

# CORE Comments

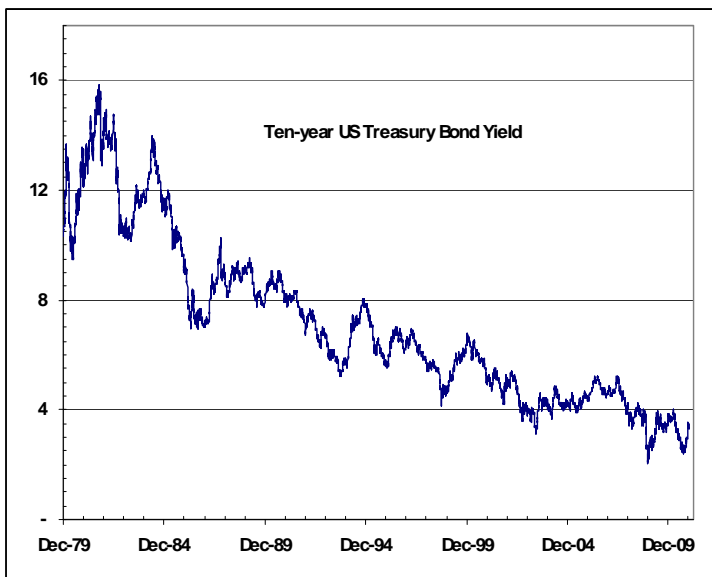
ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

January 7, 2011

## A New Year Begins... ...A Look Back and Forward

*For thirty years, the yield on the benchmark 10-year US treasury bond has fallen. During the worst of the financial crisis at the beginning of 2009, and again last autumn, yields fell to extremely low levels, reflecting fears of deflation. The very recent rise in yields (and fall in prices) is quite modest in this context.*

The US economy ended 2010 similarly to the way it began, with signs of increasing strength. Much of the year, however, was characterized by palpable concern that the tottering economy was poised to sink into recession once again. The labor market was distressingly weak and house prices began to fall again in the second half of the year. Recovery from the severe recession began in the middle of 2009 and, a year ago, things seemed to be proceeding with some vigor. But late winter brought the beginning of the still-unresolved problems with sovereign debt in European countries. At the same time, growth faltered in the United States. By August, the Federal Reserve, which had been hinting in the spring that it would begin to ‘normalize’ monetary policy, announced that it was planning a second round of so-called ‘quantitative easing’ in order to ease fears of that the economy would contract again and that price deflation was at hand.



Within the last month, and despite a very poor employment report for November, it appears that the ‘soft patch’ of the summer months has given way to more vigorous economic growth. Thus, we enter the new year with the economic winds blowing more favorably. The big question, discussed below, is whether economic growth in the United States has become ‘self sustaining’, that is, whether the economy can continue to grow without the stimulation provided by high levels of government spending and by the Fed’s exceptionally easy monetary conditions. This question looms especially large because of the hostility expressed by Tea-Party Republicans to the Fed’s policies and to deficit spending by the Federal government.

*By*

*Jack Mayberry*

The mid-year economic weakness and the troublesome euro-land crisis had their impact on financial markets: The dollar rallied against most currencies and especially the euro as the near-insoluble problems of Greece and other ‘peripheral’ European countries became apparent. Stocks and commodities, sensitive to global economic growth and reflation, fell as fears grew in the spring and early summer. Bonds, especially long-term US treasuries, rose sharply in price and their yields fell. Gold, which had been rising steadily for some time, took further support from the euro-currency crisis, and continued its ascent.

*The chart below shows the rising price of gold over the last several years. (It is a chart of the price of the exchange-traded fund that tracks the gold price.)*

*Does the rising price of gold reflect fears of future inflation? Does it reflect disenchantment with paper currencies? (Note that this graph shows gold in US dollar terms. The slope is the pretty similar when gold prices are measured in Japanese yen or the euro or other currencies.)*

*In addition to our gold investment, most Core portfolios have investments in silver and in agricultural commodities.*



*Each year, Core Asset Management Company files with the SEC a Form ADV with information about the company. If you would like to receive a copy of Part II of Form ADV, please contact us and we will send one to you.*

As Federal Reserve officials gave speeches through the late summer and early autumn about its planned quantitative easing actions, the markets responded. Stock prices and commodities made lows in the summer and began to rise anew. Treasury bond prices rose further on expectations that the Fed would be a big buyer of these securities. The yield on the benchmark ten-year treasury, which stood at 4% in early April, fell below 2.4% in October, an astonishingly low level, suggesting real fears of recession and deflation. But then, as the economy steadied and grew more vigorous, the yield on the ten-year rose sharply in the last weeks of the year to about 3.5%. Surely, this suggests a return to more normal price and yield levels and presages, we can hope, more 'normal' economic growth.

