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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January 7, 2013

From 2012 to 2013

By

Jack Mayberry

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.

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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