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

April 11, 2014

Beyond Revanchism

There is nothing to excuse or to justify Russia's invasion and seizure of Crimea from Ukraine. Crimea had, indeed, been part of the Russian Soviet Federative Socialist Republic of the Soviet Union until 1954, when Nikita Khrushchev turned it over to the Ukrainian Soviet Socialist Republic. And, of course, Kiev was a major Russian city since at least the seventeenth century and was ruled by Russia's Tsars prior to the Soviet period. Only Petersburg and Moscow were more important cities in Russia. In 1991, when the Soviet Union collapsed, Ukraine became an independent state. Kiev was and is its capital.

In the last few days, we again read reports of masked soldiers without insignia in various cities of eastern Ukraine and of seizures by these forces of government buildings. Russian troops are massed at the border of eastern Ukraine, but it is quite clear that the Russian invasion of Ukraine is well underway even as these troops remain on the Russian side of the border. The fledgling government of Ukraine is scarcely able to oppose the Russian invasion, nor is it able to assert control of these parts of Ukraine overrun by Russia. It seems quite likely that the Russia's covert invasion will destabilize Ukraine and prevent or utterly screw up the presidential election scheduled for next month.

The United States and the western European countries have foresworn military action against Russia. This probably emboldens Vladimir Putin and leads him to think he is free to carry out his covert invasion. An initial set of sanctions against Russia has been put in place by the United States. President Obama has promised increased sanctions should Russia continue. Despite the very alarming news in the last few days, nothing further has been announced by the United States. Russia is now demanding immediate payment for natural gas to Ukraine, demanding higher prices for its deliveries, and threatening to cut its deliveries to Ukraine. As mentioned in my last letter, Germany and other western European countries import large amounts of natural gas from Russia, which gas flows through pipelines that pass through Ukraine.

These natural gas threats are tactics that Russia has employed more than once in recent years; they point to Russia's strength in the contest--but also to its weakness. Russia's economy is overwhelmingly dependent upon oil and natural gas; the theft of those resources by Vladimir Putin and his cronies, the 'oligarchs,' is what has enriched them to such a degree. However, the cost of production of Russia's oil and gas is quite high. If world oil prices were only 10 percent lower and if Europe could import natural gas from the United States, Russia's income would be cut enormously and its political power, deriving from its natural gas exports to Ukraine and the west, would evaporate. The United States could release oil from its huge Strategic Petroleum Reserve,

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which, at the end of 2013 held 695 million barrels of crude oil. Even the announcement of a substantial release would caused a sharp drop in global prices for oil. America could also export huge amounts of natural gas to Western Europe to replace the Russian gas (and Russian leverage over Germany and other countries). Moreover, banking and financial sanctions could become much more harsh than those of the first round.

Putin's Russia is in the active phase of restoration of its control of the former dominions of Tsarist Russia and the Soviet Union. It is entirely appropriate that America recognize that it will not oppose these actions by tanks, bombs and troops. The policy of containment served well during the Cold War; a related strategy is now needed to put a stop to Putin. This will necessarily be a long game and Putin's willingness to disregard norms of state behavior will likely give him short-term advantages. But let John Kerry and Barack Obama speak clearly about what is going on: Russia has invaded Ukraine. Suggesting that, so long as Russia's troops stay within Russian territory, Russia has not 'invaded' Ukraine is disingenuous. America knows this: America goes to war fairly often. For example, in Iraq and Afghanistan, the sending in of troops followed a period covert action by special forces. To a degree, Russia is following America's play book.

The Economy and Markets. So far this year, a cold winter in much of America restrained economic activity to a degree, but has not upset the trajectory of modest growth. Last week's employment report for March, was reasonably strong and included upward revisions in the prior estimates of employment in January and February. Various factors, including Russia and slowing growth in developing countries, have disturbed financial markets and increased price swings. The net result since the beginning of the year for stocks and for bonds is essentially nil. It seems likely that corporate profits for the first quarter, just now beginning to be announced, will show very modest growth. Prospects look better for later in this year, because of synchronized improvement in economic growth in most developed countries. Core has maintained its greater weighting to European stocks and only a very small allocation to developing economies.

