

CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

April 19, 2015

What will be the outcome of negative interest rates?

Stock markets in Eurozone countries have been flying this year. Bond prices are soaring and their yields are falling, in many cases to negative territory. Even economies in these countries are coming to life in the context of a set of favorable conditions.

Although Japan's economy is far from vibrant, its stock market is reaching heights last seen at the turn of the century. The Quantitative Easing programs in Europe and Japan are a tonic for investment markets, whatever is their effect on real economies.

European stock markets have continued to be strong and it now appears that economies in most of Europe are beginning to improve, as well. As I have written, the enormous asset purchase program by European Central Bank (ECB) has caused the value of the euro to drop in relation to the dollar and has caused asset prices, including stocks and bonds, to rise. At the ECB's recent press conference, its president, Mario Draghi, commented that the asset purchase program is only one kilometer into its marathon. This suggests that the recent trends--falling euro and rising stocks and bonds--will continue.

Growth in the Eurozone countries. Moreover, after several years of wavering between recession and anemic growth, economies of Eurozone countries are improving and might just grow faster in 2015 than the US economy. Four things appear to be helping these countries, First, sharply lower oil prices help consumers and businesses. Second, the decline in the euro's value makes exported goods cheaper in dollar terms. Third, after years of fiscal austerity, government spending is growing a bit. Finally, the pressure to reduce debt is easing and credit is expanding. All this may be temporary, but it is quite welcome; there are positive signs of economic growth throughout the region. This provides a contrast to the American economy, which faltered in the first quarter, presumably as a result of the strikes in California ports and the quite severe winter weather in the Northeast. Given the strength in US stocks markets in 2014 and the weakness in the Eurozone, it is unsurprising that European stocks have raced ahead in 2015, while US stocks have barely budged. Our substantial investments in European stocks have done very well.

Greece and other risks. Several weeks ago, as the new left-wing Greek government was beginning negotiations with the European Union (EU), the International Monetary Fund (IMF) and the ECB to alter the terms of bailouts of Greece by these three entities, there appeared to be a clear path to a new agreement. In the weeks since, positions have hardened, but Greece's funds available to meet its obligations over the next two or three months seem insufficient. A Greek debt default and the possibility of its exit from the Eurozone ('Grexit' is the infelicitous term that denotes it) seem to be distinct possibilities. Although Grexit might be accomplished without too much collateral damage to the European banking system and to other countries in the Eurozone, there is, of course, no precedent for this. The sanguine predictions might prove to be so much wishful thinking. More generally, the various issues that have kept the Eurozone economies weak--including an aging population, an ineffective currency union, and damaging fiscal austerity--are likely to restrain growth in coming years. For now, however, our European investments should prosper.

By

Jack Mayberry

One unforeseen consequence of all the radical monetary projects since the financial crisis is a new era of negative interest rates on many European bonds.

This phenomenon is essentially a new one and distortions it may cause in economies and financial systems are yet unknown.

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Japan, a somewhat similar story. Japan began its massive asset purchase program well before Europe's. Since Japan's quantitative easing (QE) program began, the yen has fallen sharply against the dollar and Japanese stocks have soared in price. However, the deflationary pressures in Japan and its economic contraction have hardly abated. These were the reasons to engage in QE in the first place. Thus, there is a good chance that the asset purchases and other unconventional monetary practices will be increased in coming months. Whatever is the effect on Japan's economy, further appreciation in Japanese stocks is likely.

The worrisome aspect of the ECB's bond purchases. I have written often in these letters how the QE programs of the Federal Reserve (which has come to an end), the Japanese Central Bank and the ECB are so beneficial for the investment markets in which we invest. The ECB's new and huge program may come to reveal how it can damage markets. The ECB is buying €60 billion per month of bonds and plans to continue for an extended period. (A 'marathon,' Mr. Draghi calls it.) The problem is that there are not really enough bonds being issued by Eurozone countries or readily available in the secondary market to support buying of such magnitude. As a result, interest rates for European bonds are plunging (and their prices rising) to hitherto unimaginable levels. The German 10-year government bond, the *bund*, which yielded a very spare 0.5% *per annum* as QE got under way, has seen its price rise and yield fall. On Friday, the yield fell to 0.05% and is moving inexorably to negative territory. The Swiss government recently issued a new ten-year bond at a negative yield. Something more than half of all European government bonds and notes now have negative yields. If one buys a newly-issued bond with a negative yield, one pays the issuer for the privilege of lending. Why would one pay 10,500 Swiss francs to the Swiss government for the promise by Switzerland to repay 10,000 francs in ten years? What are mattresses for anyway?

