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

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The New Year Begins. Yikes!

Strong selling in stock markets around the world, sharp declines in oil and industrial commodities, some wild swings up and down in prices: welcome to 2016.

The beginning of a bear market? The onset of a recession? Is the sky falling?

From Core's perspective this is not the beginning of a bear market. A recession in America seems unlikely.

By

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Given the unsettling start to this very young year, let us consider the implications, specifically the likelihood that the selling presages a real bear market in stocks. In the first two weeks of the year, the S&P 500 fell by 8%. The magnitude of the selling makes it the worst start on record to a new year in American stocks. However, the decline—dramatic as breathless new reports characterized it—has only brought the S&P to the level of the lows it made in the August squall of selling. As of this writing, the S&P stands a mere 13% below its all-time high set in May of 2015.

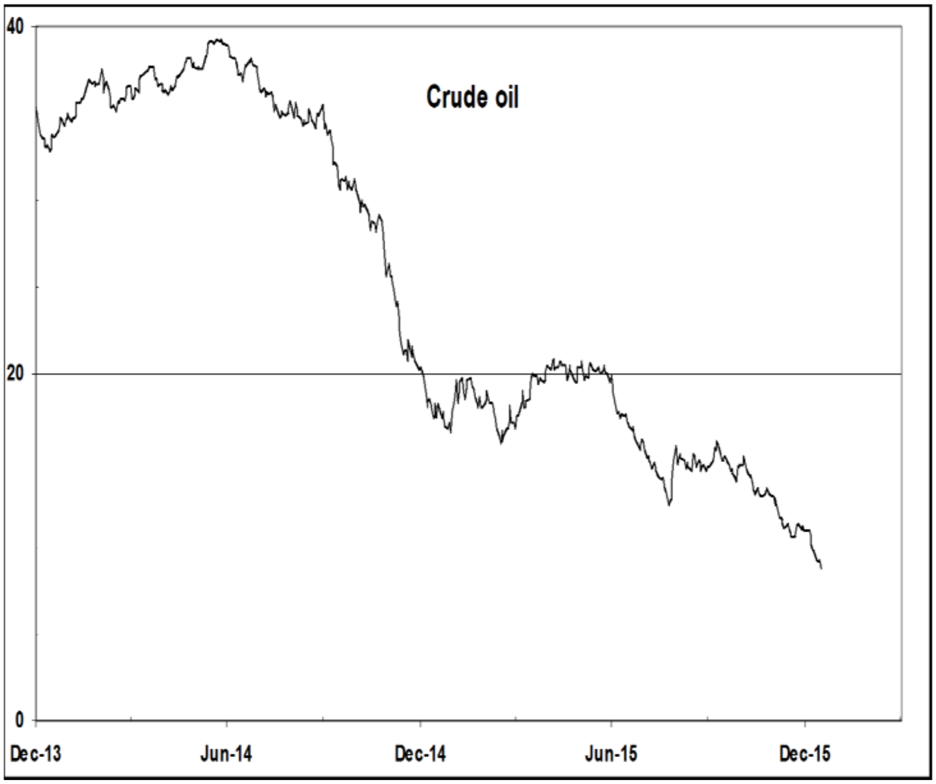
Of course, the fact that this year's decline is just 8% in itself gives no comfort: It is a tautology (of a kind) to say that the 2000-2002 and the 2007-2009 bear markets--of 50% and 58% respectively--both began with declines of a just 8%. Other factors may be more relevant: Bear markets generally begin in the context of economic recessions, either underway already or soon to begin. What is the likelihood of a recession beginning soon in the US? From our perspective recession is not imminent. Economic growth is modest but fairly steady, notwithstanding the likelihood that growth in last quarter of 2015 will be shown to be quite slow. Job creation (happily) remains robust; consumer spending is reasonably strong; there do not appear to be significant imbalances in the economy as a whole. Remember, for example, the house price mania and the mad mortgage lending practices that characterized the run up to the Great Recession. Nothing similar is before us now.

Two major disturbances to stock markets are the relentless decline in oil prices and the unsettled conditions in China. First, oil prices: On Monday, when markets in the US were closed for the Martin Luther King holiday, crude oil fell to $27.67 per barrel (as measured by Brent crude, the international benchmark). This represents a decline of 25% in this young year and a decline of 76% from the high in oil prices in June 2014! This remarkable collapse in prices is now being fueled (pun intended) by a number of factors: Saudi Arabia decided not to cut its production, as it has done in the past, with a view to driving higher-cost producers, including US shale oil producers, from the market. As of Monday, after sanctions on Iran were lifted in connection with last year's nuclear deal, Iran has begun to ship oil. It intends to increase its production from one million barrels a day back toward its old level of 2.5 million per day. Given that demand for oil is barely growing across the world, the supply of oil is far greater than demand. The prospects for immediate decreases in supply are not evident; indeed, with Iran coming back to the market, supply is about to increase further. We may soon see Brent crude changing hands at less than $20 per barrel, before some equilibrium is restored to production and demand.

The chart below (of an ETF that tracks crude oil prices) shows the collapse since the beginning of 2014. Crude oil had traded above $100 for few years before the decline that began in mid 2014. The price decline has exceeded seventy five percent so far.

The economic effects of these far lower oil prices include savings to consumers who pay far less for gasoline, heating oil and natural gas, but also significant cuts in capital spending by oil companies, with a concomitant loss of jobs in the oil patch. For the US economy, the benefits of lower prices for fuel probably outweigh the drag from cuts in capital spending and job losses in oil-producing regions. Thus, the sharply lower crude oil prices are unlikely to pull the US into recession.

China is undergoing disruptions in its currency and stock markets and difficulties in its transition from its booming, export-driven growth of the recent decades to a more balanced economy. In our letter in September and the one earlier this month, we discussed China's actions and their global effects. As in August of last year, it has made matters worse for itself (and global financial markets) by desperate and ill-conceived attempts to prop up its overpriced stock market. And, similarly to last August, it is handling revaluation of its currency poorly. Loss of credibility in China's policy makers is driving capital from China in large amounts and China is spending hundreds of billions of dollars of its (vast) reserves in its doomed efforts to control the markets for its currency and its stocks. Given the importance of China to the world's economy, the loss of credibility in China's policy makers is deeply unsettling to global financial markets.



Core's investments. We began this year with Core's clients' portfolios in a defensive position, which has mitigated the effect of the stock market's decline. A typical account held about one sixth cash and more than one quarter in bonds and preferred stocks. The overall decline in accounts has been about 4% or half the declines in stocks.

Although we do not expect this year's selling to become a major bear market and although we think that the US economy will continue to grow this year, we have no illusions about our ability (or anyone's) to make accurate predictions about these things. We have done no buying as the markets have tumbled, mindful of the old warning against trying to catch a falling knife. Opportunities will surely present themselves. We will be mindful of risk and alert to these opportunities.

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