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

June 21, 2013

The End of Quantitative Easing is in Prospect

Mr. Bernanke's discussion of the Fed's plans to reduce and then to cease its asset-buying program, referred to as 'quantitative easing,' sparked a steep sell off in bonds and stocks.

The market's response may have been overdone, since Mr. Bernanke made it clear that the so-called 'tapering' would begin only after economic growth warranted the reduction in the Fed's purchases of Treasury bonds and mortgage-backed securities.

When those conditions--including meaningful gains in job growth--have been achieved, economic growth will be self-sustaining and there will be less need for Fed purchases to support that growth.

By

Jack Mayberry

On Wednesday, Fed Chairman Ben Bernanke held a press conference at the conclusion of the Fed's two-day meeting of its Open Market Committee (the FOMC). His explanation of the FOMC's action proved consequential: he described the Fed's plans for concluding its extraordinary monetary policy actions. About a month ago, during testimony before the joint Congressional committee for financial services, Bernanke discussed, but without specifying the steps, the process of 'tapering' its buying of treasury and mortgage-backed securities. Recall that for almost a year, the Fed has been buying these securities at the rate of $85 billion per month--about one trillion dollars per year--to foster economic growth and to stimulate the employment market. This is the third round of the Fed's 'quantitative easing' by which it has been buying such securities; it is now more than five years since the Fed began its radical policies during the financial crisis in 2008. Since then, the Fed has undertaken several actions to deal with the deep recession and very slow economic recovery.

As discussed in earlier letters, the central banks of the other major developed economies, the European Central Bank, the Bank of England, and the Bank of Japan, have all taken extraordinary measures in these years. It is quite likely that central bank actions have forestalled serious damage after the financial crisis and have helped global economies struggling under the weight of widespread deleveraging and tight fiscal policies by many governments. Recall that in recent months, Japan's government and its central bank have undertaken coordinated, concerted, and aggressive action to stimulate Japan's long-sagging economy. Of the major economies of the developed countries, that of the United States is the strongest. The European Union countries mostly languish in recession, some quite deeply, some less so. The Fed has a dual mandate to control inflation and to support employment. Since the announcement of this latest round of quantitative easing, QE3, as it is called, the employment picture in the US has improved. Just under 200,000 new jobs per month have been added in the last six months; the unemployment rate is falling, and the participation in the job market--the proportion of the working-age population that is employed or actively seeking employment--has begun to improve. The housing market is making a meaningful recovery.

In light of recent economic improvement and in light of the Fed's expectations for economic activity in the coming year, the FOMC announced its intentions to slow the rate of purchases of treasuries and mortgage-backed securities from its current $85 billion per month. As Mr. Bernanke discussed in the press conference, the FOMC's current plan is that the economy's strength will permit a reduction in asset purchases around the end of the year and will permit the full cessation of those purchases by the middle of 2014. Only after that will the Fed begin to raise short-term interest rates from the near zero level that has prevailed since the end of 2008. However, Mr. Bernanke stressed the point that the timing of the decrease in asset purchases will depend on economic conditions, not on the calendar.

As you are certainly aware, the hints about all this dropped by Mr. Bernanke in his May Congressional testimony, followed by his very explicit discussions on June 19, have stopped the placid advances in bond and stock markets and thrown all kinds of markets round the world into hyperactivity, mostly involving a rush for the exits. Most dramatically, the yield on the ten-year Treasury bond, the world's benchmark bond, has risen from 1.66% on May 1 to 2.51% today. This is an enormous increase and represents the highest yield (and lowest price) for the ten-year since August 2011. Because the prices and yields of other bonds around the world are tied to this benchmark bond, almost all bonds fell in price and rose in yield in similarly dramatic fashion.

Investment considerations. Mr. Bernanke was at pains to say that the timing of the decrease in asset purchases, the cessation of them, and the subsequent increase in short-term interest rates would be a function of economic conditions. He explained the Fed's current economic forecasts, and mentioned dates for these steps based upon those forecasts. He stated--as he and other Fed officials have remarked before--that if economic conditions should weaken, or if inflation should remain below the target level of two percent, the Fed could well <u>expand</u> its asset purchases, rather than begin to cut them. From these remarks, I conclude that prices of US stocks will rise from current levels.