In the past, there have been occasional, brief, and infrequent episodes of negative interest rates--paying to lend. (These have generally involved Switzerland, always a haven for nervous owners of capital.) There has never been a situation in which hundreds of billions of government bonds and notes have yielded less than nothing. What will be the outcome, particularly as the ECB's marathon buying spree is only beginning? Insurers sell annuities with promises to pay sums certain over a period of years; they sell promises to pay sums upon the deaths of insureds. To honor these promises, insurers need to earn positive returns on the premium income they collect.

Although much is being written about benign or dire effects of negative interest rates, in truth, no one knows how this will play out. Our letters have noted in recent months that volatility (price fluctuation) is becoming more pronounced in various markets. These wide swings in asset prices reflect the risk and the uncertainties created by these bond market developments. We at Core are mindful of risks exemplified by this price volatility. Although markets have favored our investments, particularly currency-hedged equity investments in Japan and Europe, we will not get carried away by the exuberance on display in some markets.

Energy in the future: oil and solar. For another letter is a discussion I had planned for this one about oil-related investments after the tremendous decline since last summer. In short, it appears that the Saudis and OPEC no longer control oil prices; instead these are set by the costs of production. Ever-improving oil and gas extraction technology will keep oil prices low--or so I think. I also plan to discuss solar power, where technology has driven costs ever lower and permitted the doubling of installed photovoltaic generation capacity every two years. It will not take too many more doublings to supply all we need. More to follow.

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March 5, 2015

A Strong Start to the Young Year

Strong stock markets in Europe and Japan and the weakening euro and yen flow in large part from the massive European and Japanese central bank asset purchase plans.

The European Central Bank will begin its asset purchases next week, but its January announcement of the program's dimension galvanized stock and currency markets.

The combination of liquidity provided by central bank programs and modest improvement in economic growth have been the forces behind this year's healthy stock market gains.

The new year has begun very well for our investments, particularly in foreign stocks. This somewhat reverses the results from 2014, when US stocks were quite strong and European stocks rather weak. As discussed in our last letter, the European Central Bank (the ECB) finally announced its plans for a very large and open-ended program of asset purchases, referred to as 'quantitative easing' or 'QE.' This plan, involving the purchase (mostly of bonds issued by European governments) of €60 billion per month for eighteen months, was announced in January and will commence next Monday. The planned purchases are designed to enhance economic growth in the Euro-zone countries and to counteract deflationary forces in Europe. Whether these results are achieved by the ECB's program is by no means certain. However, it is quite likely that the asset purchases will cause prices of various European (and other) assets--including bonds and stocks--to rise in price. The outperformance by European stocks this year may be attributed in part to the ECB's announcement of its QE intentions.

The decline of the euro. Additionally, it is reasonable to expect that QE will cause the exchange value of the euro to continue its decline against the US dollar. The euro has already fallen by about 20 percent against the dollar since May. It may fall further because the US economy is stronger than Europe's and because the Federal Reserve has finished its asset purchases and will probably begin to raise interest rates later this year, while the ECB just begins its own quantitative easing now. The differences in rates of growth and in monetary policies are likely to cause the euro to decline further against the US dollar. (Note that for Core's investments in European stocks, we use a fund that hedges away the euro currency effect, thus the decline in the euro does not cut into the returns earned by appreciation of European stocks.)

The tone improves in Europe. Despite slower growth in Europe, things European are decidedly less gloomy than they have been in recent years. The interim deal made last week between Greece and the parties involved in 'assisting' Greece with its large debt burden--the European Union, the ECB, and the International Monetary Fund (the IMF)--suggests strongly that an arrangement will be made with Greece that will keep Greece within the Eurozone and will not disturb financial markets unduly. (Whether it lessens the severe pain that Greeks have suffered in recent years from the economic depression into which the country has fallen is quite another matter. Let us hope so.) And, after a rather grim 2014, when most European economies were teetering at the edge of recession and deflation, the prospects for 2015 are more positive. Economic growth is hardly robust, but estimates are being raised, not lowered.

