

CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

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Threading the Needle

The interplay of various factors has given rise to a selling squall in stock markets. Russian belligerence is one factor; questions over monetary policy of the Federal Reserve is a second.

Financial markets turned sharply lower for several days last week and again yesterday, after a long period of very quiet markets with modest gains. The factors involved are several, notably including the Russian and Ukraine matter, and signs of strengthening economy in the United States. To begin, the Russian matter: After the loss of the Malaysian flight over eastern Ukraine came two notable developments: firstly the increased flows of Russian arms into Ukraine and a large-scale build up of Russian military forces at Ukraine's border; secondly the rather strong economic and financial sanctions against Russia imposed by member states of the European Union. This latter is striking because several important European countries, including Germany, France, Britain and Italy, have previously been reluctant to impose significant sanctions in light of their various different but substantial economic ties to Russia. The Russian military build up is worrisome in suggesting that, despite the world-wide outrage at the shooting down of the Malaysian flight and despite the already-apparent economic damage that US and European sanctions are causing, Vladimir Putin is not looking for a diplomatic way out of the problem he has created. Rather, he seems to be escalating Russian aggression against Ukraine, with all the unknowable mayhem that may ensue

The rather severe sanctions imposed by the Europeans on Russia will likely curtail European economic activity to a degree--putting aside for now the more serious damage that will be done to Russia's. Because European growth has hardly been robust and because inflation is dangerously low (at 0.4% per year at the most recent reading) and apparently still falling, the sanctions might stop Europe's modest recovery, depress the profits of European companies, and slow the recovery of European stock markets.

As for the American economy, US sanctions on Russia will have a much milder effect, because America's trade with Russia is rather small. Instead, the market's recent ructions may flow in part from the very strengthening of the US economy. After the severe winter weather that caused the US economy to contract in the first quarter, the spring quarter showed very smart economic growth. Recent corporate earnings reveal faster profit and revenue growth by US companies than in the last few years, and job growth has been solid.

By

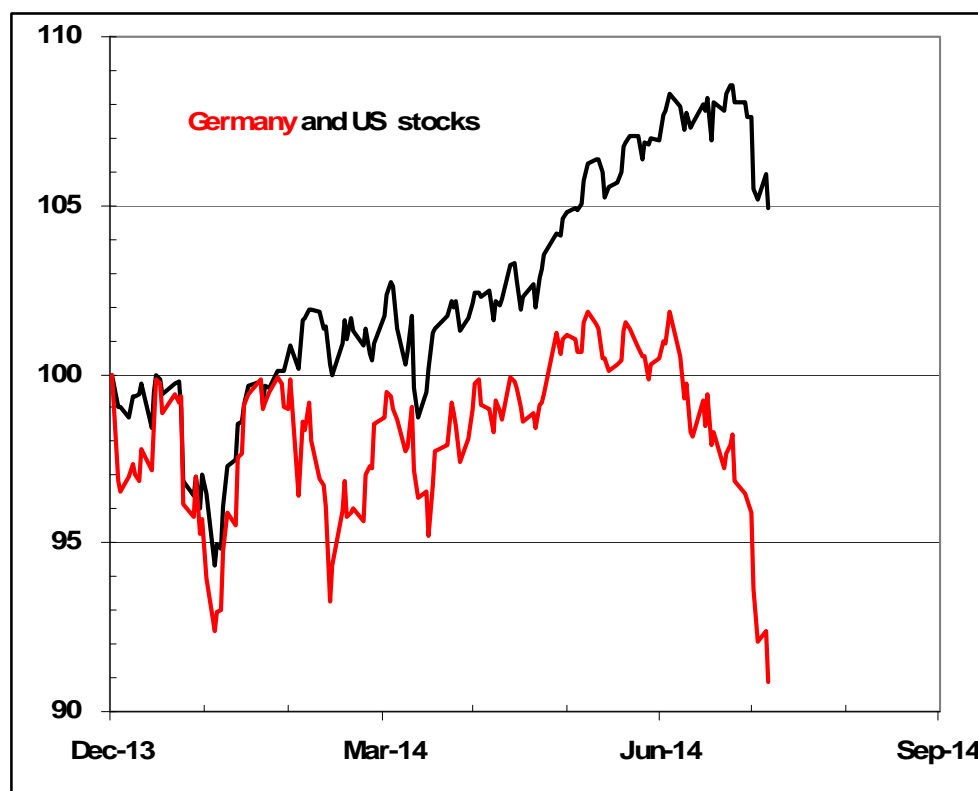
Jack Mayberry

The Federal Reserve has been reducing by \$10 billion per month its asset purchases and these will almost certainly come to an end in October. Fed Chair Janet Yellen has been insistent that the Fed will not begin to tighten monetary policy by raising interest rates for a good long time. But, in the fullness of time, the Fed will tighten. Because the Fed's extraordinary monetary policies since

2008 have been such a support for stock and bond markets, suggestions of stronger economic activity gives rise to fears of earlier Fed tightening.

The investment considerations of these matters have several strands. First is the general question of the impact of uncertain future actions by Russia on the markets in which we invest. Of course, we cannot know what Mr. Putin will do. But, if we assume that he will not bring his nuclear arsenal into the picture and will not invade other European countries, then, as investors, we can take a fairly relaxed view of Russia's quite appalling adventurism. Localized conflict around the world rarely has a lasting impact on financial markets.

The chart below shows US stocks and German both rebased to 100 as of the end of last year. The weight of Russian and Ukraine problems lies much more heavily on Germany because of its deeper economic ties with Russia.



The second thread in investment considerations concerns Europe. Because the sanctions already imposed on Russia are likely to depress Europe's economy to a degree and because further and more stringent sanctions must be considered somewhat likely given Mr. Putin's provocative actions, we can expect an adverse effect on European corporate profits. Mario Draghi, the resourceful and shrewd president of the European Central Bank, is likely to take actions to counter this European weakness. If so, the negative effects on Europe's financial markets may be muted.

The third thread is the strengthening picture in the US, in the broad economy and in the corporate sector in which we invest. At last week's meeting of the Fed's Open

Market Committee, its policy making arm, one member dissented from the FOMC actions. This dissent, the first in Janet Yellen's term as Fed chair, heightened fears of earlier tightening of monetary policy. Core does not share the view that this single dissent is a harbinger of monetary tightening. But growing economic strength in America, even if it does shorten the time before the Fed begins to raise short-term interests rates from zero, suggests faster growth in corporate profits, for which recent results provide evidence. Thus, the situation in America looks favorable: either the Fed continues its very favorable monetary policies for a good long time--a factor that clearly supports stock and bond prices--or stronger growth presages higher profits that justify higher asset prices.

Core's conclusions. Disturbing, not to say frightening, as Mr. Putin's actions are, Core's expectation is that they will not plunge stock and bond markets into a new bear market. The stronger force for financial markets emanates from the major central banks, whose actions will continue to foster economic growth and support asset markets. Given the different rates of growth in the US and Europe, it is sensible to tilt our portfolio allocations back toward American assets, by withdrawing a bit from Europe.

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