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

July 7, 2011

A Shift in the Balance…
...For the Better

In light of some positive developments over the last week, we take a more positive view of the economy and the stock market over the next six months.

In light of these constructive developments, we have added some equity positions and increased our high-yield bond holdings.

By

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In recent letters, I have argued that risks to the economy, financial system, and financial markets outweighed opportunities, and from the beginning of May until quite recently, Core had been cutting our more risky investments in accord with this view. My view now is that the balance of risks is shifting.

Greece. More favorable recent developments include the complicated moves in Europe to deal with Greece, especially the "French option", whereby major French banks have agreed to exchange maturing Greek government bonds for long-term bonds at fairly low interest rates. Presumably German banks, also large holders of Greek debt, will also agree, however reluctantly, to this exchange. In response to this and to the enactment in the Greek parliament of new austerity measures, the IMF is set release more funds to Greece. This buys more time and postpones chaos. It is not a final solution, but it reinforces the notion that policy makers in Europe and at the IMF in Washington will work hard and with imagination to avert the looming crisis.

Oil. Global oil prices have fallen, and the release of a modest amount of crude oil from reserves of major Western countries has pushed oil prices down a bit more. In the US, gasoline prices have fallen in recent weeks and appear likely (as the futures markets suggest) to fall further. This is a modest boost to the US economy.

China and Japan. Chinese Premier Wen Jiabao wrote a piece in the Financial Times last week saying that the cycle of tightening monetary conditions in China is near its end, reducing the risk of a 'hard landing' in China. Global manufacturing disruptions caused by the Japanese earthquake and tsunami are abating, suggesting that industrial production will improve in coming months in the US and elsewhere.

As always, risks remain. There is still no deal in Washington to raise the debt ceiling. Although it seems likely that the impasse will be resolved and that the United States will not default, it is not too easy to be sanguine as one listens to the expressions of intransigence from both sides. And, of course, it is hard to imagine really strong economic growth in the US and Europe for the rest of the year. Modest growth seems likely, with the continuation of weak job markets.

Although the economy may be lackluster, financial markets may be healthy. Relatively weak growth is perfectly fine for bond markets, and many corporations have learned well how to earn ample profits in the environment that has prevailed since the recession ended. Core's portfolios earned decent returns in the first half of the year, when external conditions were uninspiring, at best. We can expect fair returns in the coming months in similar conditions.

Consistent with the view that the balance is beginning to tip toward opportunity and away from risk, Core has made some additional purchases of high-yield US bonds and equities. Our portfolios are still decidedly on the conservative side, but we are willing to add some risk and buy some assets that appear attractively priced.

Please note that the comments about our investments do not apply to the fixed-income portfolios that we manage for some clients. In these, we do not hold any equity positions. If you have questions about your individual portfolios, please do not hesitate to contact us.

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