By

Jack Mayberry

Japan and other equity markets. Similarly, Japanese stocks have been quite strong so far this year. The massive quantitative easing program by Japan's central bank has been under way for over a year. Its effect has been to increase the prices of Japanese stocks and to bring down the exchange value of the yen. (Precisely as we expect, *mutatis mutandis*, from the ECB's QE program.) As with our European stock investments, so our Japanese investments have been hedged against the yen's decline. Early this year, we added an unhedged Japanese stock investment, alongside our hedged one, on the notion that the yen's decline may largely be over. The US stock market has lagged Japan and Europe a bit this year, but it made another new high at the beginning of this week. Although the Fed will begin 'normalizing' interest rates later this year, its policy is still very accommodative; it provides a good tail wind for US stocks and helps the US economy.

Two factors have helped the world's stock markets recently: the liquidity provided by the world's major central banks and the modest but real economic growth in most regions. Central banks increase funds available for investment through their asset purchase programs, while, at the same time, their purchases withdraw significant amounts of government bonds from the markets. The Federal Reserve now holds \$4 trillion of securities; Japan and Europe are engaged in multi-trillion dollar purchase programs. The effect is to drive up prices of bonds and push investors into other assets, like stocks and real estate. Central bank liquidity will remain a formidable factor in financial markets all this year and perhaps some time beyond.

Russia. After writing this rather cheerful account of central bank actions, financial markets, and growing economies, it is depressing to turn again to Russia. In the last month came another cease fire agreement settled in Minsk among Putin, Merkel, Hollande and Poroshenko. Before the ink was dry, the Russian-backed forces in the eastern part of Ukraine declared that the agreement did not apply to the railroad junction they were attacking, so the fighting continued there. Then came last Friday's murder on a Moscow bridge in the shadow of St Basil Cathedral of Boris Nemtsov, the able Russian opposition leader. It is plausible to consider this an assassination approved, if not ordered, by Putin. Or, in the climate fostered by Putin's characterizations of political opponents as 'traitors' or members of 'fifth columns,' it might be that a radical group sympathetic to Putin murdered the 'traitor.' It is quite possible that we will never know what happened, but this act shows us once again that Putin is prepared to go to extremes to maintain his power.

Dreadful as Mr. Putin's Russia has become, we should not overestimate the impact of these Russian and Ukrainian matters on investment markets. Geopolitical events, however nasty, rarely have a meaningful impact on financial markets. The Arab oil embargo in the mid-seventies is an event that did bear heavily on markets for a long time, but all the wars and terrorist attacks since have had little more than fleeting impact. To put this another way, Janet Yellen is far more important to investment markets than Vladimir Putin.

Mr. Putin, with his vast arsenal of nuclear weapons and, apparently, some very able special forces units, could rival Ms. Yellen in importance if he should escalate things enormously, by invasion of Estonia and the other Baltic states, or otherwise. Until then, we can consider these unhappy events in Russia and Ukraine without worrying unduly about their impact on our portfolios.

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January 24, 2015

The European Central Bank Lays out its Plan

The European Central Bank has announced its Quantitative Easing program, after many months of hints, speculation, and behind-the-scene negotiations with the Germans and others who have opposed the plan.

It is a massive program, under which €60 billion will be purchased each month for at least 18 months. Will it reverse deflationary expectations? Will it stimulate demand and rouse the eurozone economies from slumber? Time will tell.

It is quite likely that the ECB's QE program will cause stock and bond prices to rise and the value of the euro to fall.

The new year has begun with financial markets and the global economy roiled by uncertainty and unexpected events. The European Central Bank has been the source of major uncertainties: firstly, what action it would take to attempt to revive growth in Europe, and, secondly, what effects will its actions have. The relentless decline in the price for crude oil has unsettled markets, economies, and geo-political calculations. The startling and utterly unforeseen action by Switzerland's central bank to end its 'peg' to the euro focused investors' fears that central banks had so manipulated normal prices for credit, currencies, and other assets as to render these prices and their underlying relationships unpredictable and vulnerable. This list could readily be lengthened.

These events, these uncertainties occur at a time of difficult economic conditions. Pervasive weakness in global economic demand has caused prices for goods and services in many countries to stagnate. Median inflation in developed economies is now below 1 percent. Deflation--i.e., falling prices--is at hand in many countries; the 50 percent decline in oil prices in six months pushes prices even lower. While the United States had reasonably strong growth in last nine months of 2014, Europe, Japan, and other developed economies have been barely positive. China's growth, still strong by standards of mature economies, has slowed considerably.

