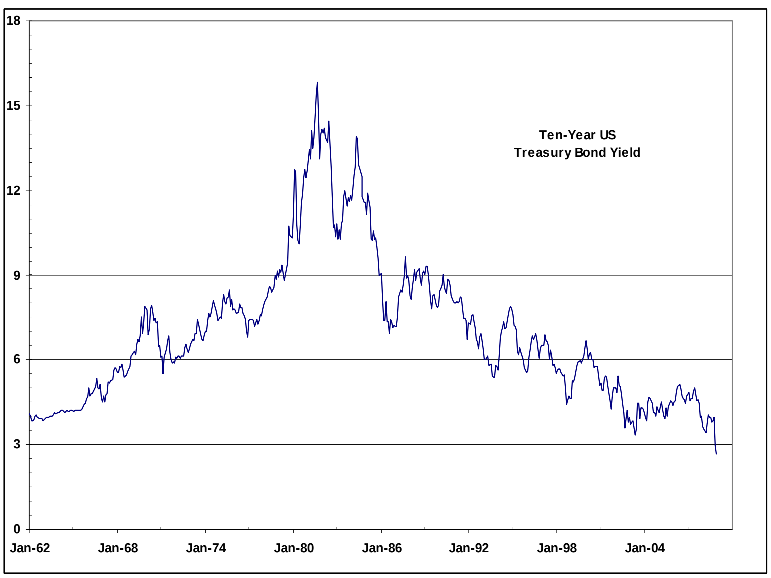
CORE Comments
ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

December 8, 2008

Deflation and Recession

Mr. Bernanke's speech on November 21, 2002, about actions the Fed would take to prevent deflation may be found at http://www.federalreserve.gov/BOARDDOCS/SPEECHES/2002/20021121/default.htm
My letter discussing his speech is at http://www.coreasset.com/publications/archive/jan2003/CoreComments20030128.pdf

In a week of really dreadful economic reports, US treasury bonds fell in yield and rose in price to levels not seen for a half century. The ten-year treasury bond, the benchmark for all other interest rates, plunged to touch 2.50% during the week and ended at 2.66%. This tremendous demand for treasuries suggests two things: first, the flight from risky assets to safe ones; and second, the expectation that the Federal Reserve will take actions to combat deflation, including outright purchases of long-term bonds. In 2002, then Federal Reserve Governor Ben Bernanke gave a speech outlining the steps the Fed could and would take to prevent deflation--falling prices. His speech was widely noted at the time; I wrote a lengthy letter to Core's clients about it then. Links to Bernanke's speech (extremely interesting) and to my letter (less interesting) are in the box on the side. His speech provides a precise road map to the Fed's actions now as it attempts deal with these fantastic problems. It is worth reading.



Core's recent letters have mostly focused on equities; we have pointed out the extraordinary dislocations, losses, and opportunities thrown up in stocks in this chaotic period. The bond market, unsurprisingly, presents similarly bizarre structures. As money has poured into treasuries, it has been pulled from bonds that should trade very closely with treasuries. For example, the mortgage-backed securities issued by Fannie Mae and Freddie Mac, recently taken over by the our government, should trade at yields only a tiny bit higher than US treasury bonds of the same maturity. After all, these companies, which enjoyed 'implicit' backing by the US government for years, are now essentially subsidiaries of the United States. However, they have been trading at yields 2% higher than treasuries. Impossible, but true. High-grade US corporate bonds are yielding 3% or so more than treasuries, far, far higher than normal. High-grade municipal bonds are yielding about 50% more than similar treasuries; they should yield less than treasuries, because their interest payments are not taxed.

