

CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

August 21, 2009

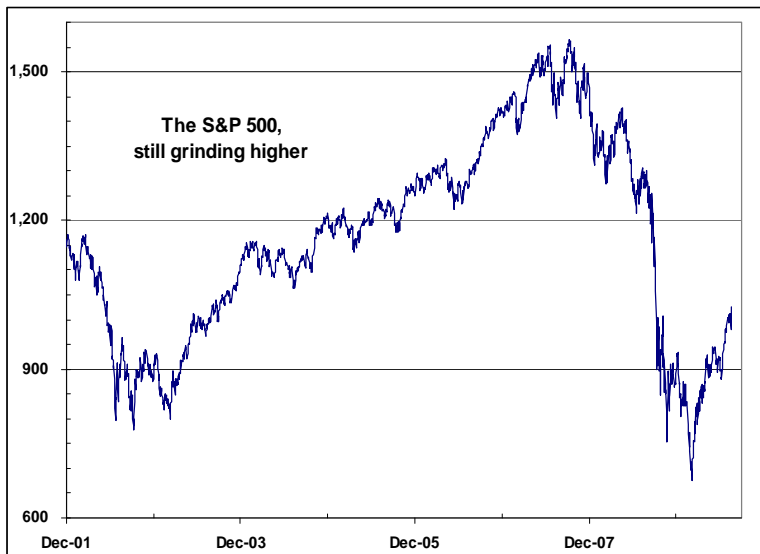
An Uncertain Juncture for the Economy and the Markets

The financial markets have continued to rally, even as some of the 'green shoots' appear to be withering.

Economic growth may turn positive in this third quarter, but a strong sustained economic recovery seems unlikely to be commencing now. Given somewhat high prices in the stock market and other risky investment assets, what are the risks?

Since my letter from last month, the stock market has staged a big rally. The S&P 500 stands about 13% higher now than when I last wrote. Other markets in which we invest have also rallied, and Core's clients' accounts have all appreciated well. However, the economic news has shown neither a corresponding increase in economic activity nor the prospect for significantly higher corporate profits. So where does this leave the investment markets? What are the prospects for further appreciation?

The recession may be coming to an end. It seems likely that businesses will increase production in coming months, having drawn down inventories at an exceptional rate since last autumn. New orders are rising at a rate faster than production, suggesting that production will increase, providing a lift to the economy as a whole. And the Federal Reserve assures us that it will continue for a long period its extraordinary policies designed to reflate and to stimulate the economy.



Recall, however, that consumer spending has, in recent years, accounted for about 70 percent of America's economic activity. Real (i.e., inflation-adjusted) personal spending fell again in the most recent month. People are saving far more than in recent years, in order to rebuild personal balance sheets, damaged by falling income (job losses and pay cuts) and falling asset prices (houses and securities portfolios). Until businesses begin hiring in earnest again and until house prices begin to increase, it is likely that consumer spending will be weak. Unfortunately, the job market will most likely be very poor for another year, perhaps for longer. There is some indication that home prices are not falling as precipitously as in the last year, but it is difficult to imagine any significant price appreciation in the housing market in the next year. Indeed, with prices as low as they are now, mortgage defaults and foreclosures are still rising, putting a further obstacle in the way of robust consumer spending.