Russian actions in Ukraine have had so far only transitory effects on financial markets. The sense is that the direct economic consequences of Russia's acts to the United States are very small. The shorter-term consequences are greater in Europe because of its dependence on Russian natural gas and the somewhat greater level of exports to Russia, particularly from Germany and France. Moreover, there appears to be the view that restraint by the West in response to these actions will prevent a huge crisis. Putin's ominous actions may explode into something far worse. The Baltic states are concerned, unsurprisingly. We will attend to these developments closely, while hoping that the United States will use its oil and gas reserves effectively and will tighten the constraints on Russia's participation in the world's financial and banking systems.

Tax Matters. We have had a number of discussions with clients and their accountants about the K-1s issued by KKR Financial and Brookfield Infrastructure Partners. Both sets of K-1s were issued rather late, to the consternation of many. Note that we sold both those positions in 2013, so that this year is the last in which we have to deal with these. Happily, both investments were quite successful from the investment point of view; they proved to be a bit unsuccessful from the tax preparation point of view, particularly because the rules about reporting K-1s changed and became somewhat more complex than previously.

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ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

March 18, 2014

Russia and Crimea

Geopolitics once again presents obstacles for financial markets, markets that for a long spell have looked only at macro-economic issues. While the questions remain about sources of growth in developed economies, in China and in other emerging markets, into the mix come the brazen acts of Vladimir Putin. It is amazing to contemplate a possible military encounter with Russia more than fifty years after the Cuban missile crisis. The rather mild market response to matters in Ukraine suggests the belief that the United States will not confront Russia militarily. Of course, the Russian occupation of Crimea presents far less risk to the United States than the early 1960s installation of Russian nuclear-armed missiles in Cuba. However, Putin's startling invasion of Crimea warns us that he might be willing to undertake further incursions into Ukraine and perhaps into other former Soviet republics. Further steps could certainly offer to the United States a much more serious challenge than is presented now in Crimea. How does one calculate and assess such risks?

As an economic matter, Crimea and Ukraine are utterly insignificant to the United States. Russia is only slightly more important to the US economy. By contrast, the financial sanctions and visa restrictions that the US and Europe might impose upon Russia and the circle of individuals around Putin might be quite hurtful to Russia and those individuals. During the Soviet era, the Soviet Union did not participate in the banking and financials systems of the West. Since that time, however, the very rich Russians and the Russian state are deeply embedded within the global financial system and enormous amounts of assets, including real estate and financial assets, are owned by Russia and its 'oligarchs.' An indication of the scale of these assets was provided late last week in the weekly report the Federal Reserve makes of its holdings. More than $100 billion of 'foreign-owned funds' on deposit in the New York Federal Reserve Bank were withdrawn. Typically there are large weekly <u>inflows</u> of foreign assets to be held by the Fed. It is quite likely that these assets were Russian and removed against the risk that the US would freeze such Russian assets.