By

Jack Mayberry

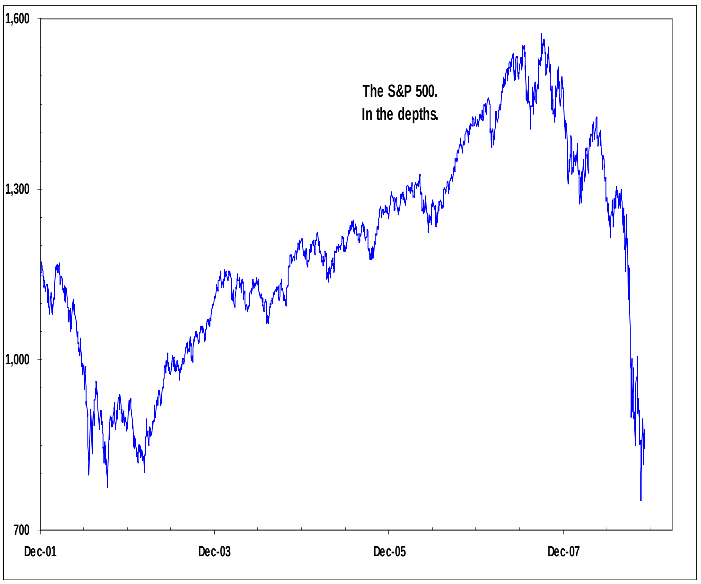
Such pricing anomalies make sense only if our recession becomes nearly as severe as the Depression of the 'thirties. To my mind, this is unlikely. The lessons of that era have long been studied; Ben Bernanke, formerly an economics professor at Princeton before joining the Federal Reserve Board, has a long and widely-respected career as a scholar of precisely these matters.

On the first page is a graph of yields on the 10-year US treasury bond since 1962. Yields have not been lower than now in a half century.

The chart below shows the dismal path of the stock market.

The Fed's actions in recent months and the forcefully articulated plans of the incoming Obama administration are designed precisely to prevent deflation and to ameliorate the dire consequences of the mortgage crisis and of world-wide deleveraging. The economy is bad and it will probably get worse, but the end of the world is not at hand.

Last week we made an investment in a highly-regarded US bond fund, Pimco Total Return, the investments of which are designed to capture the opportunities presented in bonds. We are considering an investment in high-grade US corporate bonds for the same reason. It has been our investment practice for years to seek our capital gains in equities and to invest in bonds for income. Now the bond markets are offering us plenty of interest income and the opportunity for attractive capital gains, as well.



Stocks. At the time of our last letter, the stock market had just plunged to new lows, breaching the levels at the bottom of the 2002 bear market. In what is becoming typical, the market promptly rallied sharply; it even advanced on Friday after the quite devastating employment report. We cannot hail victory yet, and assume that the new bear market began in late November. We know, for now, what we want to buy, but we are unwilling to commit new capital to stock markets except slowly and carefully. Further problems in the economy and the credit markets, which surely lie ahead, present too much risk to the stock market. It is quite likely that we will not be fully invested in equities when the stock market finally reaches its lows and we will miss the beginning of what promises to be an enormous rally. If we are careful and smart, we will still earn lots of money on the other side of this calamitous bear market.

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.

A Request for Referrals. We at Core would be very happy, as you might imagine, to bring more clients into our fold. There is discussion everywhere about these climactic events in the economy, the credit markets, and the financial markets. I have heard from various acquaintances that their financial advisors have gone AWOL during the last many months. If acquaintances of yours should make comments like that to you, please recommend Core to them. In this extraordinary year, no assets except US and Japanese government bonds have survived intact, not real estate, not stocks, not commodities, nothing. Our defensive stance has mitigated losses that these markets have imposed. Core's client accounts hold large cash reserves; we have the ammunition to invest carefully and opportunistically and to recover from this year's losses.

We have been trying to explain our thinking, our observations, and our investment plans in this series of letters. We will continue to let you know regularly and often during this extraordinary period what we are doing with your money. If our approach seems like a good one to you, we would be grateful for the opportunity to work with any friends of yours for whom you think we might be useful. Don't hesitate to pass our letters on, to give our contact information to others, or to give us the name and contact information for anyone whom you would like us to contact.

We are moving into the holidays. Will the markets and the economy pause to celebrate? Unlikely. We'll keep at work. And, please call or email if you wish to discuss things directly. (JNMayberry@coreasset.com or 800 451 2240.)

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