The European Central Bank settled one open question on Thursday with its announcement of its plan to buy a huge quantity of bonds issued by the various eurozone member governments. The scale of purchases is larger than expected; it is comparable in size (€60 billion per month) to the recently-ended Federal Reserve's asset purchase program; it is potentially open ended insofar as the ECB promises to continue the asset purchases until inflation returns toward the ECB's target level. The planned purchases are very great, €1.1 trillion or more, and the concessions to Germany's opposition are modest. Thus, at long last, the ECB begins its quantitative easing program (QE).

The ECB's announcement and the market's favorable initial reaction begs the question: Will it succeed? This is unknowable. QE programs initiated by the Federal Reserve and the Bank of England have been followed by higher economic growth in the United States and the United Kingdom, but those programs began several years ago. Has the ECB come too late to the party? Japan's central bank is in the midst of an enormous asset purchase program, but its was also begun rather late in the game. So far the result in Japan has been to weaken the yen and to bolster the stock and bond markets. These results were intended and expected, but the bigger targets, the revival of Japan's growth and the escape from deflation, have not been hit. It is simply impossible to know if the ECB

By

Jack Mayberry

can halt the deflationary spiral in Europe and stimulate economic demand. Europe, like much of the developed world, suffers from too little demand. As a result, it is awash with savings not put to productive use, while it has terribly high and very long-term unemployment, particularly afflicting younger people.

Investment implications. Three points to consider: First, European stocks will probably rise with the ECB's QE program, while the euro declines in value. Second, US stocks and the US dollar are the favored investments by most investors around the globe. Finally, volatility--wide and sharp swings in asset prices that have characterized the last six months--is likely to continue.

Whether the ECB's asset purchase scheme will raise inflation toward ECB's close-to-but-less-than 2% target is an open question, about which skepticism is well warranted. Whether the program will stimulate much-needed economic growth is similarly unknown. What seems quite likely, however, is that the ECB's program will stimulate the prices of investment assets in Europe and around the world, just as has been the result of the QE programs of the Fed, the Bank of England, and the Japan's central bank. Stock prices in eurozone countries will rise. Equally likely is that the euro will continue to decline against the US dollar. Since the middle of 2014, the euro has fallen from about \$1.40 to \$1.12 today. Although the euro may not continue its straight-line descent, over the next 18 months of the QE program, it is likely to fall further. Accordingly, we will continue our investments in European stocks and we will maintain our currency hedge, so that the decline in the euro does not offset the gains in the stock prices.

The US stocks dollar was as strong as new rope in 2014 and US stocks provided better returns than did most other equity markets. Surveys show that many investors expect similar results for 2015. This remains to be seen; rational expectations are often dashed by reality. We maintain a balanced approach and hold European, American, and Japanese stocks. The continuation of Japan's very large scale QE program and the initiation of the ECB's will support their stock markets and others around the world. The Fed promises to take great care in raising interest rates. The result is likely to be decent, if unspectacular, economic growth in the US, giving rise to improved corporate profits and supporting stocks valuations.

Finally, we have seen an increase in the frequency of sharp falls and rises in the prices of various assets and currencies. Expect this to continue. The unsettled nature of economies and the divergence in monetary policies between Japan and Europe on the one hand and the US on the other will probably disturb markets. The very sharp decline in oil in since last summer is also a cause of increased volatility, in part because of stresses it creates in Russia and the Middle East. (Witness the violent upsurge in fighting in recent days in eastern Ukraine, again at the apparent instance of Russia and with another large influx of Russian arms and personnel. This appears to be Mr. Putin's response to the economic distress in Russia caused by the collapse in the rouble and oil prices.) Geo-political concerns, also including ISIL, the Iranian nuclear threat, the Sunni-Shia violence throughout much of the Muslim world, and Ebola, are likely to unsettle markets more than once this year.

Core seeks to strike a balance between opportunities and risk, by maintaining a goodly set of investments that stand to gain in coming years, while taking measures to mitigate the risk of deep declines in portfolios. Increased volatility certainly heightens risk, but it also gives alert investors opportunity to buy at temporarily low prices. Onwards into 2015!

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