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

February 11, 2011

Gingerly into 2011...

The resignation of President Mubarak is a welcome development; the people's revolts in Tunisia and Egypt are hopeful and exhilarating.

Financial markets have generally observed these events in a placid manner, perhaps underestimating the complications and difficulties that lie ahead. However, for now, celebration is the order of the day.

The still-young year has been characterized--at least as it relates to our investing--by several strands: the exceptional political uprisings by the people of North Africa against entrenched, corrupt, and autocratic regimes; steadily advancing stock markets, especially in the United States; increasing evidence of strengthening in the US economy; and apparent movements within Europe to resolve the sovereign debt crisis in a way that preserves the decades-long goal of closer integration of the countries of western Europe. Lurking just ahead of us are decisive battles in Washington between newly-empowered, radical Republicans on the one side and Federal Reserve Board and the Obama administration on the other.

The Mahgreb, Egypt, the Levant and Arabia. The uprising that began in Tunisia has electrified the peoples of North Africa, the Arabian peninsula and the Middle East. It is impossible to offer a meaningful discussion in this short (investment-oriented) letter. But we can offer our opinions that this event has just begun, that the resignation of Mubarak does not end the uprising, and that change to political alignments around the globe is now underway. Israel excepted, none of the countries of these regions is a democracy. This popular uprising may be the first phase that lifts the lid from decades-old autocratic teapots. The consequences may only be imagined, but, as your investment manager, we must imagine. The insouciance so far demonstrated by financial markets is probably more a proof of short-term thinking that drives markets rather than a reasoned judgment that these consequences will not disrupt the stately advance of prices of securities. Core expects uncertainty and difficulties flowing from this in the months and years ahead; these will find periodic expression in financial markets by crisis-driven selling. This set of events will have the importance to financial markets at least as great as that posed by the European sovereign debt problems.

By

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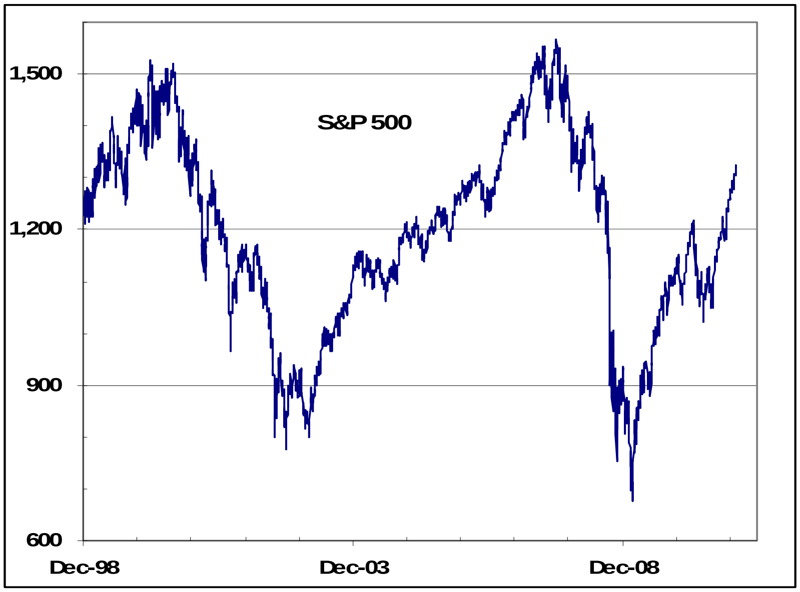
The US economy and politics. Despite the persistent--let us call it 'agonizing'--weakness in the labor market, data showing economic growth in America are encouraging. It seems likely that US growth will be strong, at least in the first half of this year. The significant and unresolved question is whether this economic growth in the private sector is 'self-sustaining.' In the lame-duck session of Congress, the Obama administration negotiated an arrangement with incoming Republicans for significant fiscal support (lower FICA withholding and extension of unemployment benefits) in exchange for an extension of the Bush-era tax cuts for those with high incomes. Coupled with exceptionally accommodative policies of the Federal Reserve, the US economy enjoys meaningful support from the government. This support will fall away in time. When that time comes, will the private sector exhibit suffi-

Darrell Issa's article may be found at http://www.ft.com/cms/s/0/d949c6c8-32fc-11e0-9a61-00144feabdc0.html#axzz1DVgjBjc4. It is not terribly persuasive.

cient vigor to keep the economy growing? This is an open question. The tart exchange on Wednesday of this week between Paul Ryan, the new chair of the House Budget Committee, and Ben Bernanke, chair of the Federal Reserve Bank, gave a fair outlook of the disputed ground: Is the Fed's QE2 policy inflationary? Will present federal deficits lead to debasement of the dollar and future inflation? Is rising inflation in emerging economies a result of Fed policy or of droughts in Russia and the like?



The US stock market has been strong, in absolute and relative terms, since the early autumn. The strengthening economy offers hope that real job growth lies ahead.

There is a settled view on the right that the federal government policies--of the Fed and of the Bush and Obama administrations as the crisis unfolded--were unneeded, ineffective, and destructive of economic growth. This view is driven more by ideology than evidence, but we shall be hearing lots about this. No less an economic thinker than Darrell Issa, the new chair of the House committee on oversight and reform, opines in the Financial Times on the subject (reference in our side bar). His view is a good synopsis of the argument from the right, a rather weak argument as Core sees it.

Inflation. Increases in prices for food and fuel may have engendered some of the problems behind the North African uprisings. We shoppers in America see them here; politicians raise voices about inflation and point to higher yields on US treasuries as proof that rising inflation lies ahead. Yields on government bonds have risen, but the inflation portion of these increased rates (as measured by the market for inflation-adjusted securities) is far smaller than is the increase in 'real rates', which have risen on expectations of faster and stronger economic growth. In effect, increases in Treasury bond yields represent a return to more normal, but still very low levels, after the scare last year of deflation and 'double-dip' recession.

Investments. We have expressed our views about the world and the markets in your investment portfolios by selling equity positions in Brazil and Malaysia in favor of US industrial and energy-related investments. (Better prospects for the US export-intensive companies and for oil energy companies, when weighed against the tightening monetary policies in Brazil and China, informed these changes.) We did a swap (after the calendar turned over--no taxes on the gains payable until April 2012) into a very inexpensive Vanguard emerging market ETF from an somewhat more expensive iShares ETF, to save us all some underlying fee expenses. We took a small position in the Swiss franc against the risk of further confusion and distress in the European sovereign debt conundrum. As mentioned at the top of this letter, although we think that the political support for the Euro and for the general European integration project of the last forty years will produce a favorable resolution to European sovereign debt problems, we can buy some very inexpensive insurance by investing in Swiss francs. We have reduced your investment in utilities and in preferred stocks of large US banks to fund these investments. These high-yielding and quite safe investments are still attractive and we retain investments in them for most client accounts, but we think we can earn somewhat more than offered by these securities, without taking on much more risk. We contemplate shifting some of your bond investments from the highest-grade corporate debt to somewhat lower grade debt. We will continue to watch the political, economic and financial market developments to keep your investments on a safe and production path.

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