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

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A Foolish Consistency….

Emerson reminds us that 'a foolish consistency is the hobgoblin of little minds.' In the last month, I have changed my mind about economic and stock market conditions. I now think that the risk of a further sell off in stocks is high enough to warrant reducing risk in Core's clients' portfolios.

This letter attempts to explain the negative factors that give rise to my sense that market risk is high.

Since writing last month, conditions in markets have remained sour. Although we entered the year with Core's portfolios positioned more conservatively than in several years, I decided recently to reduce remaining equity positions. As I perceive things now, the risk that a substantial bear market may be in the offing has become uncomfortably high.

As is always the case, there are both positive and negative factors to the stock market. It is not hard to make the positive case for the market and economies; I made such in the letter I wrote last month. In brief, the points were that the US economy is still growing steadily (if unspectacularly) and that the monetary policy of the Federal Reserve is still quite accommodative, despite its having begun to raise short-term interest rates. Against these factors is a rather long string of issues that weigh on the market and give rise to the intense bouts of selling. In no particular order, I discuss some of these.

Oil prices, as is well known, have declined very sharply since mid 2014 when crude oil was selling at about $115 dollars per barrel. The Saudis, who had often in the past been willing to cut production to support prices, declined to do so this time, so as to force down the price and persuade high-cost producers (including shale oil producers in the US) to cut production. This strategy caused the supply of oil to exceed global demand by a large amount and drove prices lower, reaching a low in January below $28 per barrel. Although low oil prices are a boon to consumers and to countries that import oil, they cause losses for oil producers and associated industries. The decline, which has seemed unstoppable, rattles the markets. Prices of many other industrial commodities--iron ore, copper, and the like--have also collapsed. Over supply is an issue in industrial commodities beside oil, but there is a concomitant weakening of global demand for these commodities. Stock markets are fearful of these signals that economies around the world are slowing.

China. As discussed in our last *Core Comments* in January, China's rather ham-handed actions in trying to prop its stock market and to 'adjust' the value of its currency roiled markets last August and then again this year. Very recently, China has kept the exchange value of its currency quite constant in dollar terms, so as not support the belief that the yuan will depreciate. Given that almost all currencies in the world have fallen when measured in dollar terms in the last couple of years, and given that China competes against other east Asian countries to manufacture goods for America and Europe, China probably should allow the yuan to depreciate. The expectation that the yuan will fall in value against the dollar has given rise to enormous capital flight from China, recently at the rate of $100 billion per month! China's well-founded concern about capital flight and its desire to prop up its over-priced stock market have given rise to rash and ill-considered actions. China has the resources and tools to manage its problems, but it lacks the experience to craft the right strategies and to communicate those strategies to the world. The world's markets have become quite concerned and expressed those concerns by somewhat indiscriminate selling. Such are the problems of China's having become a very important country.

By

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Central Banks. Most people recognize that the major central banks, especially the Federal Reserve, prevented economic depression and disaster to the global financial system by their actions during and after the financial crisis of 2008 and 2009. The central banks engaged in previously untried and quite extraordinary actions, including vast asset purchases, referred to as quantitative easing, guarantee of all money market fund deposits (in the immediate aftermath of the Lehman Brothers collapse) and, most recently by the European, Japanese, Swiss, and Swedish central banks, negative interest rates. The asset purchases <u>certainly</u> raised asset prices (including stocks, bonds and real estate) and <u>probably</u> helped real economies grow in those fraught recent years. But there are now real doubts about the efficacy of recent central bank actions, especially the negative interest rates.

Perhaps the most unsettling factor confronting markets is the sense that central banks' monetary policies are no longer effective in stimulating economic activity or supporting asset markets.

A couple of weeks ago the Japanese Central Bank surprised markets by announcing a version of these negative rates. Among other things, such an action should have caused the yen to fall in relation to the dollar, and so it did for a day or two. Then, within a week, the situation reversed and the yen appreciated by about 10 percent against the dollar, a huge move. This is a stark example of the new distrust of central banks. Another is the rather loud clamor to declare the Fed's December increase in the fed funds rates (to a near stratospheric 0.25%) to have been a mistake and to warn the Fed not to make further increases as now planned. If the markets can no longer count upon the central banks to keep the markets and the developed countries' economies reasonably strong, what hope have we? With the exception of Japan, governments of developed countries are unwilling to loosen the fiscal purse strings for much-needed infrastructure investments and other public programs that could stimulate economies. Fiscal austerity has been the unvarying rule for several years, so markets have looked to the central banks to keep things moving forward.

Corporate earnings in the US peaked in 2014 and were slightly lower in 2015. As last quarter earnings for 2015 are being announced, it appears likely that these will trail those for the last quarter of 2014 by 4 percent or so. Projections for future revenues and earnings being discussed by corporate executives suggest that the present quarter will be weaker than the last. Among other things, workers are being paid somewhat more, after some years of wage stagnation. This is all to the good, but for the fact that higher pay for workers increases corporate expenses and decreases profit margins. We can expect the somewhat higher wages for workers to be spent, hence expanding overall economic activity. The markets, however, look to the here and now. They see lower earnings. Selling ensues.

Weakening economies. In the paragraph above on oil and industrial commodity prices, I noted that, in part, low prices reflect lower demand. This may be a sign that economies are weakening around the world. (It may also reflect the possibility that economies can produce a unit of output with less energy and other resources than before.) Many indicators show declines in manufacturing in the US and around the world, although service-related sectors remain more robust. There is palpable fear about weakening economies, which finds expression in stock market selling.

The bond market, especially long-term government bonds, have been very strong, with rising prices and falling yields. This is well and good, except that it may itself presage economic weakness. The fall in borrowing costs--that is the yield--on long-term bonds suggests that borrowing demand will be low in the long term. If that is not a prediction of generally weak economic activity in the future, I don't know what it is. The rise in long-term bond prices and the falls in their yields present a challenge, to say the least, to rising stock markets.

The list of issues could be extended, but let us leave it here for now. As problems and uncertainties have mounted, I conclude that the risk of another real bear market is high enough to warrant a sale of stocks. Core is investing the proceeds in US bonds, including high-grade corporates, long-term treasuries, and the Double Line bond mutual fund, which we have held for some time. The cross-currents and uncertainties that abound make for very volatile and nervous markets. When we perceive a lessening of risk, we will make new investments in equities, but for now, in what we regard as a dangerous time for stock investments, we will be cautious.

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