I reason that, if the economy improves as the Fed now projects, the increased activity will enhance corporate profits. As a result, stock prices will probably rise. If, on the other hand, economic activity is weaker than now expected by the Fed, it will continue--or even increase--its level of asset purchases. We know well that these asset purchases have caused stock prices to rise over these recent years. Hence, as it appears to me, stock market investments, particularly those in the US, should continue to fare well over the next year. And so, despite the recent selling in bonds and, to a lesser degree in stocks, Core intends to hold or build upon the stock positions in its clients' portfolios.

Bonds are a different matter: The market has already driven interest rates up quite dramatically, and, if the Fed's projections are correct, we may expect to see yields rise further. For five years, bonds have been a delicious one-way bet: prices have risen and yields have fallen. Deep recession, terribly slow recovery, persistent de-leveraging in the private sector, and (more recent) fiscal austerity have produced a heady tonic for fixed-income investments. This has come to an end. Although there will likely be good rallies in the bond market, the low yields of the last year will, I believe, not be seen again in our lives.

During the last month, we sold our entire position in high-yield US corporate bonds, an investment that has earned splendid returns since 2009. We have reinvested some of the proceeds in dollar-denominated government bonds of developing countries, another long held investment of ours. This security has fallen sharply in the last few weeks, far more than warranted by external conditions. Its yield is high and, I submit, quite secure. We have cash on hand, and are making plans to take advantage of the opportunities offered by the very turbulent markets, probably tilting more toward equities than bonds.

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

May 22, 2013

Japan, the Central Banks, and Stock Markets

By

Jack Mayberry

A startling change has come to Japan since the November election for the lower house of its parliament, which gave Shinzo Abe and his Liberal Democratic Party a large majority. Since then, Mr. Abe has appointed a new head for the central bank (the Bank of Japan), increased government spending substantially, and begun far-reaching structural reform of governmental activities. The Bank of Japan (the BoJ) duly announced a truly enormous program of asset purchases, proportionally much larger than the Federal Reserve's programs. This new dynamism in Japan has had stunning effects on the value of the yen and the Tokyo stock market and has already given a significant lift to Japan's long-dormant economy. The yen has fallen in value against the dollar by more than one fifth in the six months since Abe's election seemed assured; the Nikkei index of Japanese stocks has risen by two thirds in the same period; the first quarter 2013 GDP for Japan rose at an annualized rate of 3.5%.

Recall that Japan's development was extraordinarily robust for decades after World War II as it became one of the world's leading manufacturers of automobiles, electronics, and other industrial equipment. Its stock market and property markets reflected Japan's wealth and success; by the late 1980s, the total value of Japanese stocks exceeded America's. Near the end of 1989, Japan's principal stock market index, the Nikkei 225, stood just under 40,000 and Japan Inc seemed to by buying up America. Then the property markets and stock market collapsed; the economy fell into a series of recessions, and price deflation set in. Last year, China's economy surpassed Japan's as the world's second largest. With its aging population, hostility to outsiders (reflected in a policy of essentially no immigration), and the failure of its Fukushima reactor after the earthquake and tsunami, Japan was moribund. It actions and inactions since 1989 have been studied by prominent economists (including Fed chair Ben Bernanke) as examples of what not to do. Indeed, Shinzo Abe himself, as prime minister a few years ago, was an undistinguished failure.

