

CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

July 6, 2010

The Evidence Tips toward the Bears

Will this be seen as a 'soft patch' in economic recovery, or the beginning stages of more serious economic weakness? Recent economic reports bode ill, at least for the coming months.

We have shifted portfolios toward safe bond investments.

The growing clamor in developed countries around the world to withdraw government support for recovering economies, arising from fears about big government deficits, puts the economic recovery at risk.

Private sector economic activity may not be strong enough now to sustain economic growth if government support comes to an end. Fear of sliding back into recession is one that has afflicted the markets in recent weeks.

In early June we wrote suggesting that, while it was a close call, the evidence offered by economic reports and the market's action supported bullish views, namely that the economy would continue its expansion and that selling in stock markets since late April would give way to a resumption of the cyclical bull market that began in March 2009. Since then, however, the flow of economic reports, the global political climate, and continued selling in stocks have strengthened the bearish arguments.

As you will have seen from the trade confirmations for your accounts that Core manages, we have steadily been selling the 'risk' assets in your portfolios and increasing your investments in safe bonds. In a series of sales beginning on June 8, we reduced equity and commodity investments from about 45% of total portfolios to about 30% as of the end of last week, and increased the safe assets (bonds, gold, and money funds) to about 70% from around 55%. (These figures are for the aggregate of all of Core's accounts; proportions in individual accounts vary according to individual considerations of investment goals and risk tolerance.)

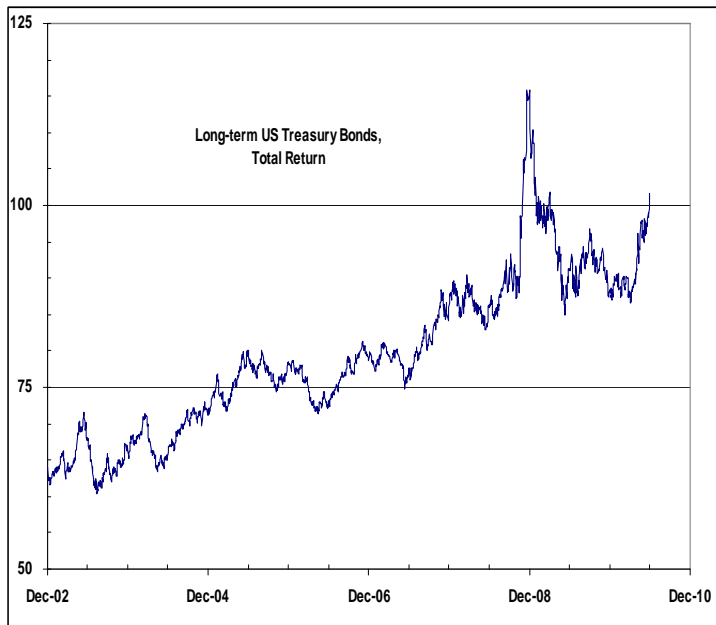
Economic problems... Job creation has been weakening in the recent two months and new claims for unemployment insurance remain stubbornly high, at levels consistent with recession. This translates, unsurprisingly, into weak retail sales, especially because individuals are continuing to save more of their income than in the free-spending period a few years ago. Manufacturing and export activity in the United States have been strong, but the developments in Europe do not bode well for their continuing strength. Europe presents two problems: first, the very weak euro makes competition with German exporters much tougher; second, the extremely poor economies in the euro-zone are unlikely to be big buyers of US exports.

...unsupportive fiscal policies... The politically potent cries in Europe and the United States to attack fiscal deficits now pose very serious risk to global economic recovery. When economies collapsed in 2008 and the banking system failed, businesses and individuals rapidly cut debts and reduced spending. It was only national governments with the will and the wealth to take up the slack, to expand spending, and to try to keep the wheels from falling off. At the worst of the crisis, there was a strong consensus to favor public support for faltering economies. There was apparent recognition that, if governments stood aside, depression and deflation might follow, as occurred when President Hoover tried to balance the budget in the early 'thirties. But now, Britain's new government has introduced a budget that will cut spending significantly. Greece and the other weak Mediterranean countries are being

By

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The chart below shows the total return (including interest payments) of long-term US Treasuries. The spike upwards at the end of 2008 marks the rush to invest in these during the most acute phase of the crisis, when every investment except US and Japanese government bonds plummeted in value.



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forced into more Draconian spending cuts and the European Central Bank has begun the process of removing its support from the European banking sector in the face of mounting losses from the sovereign debt of these countries. At the recent meetings of the G20 countries, it appeared that the United States stood somewhat alone in advocating continued government support to stimulate economic recovery; most others argued that the time for fiscal restraint had come.

The stridency of the Tea Party movement here forces Republicans to withhold support even from the extension of unemployment benefits. There is an ever-growing likelihood that public support for the still-weak economies will be withdrawn before private economic activity is strong enough to sustain economic growth. There is growing risk that economic activity in the second half of 2010 will falter and that the reasonably robust growth of the last nine months will come to an end.

... and poor stock market action. We have moved to larger investments in high quality bonds to guard portfolios against these risks. By our analysis, there is a greater risk now than since early 2009 of another large decline in stocks. Because governments and central banks used so much of their wealth and resources at the worst of the 2007 - 2009 crisis, there is less ammunition in reserve and less political will to fight a renewed crisis in economies, financial markets and the banking system. We cannot ignore the possibility of another 'riot' in stock markets.

Attractive bond investments. One of the very healthy results of the crisis is the strengthening of corporate balance sheets. As noted above and in earlier letters, the crisis induced individuals and business to stop spending, pay down debt, and restore financial strength. As a result,

bonds of American companies have been superb investments and, with improving balance sheets, ever safer ones. We have had large and very productive investments in US corporate bonds since the depths of the crisis; we anticipate continued favorable returns from these. We have been increasing our investments in bonds of developing countries in recent months. Unlike the developed countries, some of which are insolvent, many developing countries have strongly growing economies, low taxes, few unfunded liabilities (e.g., Social Security and Medicare), and large trade surpluses. Things have turned somewhat upside down over the last decade and developing countries now offer safer bond investments than many developed industrial economies. Most recently, we made a small investment in long-term US treasury bonds, for two reasons: first, in a crisis, capital flocks to Treasuries as a safe haven. Second, if the economy does slide back into recession and if deflationary pressures continue, these bonds will increase in price and their yields will fall further. The yield on the ten-year Treasury, for example, touched 4% in early April, before the recent signs of economic weakness showed themselves and before the Greek-debt crisis reached the boil. Since then the yield has fallen to just below 3%. At the most acute phase of the financial crisis in December 2008, the yield was 2.1%. To gauge what may happen if economies weaken further, consider that Japanese ten-year government bonds, during the seemingly endless years of deflation and recession in Japan, have yielded around 1%.

We cannot be pleased with apparently worsening conditions, but we invest for what is, not for what we hope.