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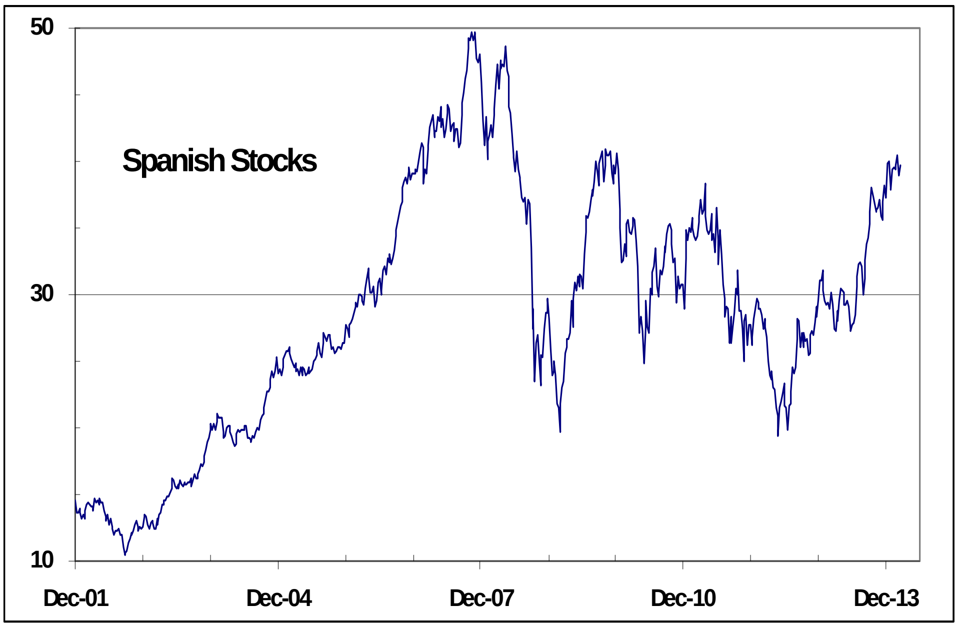
In contrast to the willingness of the United States to sanction Russia for its actions, Europeans are far less keen. Germany's trade with Russia is substantial. Moreover, Germany and other Western European countries depend upon deliveries of Russian natural gas that flows through pipelines crossing Ukraine. Russia has long demonstrated a willingness to turn off the taps to threaten and to enforce discipline. The dependence of Germany and others on Russian gas may speed some changes in the United States, which, since the oil embargoes of the 1970s, has had laws strictly constraining US exports of petroleum products. Within the last few years, the US has become a huge and very low-cost producer of natural gas and an ever larger producer of oil. There is now an excellent geopolitical reason to amend that law and lessen Russia's sway over Europeans. One hopes that the United States and the European Union will be firm and patient with Russia and supportive of the new government in Kiev.

Spain flourished in the early years of the last decade after joining the Euro, with strong immigration from Latin America and a housing boom of startling magnitude. Came the crisis in 2008-09 and its housing market collapsed, its high level of private debt weighed on its people, and a deep recession engulfed it.

Economic growth appears to have continued at a modest pace in the US this year, although the exceptionally severe winter weather in the Midwest and the eastern part of the country has rendered economic reports a little a bit less meaningful. It is quite likely that the cold and the storms restrained some activity and caused greater spending in other sectors, like home heating and electrical power generation. We will have a clearer picture of the state of the economy after winter finally loosens its grip. Meanwhile, after a bit of selling in January, stocks recovered smartly until the Crimean wobbles.



The crisis in the euro hit very hard; unemployment soared to 25%. Spain was nearly strangled by fiscal austerity. Unemployment remains very high and growth is very slow, but the ECB promise kept it from collapse. Now its market recovers.

Europe is more vulnerable to the problems flowing from Russia, as discussed above, and selling connected with this hits Germany harder. External shocks to Europe's economies are less easily absorbed than in the United States. Economic fragility, high unemployment, recession followed by very slow growth and the peril of deflation flow from the handling of the Euro-zone crisis. That crisis and the solution preferred by Germany and the other northern creditor nations--namely cutting wages and government spending in the 'peripheral' countries--puts pressure on prices and wages and tips the weak toward a self-reinforcing spiral of contracting economies, lower prices, high unemployment and low wages. The cushion protecting these countries against a shock from Russia or from China's slowing growth is thin indeed.

The acute phase of the Euro-zone crisis caused recession throughout Europe and significant selling in European stocks. As discussed previously, European Central Bank President Mario Draghi made his famous declaration in the middle of 2012 that the ECB would do 'whatever it takes' to keep the Euro intact. His promise was sufficient and he was not required to take action. From that time, the fear of Europe's collapse ended. Slowly economies began to stabilize, then slowly to grow. But much more rapidly, the deeply depressed European stock markets began to recover. Over the last two years, Core has been building a fairly large position in European stocks and earlier this year, when markets were selling off, we took a position in Spanish companies. Spain is one of the countries hit hardest by the crisis with the Euro. Its economy has begun to recover, as has its stock market.

There is, as always, plenty to worry about in investing and Russia's nastiness is an unwelcome and distasteful intrusion. The Europeans and Americans are cool headed and unlikely to press Russia to something truly drastic. Hence, for now, we are investing in the expectation of continued slow growth and favorable monetary policy from the major central banks.