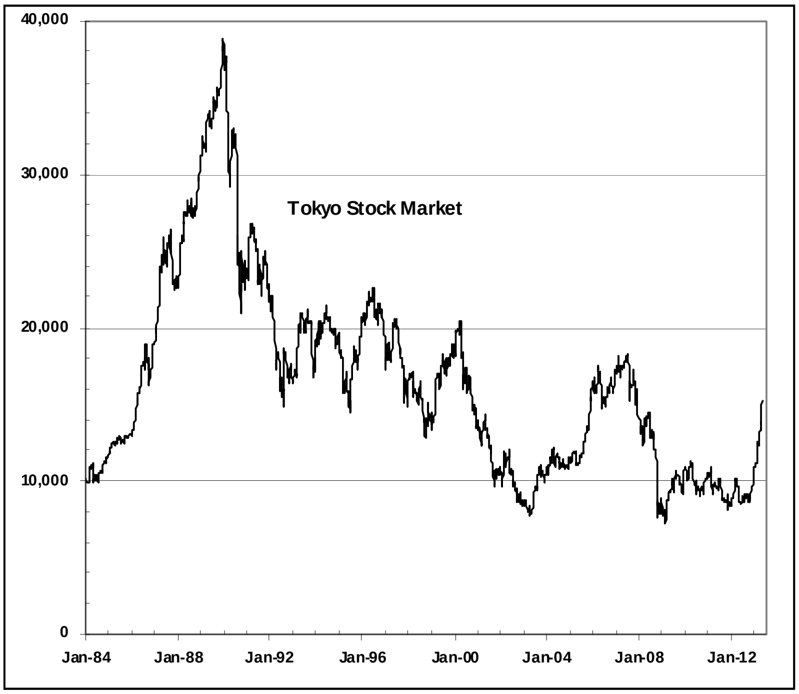
Does the remarkable new dynamism on display in Japan presage a real change in Japan? Will Tokyo's stock market continue to appreciate? Will Japan's economy grow after its two decades of slumber? Or, more ominously, is this one more important central bank engaged in an unsustainable policy of asset purchases--'quantitative easing'--destined to end very unhappily?

Despite nearly stagnant nominal economic growth since the early 1990s, Japan's mild deflation (i.e., falling prices) actually served to maintain the buying power--a real measure of wealth--of Japanese people. (Two percent deflation and zero percent 'nominal' economic growth means two percent 'real' economic growth.) And, although the yen kept rising in value against all the other

The Tokyo stock market rose enormously in the 1980s, only to begin a long collapse from 39,000 in the Nikkei 225 index in 1989 to 8000 in 2003 and 7000 in 2009. The recent torrid rally has brought the index well above 15,000.

With the yen falling markedly, the reinvigorated corporate sector in Japan may fuel higher stock prices. Core has a meaningful investment in Japanese stocks.

major currencies in the world, Japanese industry adjusted to higher the higher exchange rate by improving efficiencies. Hence, Japan continued to be a formidable export power house all through these recent decades. Perhaps Japan has been jolted into action by the increasingly assertive actions of its gigantic neighbor. Two insignificant islands long claimed by Japan, lying south of Japan in the East China Sea, are the subject of a territorial dispute in which China has taken ever more aggressive and provocative steps. There is a stridently nationalistic tone to Mr. Abe's rhetoric; the interplay between his nationalism and his fiscal, economic and monetary policies is not terribly clear. At all events, Mr. Abe and his policies are very popular and an upcoming election in Japan's upper house of it parliament will give his party a large majority there, enabling the government to enact its legislative agenda without meaningful opposition.



The central banks and the stock market's rally. We may not be able to parse the interplay between Mr. Abe's nationalism and his economic plans, but we can make sense of the interplay between central bank actions and the world-wide stock market rally. The four major central banks of the developed economies, the Federal Reserve, the Bank of England, the European Central Bank, and the Bank of Japan, have at various stages in recent years undertaken ever more aggressive monetary policies, first to lower the risk to the stability of the banking and financial systems, and second to stimulate stagnant economies. The most dramatic has been the recently announced policy of the BoJ of huge asset purchases. Smaller central banks have engaged in their own aggressive asset purchases; JP Morgan reports that one third of advanced country central banks now own equities directly. Recall that most central banks, including our Fed, generally held government securities only until the financial crisis.