**Into 2011.** And so we begin the new year. In the developed countries--Japan, the United States and Europe--it is reasonable to expect modest economic growth, the most in the US. In the developing countries, most of which rebounded very quickly from the banking crisis and recession in the developed countries, we can expect a continuation of a high rate of growth. Inflation is very low--worryingly so--in developed countries, but higher and beginning to rise in developing countries. Monetary conditions throughout the world are extremely loose; interest rates on short-term debt are near zero in most developed countries; in developing countries, short term rates are rising. (But rising rates in the developing world are offset by near-zero rates in US, whose dollar is the world's reserve currency and whose monetary policy has effects far beyond its borders.)

In the United States, households and private businesses continue the process of reducing debt and improving their balance sheets. This phenomenon shows up in the personal savings-to-income ratio among households, which turned slightly negative in the middle of the decade just past, but has, since the financial crisis, hovered around 6%. In the traumatic period of the crisis and its immediate aftermath, the move to cut spending and to save restrained economic activity in the private sector. Now, with the savings rate stable at this higher level, consumer spending is growing again with income growth. The business sector is strong; manufacturing activity is growing; capital spending and, we can hope, hiring of new staff will probably continue to improve.

The combination of moderate economic growth in the US and very favorable monetary conditions suggest that the US stock market will be reasonably healthy in 2011. But, apart from problems that may arise outside the United States, discussed below, there is the real possibility that changing government policies may upset the applecart. When the private sector--households and businesses--tightened belts suddenly and extremely in the financial crisis, it was only the federal government that could take up the slack and make up for some lost spending. Of course, tax revenues fell sharply in the recession, with the result that increased federal spending gave rise to enormous federal deficits. For all the political reasons with which we are familiar, the November elections brought to office Tea-Party enthusiasts who campaigned on cutting government spending at all levels. Another feature of many of the new folks is their abhorrence of the Federal Reserve Bank in general and of the Fed's very easy monetary policy, especially QE2, as the newly-

*The bitter partisan feuding in Washington presents a threat to the continuation of the still-fragile economic recovery. Apart from Republican opposition to the federal spending to support the weak economy and those suffering its worst consequences, there is full-throated opposition to the actions of the Federal Reserve Bank. The upcoming fights are almost certain to rattle markets, even if the economy does grow reasonably well.*

*Perhaps more serious is the worsening condition of state and local government finances. 2011 will present us with further evidence that a recession brought on by a credit crisis takes a very long time to play out.*

*The sovereign debt crisis afflicting the 'peripheral' European countries and threatening the Euro itself will continue this year.*

*Solutions are not hard to picture, but the political obstacles they present stand in the way of their timely adoption. A renewed market crisis may unfold before these problems are solved.*

commenced round of treasury bond purchases is called. If it should develop in coming months that these new officeholders succeed in cutting spending sharply and in forcing the Fed to tighten monetary policy, we might discover that private economic growth will falter. There is a serious question whether the economic recovery is 'self sustaining', or if it continues to need the federal government and Federal Reserve fiscal and monetary support. At present, this is unknowable. A cautious policy approach is warranted.

Turning away from Washington for a moment, consider the problems with state and municipal finances. A very large part of the 2009 Federal stimulus funds went to state and municipalities to help make up for declining tax revenue and increased demand for services during the recession. As we all know, financially healthy states are few and far between; their numbers do not include the big states. Unless tax revenues rise much faster than now seems likely, many state and local governments will face enormous deficits this year. The problems are substantial; the solutions unknown. Severe cuts in public spending at the state and local level are already underway; they are a tangible depressant of economic activity. More cuts will mean more economic weakness.