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ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

February 3, 2014

Tremors in Emerging Markets
Spill over to Developed Countries

After a fine year for stock markets in the United States, Europe and Japan in 2013, markets stumbled in January. In particular, most emerging markets--that is, the stocks, bonds and currencies of developing countries--fell sharply. This turbulence raises fears that crises in emerging markets could cause selling in developed markets, where stock markets rose so briskly last year.

Apart from emerging markets contagion, economies of developed countries face several other risks as 2014 begins:, including the Federal Reserve's beginning in January to cut its rate of asset purchases (the 'taper'), the specter of deflation--falling prices; and stagnant economic growth (arising from weak demand in the private sector (households and companies) and fiscal austerity on the part of governments).

Changes at the Fed. After several years of expansionary and radical monetary policies at the Fed, we are probably in early stages of the process of 'normalizing' monetary policy. As Janet Yellen begins her role as chair of the Fed, the Fed will probably continue to reduce the rate of its asset purchases and, in time, to bring them to an end. Then, should the economy continue modest growth, the Fed will probably start to raise short term interest rates, which for more than five years have been essentially zero. These Fed actions will be consequential. Note that the Fed's aggressive monetary policy commenced in 2008 as the financial crisis began served two principal functions: firstly to prevent the collapse of the financial system, and secondly to stimulate economic recovery by supporting prices of real estate and financial assets. The withdrawal of monetary support may adversely affect financial markets and the real economy.

The risk of deflation is especially acute in Eurozone, where the year-over-year change in consumer prices is alarmingly close to zero (0.8%) and well below the target rate of inflation, defined there as 'close to but below' 2%. Christine Lagarde, the head of the International Monetary Fund (the IMF), has recently begun to warn of the problem, noting that central bankers are wary even of using the term 'deflation' for fear of the self-fulfilling consequences of discussing it. We may expect the European Central Bank to expand its monetary policies if deflation risks rise further. The Eurozone recession has come to an end and modest economic recovery is underway. With the exception Greece, the hard-hit 'peripheral' economies, including Spain and Italy, are growing, although unemployment remains extremely high in those countries, especially for young people.

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Stagnant economies in the developed world seem increasingly to be the rule. The United States is several years into recovery from the Great Recession, but demand is low and wages are not rising despite modest job growth. Because jobs being created are often part-time and ill-paid, economic activity is stuck at a low level, without the vigor that we would expect after such a recession. As we have discussed several times before, Japan is taking forceful steps of co-ordinated monetary and fiscal expansion in a concerted effort to bring an end to the deflationary period stretching back well over a decade and to stimulate economic growth. It is far too early for the Japanese to declare victory, but the actions are likely to provide further support for Japanese stock market.

Spillover effects from Turkey. Because of deflation risks in Europe, the still-unresolved sovereign debt crisis there, and paltry economic growth, the new currency crisis in several emerging markets threatens Europe's economy and its financial markets. Turkey is one of the countries whose currency has declined most sharply. Poor Cyprus and Greece, ravaged in the eurozone crisis and slowly rebuilding in tourism. Turkey's much devalued currency is likely to crush tourism in these countries, which, burdened with the strong euro, can hardly compete against their Eastern Mediterranean neighbor. Emerging market currency crises have created severe problems in developed countries in the past--recall 1998. In this context, the volatility and selling in US, European and Japanese markets in January is unsurprising.

Despite January's declines in stocks--3.6% in the S&P 500, 3.4% in the UK, 1.9% in Europe, and 8.5% in Japan--these markets are likely to appreciate this year, as the underlying economies in these developed markets grow modestly. Stock markets are vulnerable to a bout of selling, not having experienced even a 10% decline since the summer of 2011. We raised some cash in Core's clients' accounts in January by selling a position in French stocks. We expect to wait until this turmoil runs its course, and then to make a further equity investment in one of these developed market countries.

Strength in bonds. Apart from substantial investments in stocks in these markets, we also have meaningful bond investments. For these investments, the deflation risk and sluggish economies are a boon and cause prices to rally. Our US bond investments rose in value in January. The benchmark ten-year US treasury bond yield fell from about 3% to 2.7% as January ended. Further reports of slowing economic activity and declining inflation will drive the bond prices up and yields down. Our bond investments and the cash we hold now provide a cushion as the market attempts to find sound footing again.

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