With the BoJ announcement, it appears that many investors have finally concluded that, while the central banks continue to be buyers of so many investible assets, stock markets will continue to rise. The stock market advance has been slow and persistent. In the US, it has been supported by continuing growth in corporate profits, modest but real economic growth, marked improvement in the housing sector, decent if unremarkable job growth, and a distinct shrinkage in the federal budget deficit, as tax revenues increase, government spending falls, and Fannie Mae makes a large, one-time dividend payment to the Treasury. As things stand, and despite the big rally in the US over the last six months, valuations are not unusually high. When stock prices are measured against corporate earnings, the rally now is not like 1999 dot-com boom; it is restrained and supported by quite favorable ratios of earnings to prices.

For now, we at Core intend to maintain or build our stock market positions, particularly in Japan and the US, in the equity-oriented portfolios we manage. The bond portion of our portfolios are heavily weighted toward US corporate bonds, including high-yield bonds. We maintain our fairly large position in US dollar denominated emerging market debt, a very fruitful investment we have held for several years.

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

April 8, 2013

Slow Growth but Strong Stocks: What Gives?

By

Jack Mayberry

On the last trading day of March, the S&P 500 set a new closing record, exceeding the previous high set in October 2007, just before the terrible banking crisis ushered in a serious recession and a huge bear market. Although that recession long ago came to an end in the US, economic recovery continues to be weak, with frustratingly slow improvement in the jobs market.

Fiscal austerity and monetary liberality. Taxation and spending policies by most of the governments of the 'developed' economies (i.e., Japan, the Western European countries, Canada, the US and Australia) have mostly fallen into the thrall of theories about the virtues of fiscal austerity, generally involving higher taxes or lower government spending or both. The calls for austerity have arisen in the context of higher government deficits. Deficits increased, unsurprisingly, in the financial crisis and recession as government tax revenues fell while the demand for unemployment insurance and other social spending rose. As a consequence of the loss of jobs and the declines in the values of homes and stock portfolios in the crisis, the private sector--that is, people and businesses--cut their own spending and increased their savings in an effort to rebuild their diminished assets. As the private sector cut spending and increased savings, the overall economy would necessarily shrink unless government spending took up the slack.

In Europe and among many in the United States, the government deficits--arguably entirely necessary as a response to private sector retrenchment--were considered quite alarming; clamor to cut government spending arose. The situation in Europe has been complicated enormously by the regime of the single currency. In the Euro-zone, the various calamities in Spain, Portugal, Italy, Greece, Ireland and Cyprus required support of the creditor countries of the Euro-zone, led by Germany. The German approach has been to impose fiscal austerity on these countries--higher taxes and sharply reduced government spending--as the price for loans. The cost to the 'peripheral countries' has been ever higher unemployment and contracting economies.

The United States has had less of fiscal austerity than Europe. However, the belief in austerity among Republicans is powerful; Republicans have used their control of the House to thwart Obama administration proposals for various kinds of spending and investment to ameliorate the contractionary effects of high private sector saving.

The countervailing force against fiscal austerity is the easy monetary policy of the major central banks, the Federal Reserve (Fed), the Bank of England, the

European Central Bank (ECB) and, most recently, the Bank of Japan (BoJ). The central banks have engaged in distinct acts: cutting short-term interest rates close to zero, buying government and mortgage-backed securities, and promising to maintain these policies until certain economic targets (e.g., lower unemployment rates in the US) have been met. (In the case of the ECB, it has made a contingent promise to buy unlimited amounts of the bonds issued by troubled countries, but has not yet had to act on the promise.) The Fed has generally been the leader in these actions, but the ECB and the BoJ have in the last year taken dramatic actions with very salutary effects on financial markets.

High levels of private savings, low demand for private capital investment, and zero rates on short-term fixed-income investments have driven capital into investments in stocks and long-term bonds. Thus, despite recession in most of Europe and tepid economic expansion in the US, stocks and bonds have rallied.

The ECB and the BoJ. We have written about the ECB's promise last year to do 'whatever it takes' to preserve the Euro. Before that undertaking, investors were (quite reasonably) obsessed with fear that another financial crisis, akin to that occasioned by the Lehman bankruptcy, would arise from the Euro-zone crisis. As markets absorbed the ECB promise, the fear of systemic collapse in the financial sector gave way to the realization that the ECB would prevent such a crisis. What has followed is an environment with low risk, low growth and central bank assurances of easy monetary policies for a very long time.

