographic balance worsens and the future for our public finances looks somewhat bleaker.

These public finance issues raise questions about capital preservation. Long-term US treasury bonds appear less attractive, although short-term US debt seems as secure and safe as ever. The United

Sentiment against 'globalization' and the process of re-regulation, particularly in the banking sector, may be impediments to stock markets now and in the years to come.

Kingdom faces problems at least as bad as those of the United States, but it benefits from a very long average maturity (about 11 years) of its public debt, as against less than 5 years for the United States. Thus, the UK has a bit less debt to roll over than does the US. Germany and the Netherlands are in a stronger position, making their long-term debt more attractive than US debt.

Several of the developing Asian countries have a strong public finance position, favorable demographics, high economic growth rates and large current account surpluses. In broad terms, the bonds of a number of these countries are very attractive investments. We have positions in these now, and expect to build them further.

Anti-globalization. In recent years, 'globalization' has been ascendant. This broad and somewhat vague term comprises different features, including the relatively free flow of capital around the world, the adoption of market economies in the developing world, the development of securities markets in countries of any economic significance, the general support for liberal economic policies and relatively free trade in goods and services. Many of these features are now a settled part of the landscape, but there are counter forces now to globalization. The sudden and sharp collapse in global trade at the end of 2008 is now being reversed, but trade and currency disputes threaten protectionism. New government intervention in previously un-regulated private activity runs counter to the free movement of goods, services and capital across national borders. At the very least, globalization is no longer viewed (if it ever was) as a panacea to the world's economic ills.

One aspect of globalization has been the growth in stock and bond markets in the developing world. This has occurred to such an extent that some of these markets have become quite expensive, requiring more selectivity in our investing in these markets. And if, just to give one example, the ongoing currency quarrel between the United States and China does not find a reasonable, face-saving resolution, new tariffs and other impediments to trade may well develop. Similarly, the anger--well founded or not--toward bankers and hedge funds for the various aspects of the financial crisis may foster ill-conceived policies that worsen economies and investment markets.

The very long term chart of the US stock market on the front page of this letter shows the two-decades long stagnation in the US stock market in the '60s and '70s, followed by the secular bull market of the '80s and '90s. We are clearly in at least a small-scale cyclical bull market now after the crushing bear market of 2008 and the beginning of 2009, but probably not within the context of the long-term 'secular' bull market.

Re-regulation. Finally, because governments and central banks had to intervene in 2008 and 2009 to prevent the collapse of the banking system and to mitigate the effects of the terrible recession, there is a quite reasonable effort now to reshape the regulatory framework to prevent recurrence of the same problems. The question now is whether re-regulation will have a good effect on the system; the question is not whether there will be new regulatory schemes. This latter question is settled.

Our investment decisions must be made against the new and significant structural issues of less private debt, more public debt, less globalization, and more regulation. The investment implications of these 'structural' changes in the world are many and varied, they will unfold over the next decade and longer.

The Secular and the Cyclical. The issues discussed above relate to long-term changes. In the investment business, it is commonplace to analyze long-term developments, perhaps stretching over decades, and to refer to these as the 'secular' conditions. After the mid-1970s bear market, the oil price shocks of the 1970s, and the terribly high inflation and interest rates of that era, a 'secular' bull market began as Paul Volcker took charge of the Federal Reserve and unleashed his successful effort to bring inflation down. Bonds and stocks rallied enormously for years throughout the '80s and the '90s. The 'secular' bull market in stocks appears to

have ended with the bursting of the tech and dot.com bubble in 2000. Bonds continued to rally in price (and bond yields fell) through the first decade of this century. The ‘secular’ backdrop has changed and the quite miserable stock market returns of the last ten years probably mark the beginning of a ‘secular’ bear market.

A shorter perspective is that provided by the investment cycle. In this ‘cyclical’ dimension measuring a few years or so, we would identify the dot.com bear market from 2000 to 2003 as the downward part of a cycle. A cyclical bull market began in 2003 and ended at the market’s top in the autumn of 2007. Then unfolded the recent and devastating cyclical bear market, which reached its bottom in March 2009. At that point began the new ‘cyclical’ bull market. Regardless of long-term ‘structural’ headwinds, regardless of whether or not we are in a ‘secular’ bear market, the financial markets are clearly rising. (Within a ‘secular’ bull market, there are cyclical bear markets: recall the market crash in 1987. Similarly, a ‘secular’ bear market will certainly include ‘cyclical’ bull markets, like that from 2003 to 2007.) It is impossible to say when this cyclical bull market will come to an end, but, given the economic recovery (which looks increasingly robust and sustainable in the United States), given the recapitalization of the banking sector, given the enormous support by the Fed and the US Treasury for the economy as whole, it is likely that this cyclical bull market will persist for another year or two or more.

The interplay between the very long-term influences, at least some of which are negative, and the cyclical forces of the bull market that began last March, lead us to invest in high-quality bonds, some foreign currencies, and a narrower group of developing country equities. We are looking for an opportunity--i.e., lower prices--to make new investments in equities.

The interplay between the long-term ‘structural’ problems that shape this ‘secular’ bear market with the unfolding ‘cyclical’ bull market is tricky. Important forces discourage investment in stocks and commodities and the like, while the Fed’s monetary policy, the ongoing support of the federal government for the economy, and growing industrial activity push higher the prices of assets that benefit from deflation, recovery, and economic expansion.

Core’s approach is to recognize the structural and secular obstacles and allocate a large portion of clients’ capital to high-grade bond investments, including US corporate bonds and short- and medium term bonds in developing economies. We think that the Fed and the Treasury will continue to seek a slow *depreciation* of the value of the dollar, especially against the Chinese renminbi. (News today suggests that a deal with China may be at hand.) We recognize, as discussed in our last letter, the almost insoluble problems with the euro, hence we focus our currency investments in emerging markets, and in the Canadian and Australian dollars.

We have a small position in commodities, including in gold, the former as a deflation and a dollar depreciation investment, the latter as a counter to the global trend to debase paper currencies. We have narrowed our emerging market equity investments to Hong Kong, Taiwan, Indonesia and Brazil. Our American equity investments are in the large technology companies, regulated utilities, and the oil industry. (Other sectors appeal to us now, but, after several weeks of a stock market rally, we prefer to wait for lower prices.) Even after this full year of exceptional gains in stocks, we expect stock prices to move higher in the next two years, but at a more subdued pace. After these several weeks of modestly higher stock prices, we await at least a bit of selling and more attractive prices, before we commit more capital to risk assets. The ‘cyclical’ forces are positive, but the long-term ‘structural’ and ‘secular’ forces impel caution and restraint.

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