

# CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

August 14, 2011

## European Crisis Worsens... ...Odds of Recession Increase

*Europe is convulsed by the ever-widening problems with government bonds of member countries. As economies weaken in Europe and America, and political opposition to government efforts to stimulate economic growth grows, the Fed and the European Central Bank are left alone to alleviate panic. Markets have reached levels of volatility and intense selling seen at the worst of the 2008-2009 crisis.*

*Large bond investments and hedges in Swiss franc and gold are helping Core's portfolios in the chaos.*

The European Central Bank (ECB) and the Federal Reserve both took new and dramatic actions last week, as financial markets rioted and economic reports showed marked deterioration, raising fears that European and American economies were slipping into a new recession. Investor panic, akin to the worst of the 2008 and 2009 crisis, produced startling market moves.

As yields on Spanish and Italian government bonds rose above 6% and threatened to bring Europe's sovereign debt crisis to these large economies, the ECB announced an expansion of its bond-buying program. This was immediately effective: Spanish and Italian bond yields fell and prices rose. But, within days, rumors of problems at major French banks began to swirl, and the locus of the crisis shifted to France.

German unwillingness to act decisively to resolve the broadening European crisis increases the chances of a widespread banking problems. Major French and German banks hold a great deal of the debt of the weak 'peripheral' countries. If these holdings are valued at now-prevailing market prices, then the capital of these banks is impaired. In addition, many other banks in Europe (and perhaps in America) are exposed to counterparty risk with banks that are direct holders of such bonds, providing an avenue for further banking havoc. As the crisis grinds on without resolution, it becomes clearer that the principal source of funds to recapitalize the banks is Germany. Thus, however unwillingly, Germany's public funds must be used to resolve the problems emanating from Greece, Portugal, Italy, Ireland, Spain, and (heaven forbid) France. (An investment colleague of mine recently made the astute and alarming point that it is in Germany's short-term interest to keep the problems unresolved. Irresolution depresses the value of the Euro and its relatively low value is important to Germany's powerful export industries. A resolution that removed the uncertainties might well cause the Euro to rise sharply in value....)

On its own, the European crisis is sufficiently serious to cause major financial market disruptions. Add to it the evidence of America's utterly dysfunctional political system as America's economy weakens, political opposition to fiscal support for lagging economies, and markets around the globe resorted to panic selling in stocks and other 'risk assets'.

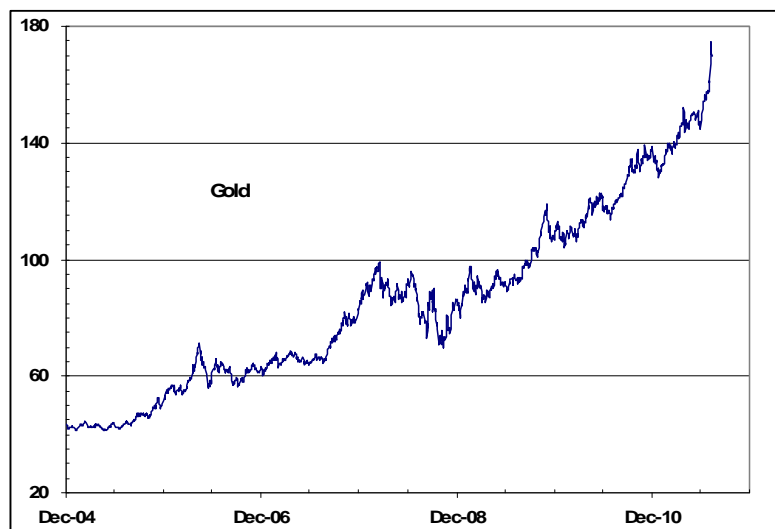
**By**

**Jack Mayberry**

The Fed's action Tuesday was an undertaking to keep the Fed funds rate at 0% to 0.25% until mid 2013. It came on the heels of the downgrade of US government debt by Standard & Poor's and a week of concerted selling of

*Like the Swiss franc, gold has attracted funds seeking a haven from the selling in stocks and the concerns about the viability of the Euro. Core continues to maintain hedges in gold, the Swiss franc and in other foreign currencies.*

stocks. In the few days since the announcement, stocks, bonds, currencies, and commodities (especially gold and oil) around the world have continued to trade with enormous swings in prices. Unanswered questions that seem to be driving the wild price swings include these: Is the United States headed toward another recession? Will the Federal Reserve undertake new initiatives to help the economy? Will the European sovereign-debt problems impair the capital of major French and German banks and lead to another massive international banking crisis? Are the resources of the United States, the major European countries, the Federal Reserve and the ECB sufficient to handle another financial crisis? Is there the political will and political wisdom to forge effective responses to what lies ahead?



**Core's investment approach.** Our view is that the odds of a US recession are higher now than they were only a few months ago. At best, it seems to us that economic growth in Europe and America will be quite weak in the coming year. In a 'normal' recession or an extended period of weak growth, high-grade bonds will continue to perform well, as they have since the spring of 2009. And if the long process of 'deleveraging'--whereby individuals, corporations, and now major Western governments act to reduce indebtedness--continues for the next several years, as seems likely, these same bonds will provide relatively safe returns. In such an environment, high-yield bonds (those issued by companies of lower credit worthiness) and stocks of well-capitalized companies with secure dividends will also provide good returns and

with only a small amount of additional risk. (In the last couple of weeks of panic conditions, high-grade bonds gave up virtually no ground and US treasuries soared in price. By contrast, high-yield bonds and stocks fell in price.) Core will continue to focus portfolios it manages in these securities.

Our hedging investments, especially gold and the Swiss franc, provided positive returns for our portfolios through the relentless selling of stocks, precisely as expected. We wrote about the Swiss franc in our letter two weeks ago; it rose further since then, to the consternation of the Swiss. For Switzerland, the enormous increase in the value of the franc against the Euro is a disaster for its economy. The Swiss National Bank, its central bank, is intervening to hold down its value and speculating openly about temporarily 'pegging' its exchange rate to the Euro. Apart from the complexity of effecting a temporary peg, the move runs counter to Switzerland's fundamental and longstanding independence from the rest of Europe. We do not expect the SNB to be successful in its effort to keep down the Swiss franc's value while the crisis in Euro-land remains at the boil. We hold our hedges in the Swiss franc gold.

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There is not too much useful information to be drawn from investment returns over very short periods, but Core's investment approach has been quite effective in the last two weeks, two months, and in this year in mitigating losses in this havoc and earning returns in excess of the stock market and of the standard benchmark including stocks and bonds. The SEC is rightfully concerned about how investment managers discuss returns publicly, so I will leave it at that. If you wish to discuss returns in your own portfolios and any other matters, please do not hesitate to contact me by phone or email.