The new Japanese government of Shinzo Abe and the new leadership in the Bank of Japan have lit a fire in Japan after two decades of deflation and stagnation. Last week the BoJ announced a program of asset buying on a scale proportionally greater than that underway by the Fed. The explicit target for the BoJ is inflation at 2%, a very far cry from the persistent deflation of the last many years. Japanese stocks have soared in price in recent months (up by more than 40% since Abe made his intentions clear), while the always too-strong Japanese yen has been crumbling (down by 22% since September against the dollar).

The interplay of fiscal drag with radical monetary policies. It is certain that the actions of central banks are distorting markets by driving capital into riskier assets. The distortion is that these riskier assets--including stocks, corporate bonds, and other relatively high yielding securities--appreciate in price more than warranted by underlying economic activity. The aim of the central bankers is that the 'wealth effect' of higher asset prices will translate into greater economic activity and offset the economically depressing effects of fiscal austerity. It is not at all clear that economies are stronger because of central bank actions. But I suspect that, without the assurances of Mario Draghi of the ECB to do 'whatever it takes' and without the ongoing asset purchase programs, economies would be weaker than they are. Moreover, without the programs, it seems certain to me that stock and bond markets would be much more volatile and much lower in price than they are now.

Since January, Core has built a fairly large position (for equity-oriented portfolios) in a fund that invests in Japanese stocks and hedges away yen exposure. Hence, the fund delivers to us Japanese stock market appreciation without the drag of the sharply falling yen. This has been a good investment for us, as have a number of others. Both equity-oriented and fixed income portfolios we manage enjoyed a very healthy first quarter. Hats off to Messrs. Draghi and Bernanke and their colleagues.

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

February 27, 2013

Central Banks: the Positive Force Behind the Markets

By

Jack Mayberry

Despite our dysfunctional government characterized by intense partisan squabbling and its failure to resolve even its short-term fiscal problems, stock markets in the United States moved steadily higher in recent months and the American economy continues its moderate growth. The private sector of the economy is finally showing more strength (notably, but not only, in housing) -- and a good thing too, because government spending is falling. European and Japanese markets have done well, despite their facing more severe problems and against the backdrop of contracting economies. Why the insouciance of asset markets during this long period of malaise in developed countries?

Fiscal and economic problems in Europe and the UK. As we have discussed in several letters, the actions and promises of the European Central Bank (ECB) last year proved to be a bulwark against systemic collapse of banks and the unraveling of the single currency. Borrowing costs for Italy, Spain and the other troubled 'peripheral' countries came down from impossibly high levels; markets have quite clearly decided to give the ECB the benefit of the doubt --or at least not to test its resolve. But recessions are deep in Mediterranean countries. More recently, the core countries joined in the recession. The entire Euro-zone economy is contracting. It is unrealistic to assume that economies of peripheral countries will be able to grow any time soon; the weakness in those countries adversely affects the stronger countries like Germany. Fiscal policies (taxation and government spending) are very restrictive across Europe; governments will do nothing to help economic growth. Keynesian economists are having fits and revising their textbooks with these further proofs that fiscal austerity is the last thing weak economies need. As a political matter, the election results in Italy show that tolerance for austerity, especially in the countries suffering from it the most, is absent. Are we surprised? Although it is too soon to predict what may flow from this election, it seems probable that the resolve of the ECB and the support from Germany will continue. The Euro-zone will remain intact.

The United Kingdom, which has its own currency and so does not face the terrible dilemma that plagues Italy, Spain and Greece, nevertheless has pursued policies of austerity for the entire life of its coalition government. Britain has slipped back into recession; Moody's downgraded UK government debt from AAA last Friday. (The Moody's downgrade does not give us any news, but it does exclaim the failures of Britain's austerity policy.)

