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

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A Strong Start to the Young Year

Strong stock markets in Europe and Japan and the weakening euro and yen flow in large part from the massive European and Japanese central bank asset purchase plans.

The European Central Bank will begin its asset purchases next week, but its January announcement of the program's dimension galvanized stock and currency markets.

The combination of liquidity provided by central bank programs and modest improvement in economic growth have been the forces behind this year's healthy stock market gains.

By

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The new year has begun very well for our investments, particularly in foreign stocks. This somewhat reverses the results from 2014, when US stocks were quite strong and European stocks rather weak. As discussed in our last letter, the European Central Bank (the ECB) finally announced its plans for a very large and open-ended program of asset purchases, referred to as 'quantitative easing' or 'QE.' This plan, involving the purchase (mostly of bonds issued by European governments) of €60 billion per month for eighteen months, was announced in January and will commence next Monday. The planned purchases are designed to enhance economic growth in the Euro-zone countries and to counteract deflationary forces in Europe. Whether these results are achieved by the ECB's program is by no means certain. However, it is quite likely that the asset purchases will cause prices of various European (and other) assets--including bonds and stocks--to rise in price. The outperformance by European stocks this year may be attributed in part to the ECB's announcement of its QE intentions.

The decline of the euro. Additionally, it is reasonable to expect that QE will cause the exchange value of the euro to continue its decline against the US dollar. The euro has already fallen by about 20 percent against the dollar since May. It may fall further because the US economy is stronger than Europe's and because the Federal Reserve has finished its asset purchases and will probably begin to raise interest rates later this year, while the ECB just begins its own quantitative easing now. The differences in rates of growth and in monetary policies are likely to cause the euro to decline further against the US dollar. (Note that for Core's investments in European stocks, we use a fund that hedges away the euro currency effect, thus the decline in the euro does not cut into the returns earned by appreciation of European stocks.)

The tone improves in Europe. Despite slower growth in Europe, things European are decidedly less gloomy than they have been in recent years. The interim deal made last week between Greece and the parties involved in 'assisting' Greece with its large debt burden--the European Union, the ECB, and the International Monetary Fund (the IMF)--suggests strongly that an arrangement will be made with Greece that will keep Greece within the Eurozone and will not disturb financial markets unduly. (Whether it lessens the severe pain that Greeks have suffered in recent years from the economic depression into which the country has fallen is quite another matter. Let us hope so.) And, after a rather grim 2014, when most European economies were teetering at the edge of recession and deflation, the prospects for 2015 are more positive. Economic growth is hardly robust, but estimates are being raised, not lowered.

Japan and other equity markets. Similarly, Japanese stocks have been quite strong so far this year. The massive quantitative easing program by Japan's central bank has been under way for over a year. Its effect has been to increase the prices of Japanese stocks and to bring down the exchange value of the yen. (Precisely as we expect, *mutatis mutandis,* from the ECB's QE program.) As with our European stock investments, so our Japanese investments have been hedged against the yen's decline. Early this year, we added an unhedged Japanese stock investment, alongside our hedged one, on the notion that the yen's decline may largely be over. The US stock market has lagged Japan and Europe a bit this year, but it made another new high at the beginning of this week. Although the Fed will begin 'normalizing' interest rates later this year, its policy is still very accommodative; it provides a good tail wind for US stocks and helps the US economy.

Two factors have helped the world's stock markets recently: the liquidity provided by the world's major central banks and the modest but real economic growth in most regions. Central banks increase funds available for investment through their asset purchase programs, while, at the same time, their purchases withdraw significant amounts of government bonds from the markets. The Federal Reserve now holds $4 trillion of securities; Japan and Europe are engaged in multi-trillion dollar purchase programs. The effect is to drive up prices of bonds and push investors into other assets, like stocks and real estate. Central bank liquidity will remain a formidable factor in financial markets all this year and perhaps some time beyond.

Russia. After writing this rather cheerful account of central bank actions, financial markets, and growing economies, it is depressing to turn again to Russia. In the last month came another cease fire agreement settled in Minsk among Putin, Merkel, Hollande and Poroshenko. Before the ink was dry, the Russian-backed forces in the eastern part of Ukraine declared that the agreement did not apply to the railroad junction they were attacking, so the fighting continued there. Then came last Friday's murder on a Moscow bridge in the shadow of St Basil Cathedral of Boris Nemtsov, the able Russian opposition leader. It is plausible to consider this an assassination approved, if not ordered, by Putin. Or, in the climate fostered by Putin's characterizations of political opponents as 'traitors' or members of 'fifth columns,' it might be that a radical group sympathetic to Putin murdered the 'traitor.' It is quite possible that we will never know what happened, but this act shows us once again that Putin is prepared to go to extremes to maintain his power.

Dreadful as Mr. Putin's Russia has become, we should not overestimate the impact of these Russian and Ukrainian matters on investment markets. Geopolitical events, however nasty, rarely have a meaningful impact on financial markets. The Arab oil embargo in the mid-seventies is an event that did bear heavily on markets for a long time, but all the wars and terrorist attacks since have had little more than fleeting impact. To put this another way, Janet Yellen is far more important to investment markets than Vladimir Putin.

Mr. Putin, with his vast arsenal of nuclear weapons and, apparently, some very able special forces units, could rival Ms. Yellen in importance if he should escalate things enormously, by invasion of Estonia and the other Baltic states, or otherwise. Until then, we can consider these unhappy events in Russia and Ukraine without worrying unduly about their impact on our portfolios.

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