

CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

June 4, 2010

A Uncertain Juncture

Do the recent weeks of selling and increased volatility mark the beginning of a renewed bear market? Or is this a normal correction in a cyclical bull market?
In our view, this is a modest interruption in an ongoing bull market.

Economic growth is robust in much of the world. Monetary and fiscal policies remain very supportive of economic growth and investment assets.

Risk remains high. Public sector debt in Europe, Japan and America is at unprecedented--and unsustainable--levels. Policy makers must balance political pressure to reduce deficits against the need to keep stimulating a still-fragile economy.

By

Jack Mayberry

The recent tumultuous action in financial markets poses a simple question, so far unanswered: Are we pausing in a 'normal' cyclical bull market that will probably continue for another two years or more, or are we now at the second precipice of the huge credit deflation disaster that began with the 2008 collapses of Bear Stearns, Fannie Mae, Freddie Mac, AIG, and Lehman?

In our view, it is the former. We are in the midst, we think, of a modest stock market decline in the context of a cyclical bull market and a global economic recovery. But this is a close call and our confidence in this judgment is not terribly high. We have a fully articulated plan to sell investments that are at risk if the evidence tells us that our judgment is wrong. There are two sides to the argument. Our bullish view first:

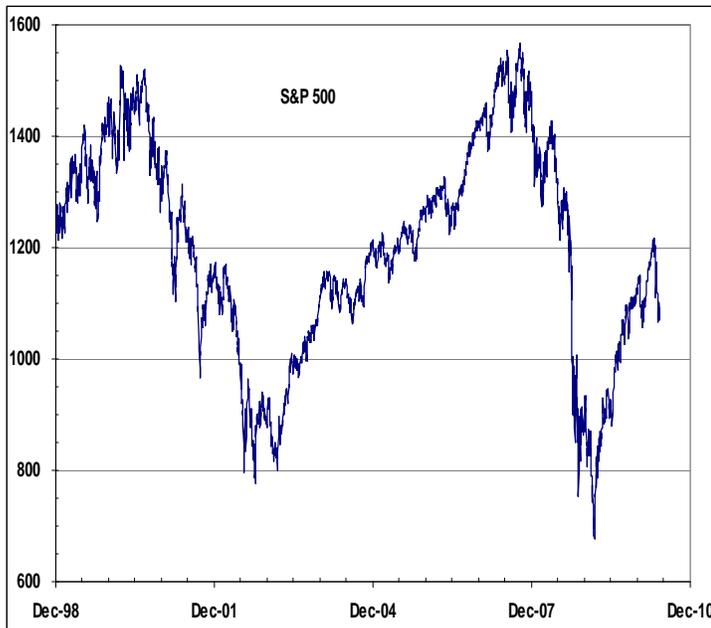
A pause . . . After the financial calamity of 2008 that projected its havoc into the early months of 2009, the exceptional actions of the central banks and the treasuries of the major countries restored a modicum of confidence. The abyss lay before us in March 2009; we pulled back from it. The unprecedented acts by the Fed and the Treasury--including recapitalizing the big banks, insuring all deposits in money market funds, buying commercial paper, taking onto the Fed's balance sheet dodgy mortgaged-backed securities, and more--halted the collapse of the world's economy and its financial markets. The low point--a very low point indeed, 58% below the S&P's high in October 2007--came in early March of last year, from whence began the rally.

The stock market rally began before the economy began to recover, as always happens, but in time manufacturing, consumer spending and employment began to grow. Unsurprisingly, rates of economic recovery differ in various parts of the world. China's recovery was early and very strong, so much so that Chinese authorities have taken actions for months to cool its economy. Economic recovery in the United States began in the third quarter last year; it has been broadening and deepening. Economic activity in Europe, the UK, and Japan has been far weaker than in China or the United States, but, taken as a whole, the world's economy is growing again. The enormous stimulus provided by the federal government and the Federal Reserve continues. Given this environment, the likelihood of another phase of economic contraction--the feared 'double-dip' recession--is low. It is likely that the last six weeks of selling in stock markets is a temporary pause in a bull market that should last for more than another year and take prices higher.

. . . or at the precipice? The 2008 crisis caused individuals and private companies to reduce their levels of indebtedness quickly and deeply. This caused

The selling since late April is like that in early 2004, a year into the cyclical bull market that began in 2003 and ended in late 2007.

a rapid, sharp and deep recession. Only the central banks and governments could take on more debt. And did they ever: According to David Rosenberg of Gluskin Sheff, a highly regarded analyst, \$200 trillion of global debt was transferred from private hands to 'taxpayer-supported public sector balance sheets' since the crisis began in 2008. Government deficits and central bank balance sheets exploded to levels never seen before. In recent months, it has become painfully clear that debt levels in some countries--Greece is just one example--cannot be sustained. The solvency of major countries is in doubt. The fear is that, as governments are forced to reduce deficits by cutting spending, economic recovery will falter and recession will resume. Should this happen, central banks and governments will not have resources to stimulate demand. A downward spiral in financial markets will commence.



The market's action in the two weeks after the May 9th announcement of 750 billion Euro package to deal with the sovereign debt problems illustrates the problem. It was clear that the size of the promised package would be sufficient to deal with *liquidity* needs of Greece and the other southern European countries. But, after an initial rally in global stock markets, selling resumed on the realization that the rescue package did not remedy *solvency* issues. Although the 750 billion Euros will enable the southern European countries to borrow new funds without resort to inhospitable public markets in the next two years, the longer-term ability of the Greek government to generate sufficient revenue to make timely interest and principal repayments is highly doubtful. The markets take the view that the Greek government is fundamentally insolvent and that its existing debt will most likely be restructured. In a default or debt restructuring, the holders of Greek debt will be forced to accept partial repayment.

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Apart from the solvency problems is the realization that public policy makers--central bankers, governments, treasury departments--are making the key decisions that affect financial markets in this very complex new world. There is real fear that mistaken judgments by any of a very large number of policy makers can cause serious problems with adverse global consequences. The scope of the debt problem and the complexities in dealing with it are enormous. All levels of US governments--federal, state, and local--have too much debt and too little tax revenue to support their obligations. Losses at Fannie Mae and Freddie Mac--now wards of the state--are enormous. Unfunded liabilities for future entitlement payments for public sector workers, for health care payments, and for Social Security are daunting. One of the many risks in all of this is that the political pressure to reduce public spending and to begin deficit reduction may remove the government's economic stimulus before the economic recovery can be sustained by the private sector. Turning off the spigot of public-sector economic support too early may return us to recession.

Conclusion. The bearish case is a grim one, indeed. We think the better argument is the bullish one and we expect higher prices for risk assets and higher values in Core's clients' portfolios in the next twelve and twenty-four months. Having said that, we have fresh memories that things can go badly quite suddenly and quite swiftly. The portfolios we supervise have large holdings of very safe bond investments and gold, positions that will protect us if things go badly. Please do not hesitate to contact us, if you wish to discuss our investments for you.

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