Changes afoot in Japan. In the last two decades, Japan has suffered persistent deflation and one recession after another. Until last year, the exchange rate of the Japanese yen kept rising, stifling Japan's exports. The new government of Shinzo Abe is seeking radically to change both the fiscal and the monetary policies of Japan. Alone among the developed countries, Japan is embracing expansive fiscal policies to stimulate the economy. Moreover, Mr. Abe is applying political pressure to the Japanese central bank for looser monetary policies. He will soon be nominating a new head for the Bank of Japan (BoJ) to support his hoped-for policies. In anticipation of sharp changes in BoJ policies, the yen has fallen sharply in recent months, while Tokyo stock market has soared.

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Meanwhile, in the United States, our central bank continues to pursue its very accommodative monetary policies, against the backdrop of ever-tighter fiscal policy. Fiscal policy here is not nearly as 'austere' as in Europe or the UK, but not for want of trying by the House Republicans. The early January 'fiscal cliff' deal increased income tax rates on the highly paid and raised payroll tax rates, which, unfortunately, mostly affect low-paid workers. The looming 'sequester'--yet another self-inflicted fiscal wound--will cut federal spending by about 1.5% to 2% of GDP, unless headed off by an eleventh-hour deal. But, as Fed Chairman Bernanke keeps reminding us, the Fed's policies of extremely low short-term rates and its persistent buying of bonds and other assets will support the economy, in which, happily, the private sector is showing increasing vigor.

The result of all this--the bizarre election in Italy, the grinding, recession-inducing austerity across Europe, and the rest--will be the continuation of favorable monetary conditions that support financial markets. However belatedly, the ECB finally last summer promised to fulfill its unique and indispensible role as buyer of last resort for government bonds of the European countries enmeshed in the frightening liquidity crisis. (Had it done so earlier, millions of the now unemployed in Italy and Spain and Greece might have jobs. Oh, well.) Mario Draghi's promise has, in effect, nullified the threat that the Euro-zone crisis would lead to catastrophic bank failures and another Lehman-like experience.

With the risk of systemic collapse off the table, the characteristics of this environment are seen to be quite favorable to the owners of capital. One can hardly like the fact that labor markets are so weak and that compensation for labor is so subdued. But the unhappy labor market situation accounts, in part, for very strong corporate profits. Rising corporate profitability, combined with this favorable monetary environment of low interest rates and the high rates of private and corporate saving, almost necessarily leads to higher stock and bond prices. In his Congressional testimony yesterday and today, Fed chairman Bernanke restated the Fed's undertaking to keep interest rates exceptionally low and to continue its purchases, at the rate of $85 billion per month, of treasury bonds and other assets. (A report in today's Financial Times puts it, in a flip but cogent way: "[Investors] have inferred from his testimony...that such headwinds [i.e., the looming sequestration] only make it more likely that the Fed will stay looser for longer." The emphasis is mine.)

We continue to have fairly large equity positions (for our equity-oriented clients) in Europe and Japan and the US. Our fixed-income investments, including a REIT holding mortgages, emerging market debt, US high-yield and high-grade corporate bonds are all doing well; the policies of the Fed and other central banks favor these. So, despite the usual problems with governance of important countries (like ours) and somewhat dangerous countries (like Italy), we are positive in our outlook and our investments reflect the positive outlook.

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

January 7, 2013

From 2012 to 2013

Despite the quite sullen tone from Washington in the last weeks of angry posturing by the President and Congressional leaders, and the failure of the government to resolve the self-created 'fiscal cliff' problems, the investment environment is reasonably favorable as this year begins. The legislation that was passed in the early hours of 2013 involved taxes and unemployment benefits, and deferred the automatic spending cuts, previously scheduled to begin as of January 1 for two months.

The tax legislation. As for taxes, income tax rates established in the Bush tax cuts early in the last decade were made permanent, except for an increase from 35% to 39.6% on income above $400,000 per year for individuals and $450,000 for couples filing jointly. Also restored was the earlier phase out of deductions from income for those in the high income brackets. Capital gains and dividend tax rates increased modestly for high income taxpayers, from 15% to 20%. The 2% payroll tax 'holiday', enacted after the financial crisis, which reduced individual (not employer) Social Security withholding from 6.2% to 4.2%, was allowed to lapse. This two percent reduction in take home pay will have a meaningful impact on lower income wage earners and will probably reduce economic activity by a small amount. The legislation also provided for a modest increase in estate taxes.