**From outside the United States.** Risks to the US economy and to financial markets come from outside the United States, as well. It is almost certain that there will be another round of distress involving the government debt of Greece, Ireland, Portugal, Spain and/or Italy ("PIIGS" in the unfortunate acronym), because there was no resolution of the underlying problems in the two episodes in the last twelve months. The European Central Bank ("ECB"), the International Monetary Fund ("IMF"), the European Union ("EU") and its strong members, especially Germany, bought time for this crisis and provided sufficient funds to provide for the borrowing needs of these countries in the short term, but they have not dealt with the solvency problems these countries face. That is, will the governments of these highly-indebted countries be able to generate sufficient tax revenue to pay interest and principal of their sovereign debt and meet their other obligations? No. It is hard to find a credible argument or to lay out a plausible scenario by which Greece and Ireland can be considered solvent. Because these countries are within the euro-zone, they cannot depreciate their currencies; they are stuck with the euro. Thus, they must lower their cost structures--especially wages--to become competitive. The austerity measures imposed by the IMF and the ECB are causing and will continue to cause shrinking domestic economies. This lowers tax revenue, which weakens their debt service capabilities. This in turn causes the interest they must pay on new debt to rise, making their indebtedness worse. A vicious cycle is underway.

The ECB or EU members individually could buy Greek and Irish debt and remove the problem; the holders of the debt, which include German and French banks, could be forced to take less than 100 cents on the euro for this debt. Debt restructuring in sovereign debt crisis is extremely common and quite fair. Both these solutions are entirely workable, but both are fraught with political difficulty. There is intense political opposition in Germany to 'bailing out' the profligate PIIGS. Forcing the banks to take a 'haircut' on their holdings of this debt would lead to undercapitalization of many of those banks, requiring one more round of public support (by German taxpayers) for private banks. To say the least, there is little appetite so far for these solutions.

Therefore, it is likely that we will lurch into another round of crisis and another round of riot in financial markets, before the ECB, the EU, and Germany are forced to take the steps they abhor. Disruption in financial markets arising from the failure of European authorities to resolve the crisis can lead to the realization that the different, but related sovereign debt problems for the UK, the United States and Japan would dwarf the problems with Greek and Irish debt.

*The contrast between the problems and risks presented by United States and Europe and the opportunities of the developing countries is striking. Economic growth is strong, government finances are generally strong, and capital seeking investment in Asia and Latin America is abundant.*

*US multinational companies are beneficiaries of this growth, many commodities, and the local bond and stocks markets themselves all present fine prospects.*

**The Developing Countries.** The developing countries of Asia and Latin America present a much more pleasant aspect. Their economies continued to grow throughout the Great Recession, in 2009; for example, at 2.5% while developed economies contracted by 3.2%. In the year just ended, the emerging countries grew around 7%, as against about 2.7% for the developed economies. The IMF forecasts growth rates of 2.2% (developed) and 6.4% (emerging) for 2011. As we mentioned in previous letters while discussing the attractions of emerging market debt, the problems that plague the PIIGS are absent: Developing economies are growing fast, demographic characteristics are favorable (lots of workers per retiree), and their governments have relatively little debt. In short, the financial condition of most developing countries is quite strong. One feature of the financial strength and robust growth in these countries is that foreign capital, a good portion of which has been set loose by our Federal Reserve Bank, finds its way into these countries and their asset markets. This in-flow of foreign capital is not an unalloyed blessing for these countries; it sets inflation in motion and presents difficult policy choices to their officials.

For us investors, however, the local problems are overshadowed by the investment and business opportunities. Foreign companies, including US multinationals, generate enormous profits in the developing world. Investors like ourselves benefit from the robust growth and in-flow of capital, which lift prices of our investments in commodities, in emerging market bonds and stocks, and in US multinationals.

**Conclusions.** My sense is that the principal risks to the continuation of economic growth in the US and the developed world arise from the possibility of policy mistakes, in Washington and Germany primarily. I also sense that the policy makers will, unwillingly and belatedly, make the 'right' decisions. Markets will be shaken as the euro-land sovereign debt crisis and the partisan bickering in Washington about the scope and activities of the federal government play out. But, at the same time, the markets will be supported by the backdrop of continued growth, low inflation, and very favorable monetary conditions.

We at Core will continue to be cautious in our investing, mindful that our favorable expectations may not be borne out. At present, it appears that our mix of investments is suitable, including high-quality bond investments, equity investments focused on the areas and companies with the greatest exposure to global growth, precious metals and agricultural commodities, and commercial real estate. We look forward to investing in 2011.

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CORE ASSET MANAGEMENT

PO Box 1629  
108 Caledonia Street  
Sausalito, California 94966  
(415) 332-2000 • (800) 451-2240  
fax (415) 332-2151  
[www.coreasset.com](http://www.coreasset.com)  
[info@coreasset.com](mailto:info@coreasset.com)