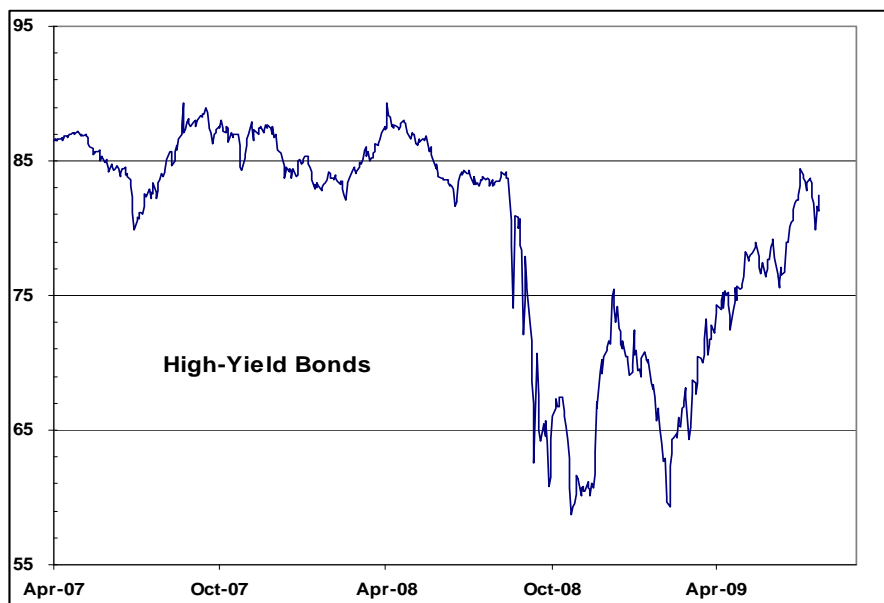
Because of these factors and others--e.g., does the "cash for clunkers" program pull automobile spending forward and rob from purchases that would have been made later this year or next?--there is a risk that economic growth that may be registered in this third quarter or next will give way to a further contraction in economic activity in 2010. This is the "W" scenario, i.e., reces-

By

Jack Mayberry

High-yield bonds, those issued by financially weak companies, always do poorly in recessions, because of the heightened risk of default.

In the autumn and winter just passed, prices fell to levels consistent with corporate defaults unimaginable except in a real depression. We invested in these bonds then, and recently sold part of our position after the tremendous rally since March.



Each year Core Asset Management files with the SEC a form ADV with information about our company. If you would like a copy of Part II of Form ADV, please contact us.

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sion, brief growth spurt now or soon, then back to recession in 2010, before the real recovery begins.

Effect on investment markets. Direct, short-term correlations between the broad economy and the investment markets are not the rule, as you know, but there is more than a nodding relationship between the markets and the economy. Thus, given a very significant rally in stocks and other assets since March, are the markets vulnerable to selling if the economy falters? I believe so. Market conditions in March suggested that the risk of the collapse of the world's banking system was high. It now appears that the so-called Armageddon risk is off the table. Timely action by the central banks and by governments in the last twelve months has prevented the collapse of major banks and of the financial system as a whole. It is therefore entirely reasonable that stocks, corporate bonds, commodities and other asset prices are now higher than at their panic lows of March. But it is also quite plausible to look at prices now prevailing in the US stock market (and others) and

to conclude that they predict a sturdy and sustained period of economic growth. However, the recovery may not be sturdy and sustained, but shaky and fleeting instead.

Last week, we sold a portion of the position in high-yield bonds that we purchased several months ago. At the time of our initial purchases, these bonds were trading at extraordinarily low prices, suggesting depression-like levels of corporate bankruptcies. High-yield bonds have rallied hugely in recent months and seem over-priced now. We are considering reducing other positions, the prices for which are now quite high, and investing in safer and cheaper securities.

Short-term caution, long-term confidence. I do not wish to paint an overly negative picture of the investment scene. There are many factors that suggest that we are in early stages of a prolonged period of economic improvement and rising markets. The policies of the Federal Reserve and the US government are designed to stimulate economic growth, provide support for the banking system and encourage investment. The scale of these actions is enormous and utterly without precedent. Indeed, the Fed's exceptionally powerful policy actions are exceedingly favorable to investment markets. The perception, which the Fed encourages, that these accommodative policies will remain in effect for a long time keeps markets marching higher. Other major countries have undertaken similar policies. Economic growth is already strong in China and other East Asian countries. We may well see a set of further policy successes, stronger economic growth than now seems likely, and sustained appreciation in investment assets.

My sense is that even if we do have another slide in the markets in coming months, investment assets will probably appreciate over the next two to four years to levels well above those that currently prevail. We are in the early stages of what will prove to be a very fruitful period for our style of investing. In short, caution now; more aggressive investing later.