Happily, unemployment benefits for the many long-term unemployed, set to expire at year end, were extended for another year, a very good outcome for the individuals who receive those benefits and for the economy, since, as is likely, virtually all those payments will be spent.

Spending and borrowing; the next round. The automatic spending cuts, a feature of the August 2011 deal meant to force Republicans and Democrats to negotiate something meaningful for government spending, were postponed for two months. Thus, we are faced with another miserable set of negotiations, which will also include the raising of the 'debt ceiling', the total authorized level of debt for the United States. Treasury Secretary Geithner announced near the end of the year that the US has reached the legislated limits of it borrowing power. Work-around solutions will permit further borrowing over the next couple of months only. Republicans vow to use the necessity to raise the debt ceiling to force long-term spending cuts in Medicare, Medicaid, Social Security, and other 'entitlement' programs. Obama declares that he will not negotiate. A couple of ugly months in Washington are in prospect.

By

Jack Mayberry

Apart from politics and governance, things look reasonably good. Despite persistent uncertainties about US fiscal policy--government's taxing and spending policies--economic growth, while not brilliant, has been reasonably solid. The employment situation is improving, as is the housing market. The development of new sources of low-cost energy is spurring domestic manufacturing and exports; corporate balance sheets are very strong, and the Federal Reserve continues to provide support for the economy and the financial markets through its very accommodative monetary policy.

In Europe, the salutary effects of the European Central Bank's promise, enunciated last summer by its president, Mario Draghi, have taken the crisis off the boil. Confidence is growing that the Eurozone crisis, harmful as it is to the legions of unemployed across the Mediterranean, will not spin out of control and cause a catastrophic banking and financial markets collapse. This has permitted the extremely depressed (in relation to US markets) European stock markets to improve. Our large investment positions in Europe are prospering.

The ever-larger roles of governments and central banks. It is hard to overstate the importance of governments and central banks on economies and financial markets since the onset of the banking and financial crisis in 2008. The Eurozone crisis and America's 'fiscal cliff' problems flow directly from that crisis, although other issues (e.g., ever-rising health care costs in the US and inherent problems of sharing a currency among countries without common taxation and fiscal regimes in Europe) contribute very meaningfully to these problems. It is quite likely that Europe's current recession results from the misguided--not to say pitiless--imposition of fiscal austerity on governments, e.g., the raising of taxes and the cutting of social spending by governments. Such prescriptions are an article of faith on the political right, despite the exceptional economic weakness in the UK and in major economies in Europe that have undertaken austerity measures too soon after the 2008-2009 crisis. The relative strength of the US economy, as compared to those, should persuade policy makers in Europe, the UK and America that fiscal austerity shrinks fragile economies. But now the US is embarking on its own premature austerity. Last week's tax increases are round one; looming spending cuts in upcoming negotiations will be round two.

Apart from the economic consequences of policy judgments is their effect on financial markets and investing. One is obliged to guess the effects on financial markets of decisions that may be made and actions taken by numbers of different policy makers. Core's recent judgment about year-end 'fiscal-cliff' negotiations, namely that something would be done at the last minute to avert the worst appears to have been correct; hence our portfolios, invested in line with that view, were untroubled. Last summer, by contrast, we feared that the Euro-zone crisis, then was driving up interest rates in Italy and Spain to impossibly high levels, would worsen and create another round of widespread selling across many financial assets. We underestimated the influence of Mario Draghi's words and his contingent promises to do what was necessary to prevent the crisis. Fearing a significant market decline, we turned Core's portfolios to a defensive posture to prevent significant loss in another wave of selling. The wave of selling did not come; Mario Draghi's promises were enough, and markets rallied. Our hedging position prevented Core's portfolios from participating in the summer-time rally.

We believe that our mandate from you is two-fold: to preserve your capital and to earn a good return on it. Often we achieve both goals; sometimes our capital preservation instincts hurt the returns our portfolios earn. Politicians do not make this job easier. On to the New Year!

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