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

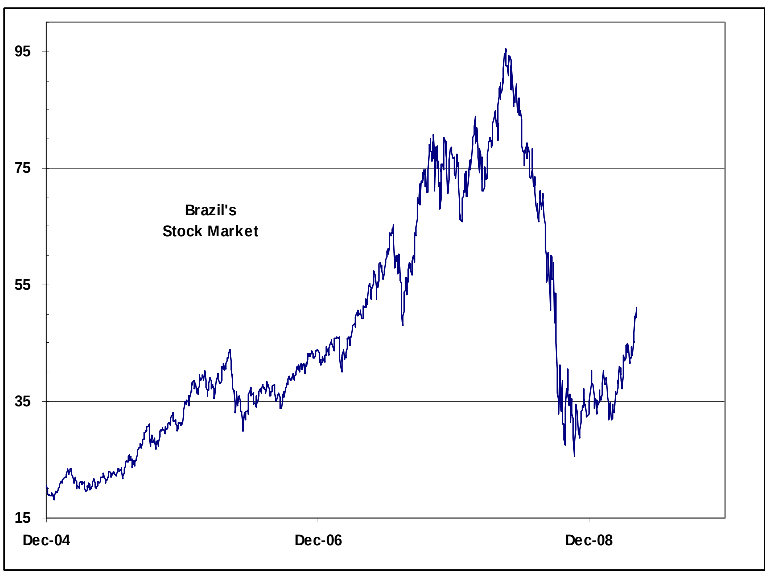
May 11, 2009

Actions and Confidence

Stabilizing the banking system and recapitalizing the banks have been the primary work of the Fed and the Treasury for many months. The process is a mix of real actions by the Fed and the Treasury, and of intangible efforts to buy time and raise confidence.

The stock market has moved ahead steadily since early March, suggesting that the financial system and the economy are on the mend--or at least in anticipation that things will improve in time. The federal government's reports on the ability of the 19 largest banks to survive losses that may lie ahead--the 'stress tests'--were leaked to the press over the last two weeks, then released on Thursday last week. The stress tests purport to show that much more bank capital is needed, but the perception seems to be that the combination of private capital and anticipated earnings can supply that capital. Markets took comfort in this view and continued to rise.

As March began, there was palpable fear that the banking system was insolvent and that the actions of the Treasury and the Fed would be insufficient to stabilize the system. At least in the short run, it appears that those fears were overdone. The intense selling came to an end; confidence in Treasury Secretary Geithner grew; fear was supplanted by optimism. The sectors of the stock markets that had suffered the biggest losses, including bank stocks, began to rally very sharply. Fixed income markets improved markedly, especially US corporate bonds, which began to trade at more normal levels in relation to government bonds. The dollar, which gained sharply in value as the crisis worsened, began to decline again against foreign currencies, another sign that markets are functioning more 'normally'.



In the months after the shocking collapse of Lehman Brothers, and the effective ends of Fannie Mae, Freddie Mac, and AIG as private firms, the world's financial system was very close to complete failure. It was only the large central banks (especially the Federal Reserve) and national governments (especially our Treasury Department) that had sufficient resources to rescue the financial systems and to keep economies from severe recession or worse. The rescue attempt was approached from two quite different levels: fixing the real-world problems and restoring confidence. The first level involved deciding how to provide capital where it was needed, deciding whether to preserve the banks as private companies or to 'nationalize' them, and choosing which firms should survive and which should be allowed to fail. These decisions are enormously complex; many were required to be made under exceptional time pressure. In the fullness of time, we will be able to judge which were the good decisions and which were poor.

By

Jack Mayberry

Confidence Building. The second category of rescue involves the intangible matter of restoring confidence that the system would survive and would be repaired. Restoration of confidence is fantastically important. A complex global banking and credit system can work only if its participants can trust that it does work. The collapse in investment markets between September and March shows what happens when trust and confidence are eroded. Awkwardly enough, America had a presidential election in November. The outgoing Bush administration did not have the authority in the months before January 20 to forge long-term solutions and to rebuild shattered confidence. It took time for the new Obama administration to take on the task effectively.

It seems to me that improvements in equity and fixed-income markets since the early March lows flow from reasonably successful work by the new administration in restoring confidence, my second category rescue. This is not to discount the very significant and helpful actions by the Federal Reserve, nor to ignore the specifics of the banking rescue and reform actions by Treasury. But at best the repair of banks' balance sheets is a long-term process; it is clear that there are huge losses that banks will incur in the coming year and more. As banks earn money and raise capital in coming months, we will see whether capital is built up more quickly than it is lost.

Brazil, China, and other developing economies have been largely untouched by the banking problems in America and Europe. We have made investments in these markets recently.

For now, though, the confidence-building efforts of the Obama administration and the Federal Reserve are working. With luck, the real economy developments will be helped by the various emergency actions of the last six months and more. If so, the recession will come to an end, the world will have a functioning credit and banking system, and investment markets will recover. It seems highly doubtful to me that these improvements will proceed in a straight line. Instead, the more likely course will be the roller coaster ride of fear and hope, each punctuated by very sharp swings in asset prices.

Core's investments. Since the beginning of March, we have moved in measured steps into various sectors of financial markets now emerging from intensive care. We have reduced cash positions in accounts by 35%, added 20% to corporate bond positions, including initial investments in high-yield bonds, took a 6% position in foreign currencies, 2% in gold, and increased equity investments by 5%. (Note that these are aggregate figures for all of Core's accounts. As always, there is variation among individual accounts.)

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Core has made its investments over these last two months on these assumptions: First, within twelve months, economies, including America's, will be recovering from the recession. Second, there is meaningful risk that banks will lose enough from commercial real estate, student loans, auto loans, credit card loans, and further losses from US housing to renew doubts about the banks' solvency. Third, developing economies, especially China and Brazil, are sufficiently divorced from America's banking problems as to be able to grow strongly. Fourth, US corporate bond markets offer exceptional value, without much risk and with good return prospects. Fifth, the Fed's expansion of the asset side of its balance sheet and the federal governments needed but risky deficit spending create inflation risk and US dollar depreciation opportunity.

In our view, the environment remains risky, but some areas--US corporate bonds (including low-grade bonds now), equities in and around China and Brazil, and some inflation hedges--present opportunity without too much risk. Your capital resides there.

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