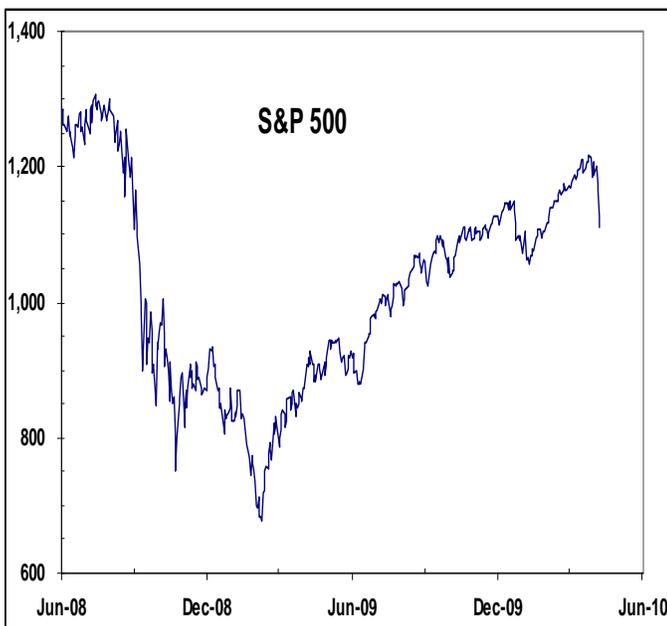


May 9, 2010

Tumult Again.... ... but with the Wind at our Backs

As the Greek debt crisis worsened and European leaders dithered, waves of selling swept across global markets, interrupting the strong recovery in stock markets.

In the midst of another bout of fear and indiscriminate selling in global markets, it seems the occasion to write again. After some dalliance with Goldman's misdeeds in arcane securities (which may well affect the future schemes of regulation of bankers and traders and markets), the sovereign debt problems with Greece and the slow unwinding of the Euro took command of investors' attention. On Thursday, we were treated to the inept performance of Jean-Claude Trichet, the head of the European Central Bank, as he carefully explained that the ECB would not take extraordinary action to counter the deflationary aspects of the crisis. Afterwards, our attention was directed to the ongoing demonstrations, strikes and riots in Athens, while its Parliament reluctantly debated the choices on offer: disaster or catastrophe.



As we watched some live TV from Athens, showing a line of calm, heavily armored police facing a line of young, unarmed protestors, the US stock market was absorbing a third day of selling, down about 300 Dow points. In a weird kind of simultaneity, the Dow began to drop precipitously and the baton-swinging police moved forward. An unfortunate lad stepped into the line of police and received a painful whacking. At the same time, the machinery of the US stock market went haywire. Stock in Procter & Gamble, the unassailably strong consumer products company, which had been trading at 62 at 2:40, was suddenly shown to have changed hands at 46. The Dow, in which P&G is a big component, suddenly began a spiral down. Within minutes, it had fallen by more than 950 points. Other important stocks also fell by 30% or more (Accenture fell by more than 95%). But then, within a few minutes, the weird declines were reversing, and within a half hour, the market was back to its level of an hour before. The system had failed, in ways not yet known as we write on Sunday.

Things are a mess, it appears.

By

Jack Mayberry

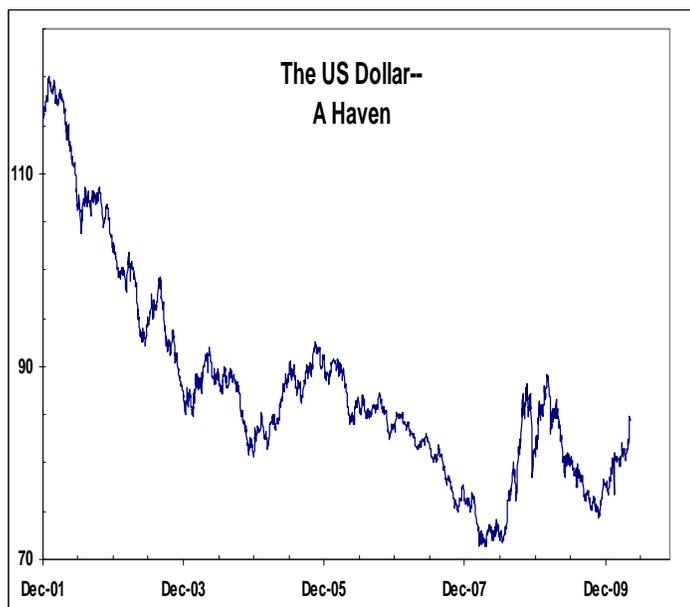
Investment prospects now. Before discussing aspects of the disorderly markets and the problems in Europe, a word on investment prospects. From the summer of 2008, as Fannie Mae and Freddie Mac were at the point of failure, through the collapse of Lehman in September, and until March 2009,

The crisis in Europe has weakened the Euro and put into question its long-term survival. The US dollar is seen once again as a haven during crisis, as it was during the acute phase from the summer of 2008 until the spring of 2009. It has been rising this year.

As discussed in previous letters, some minor currencies (e.g., the Canadian and Australian dollars) and a number of currencies of the developing Asian and Latin American economies have been stronger even than the dollar. We expect those currencies to remain strong.

the growing catastrophe in the financial world made the collapse of the banking system and the investment markets seem a distinct possibility. The Federal Reserve Board, the US Treasury and Congress undertook a series of policy actions entirely without precedent. In time, it became clear that the extraordinary set of actions was sufficient to stabilize the banking system and the financial markets. Slowly banking began to return to more normal functioning and markets began to recover from the lows of March 2009. Because all investment assets--with the exception of the US dollar, the Japanese yen, and US and Japanese government bonds--fell very sharply in the nine months until March 2009, the subsequent rally was very widespread and it was very powerful.

The severe recession in the United States continued after markets began their recovery, but the economy resumed growth in the second half of 2009; growth has continued this year. Indeed, after the terrible loss of jobs--more than eight million in the United States--jobs are now being created again at a reasonably robust pace. The recovery owes a great deal to the largesse of the federal government, just as the healing of the banking sector is unfolding because of exceptional policy actions of the Fed and Treasury. It is not at all certain that growth is self-sustaining yet; that is, one cannot be sure that growth would continue without government support. It would be a risky and unwise experiment to withdraw that support too early. The Fed and the Obama administration have no wish for the federal government to stand aside now, but there is an ever-louder chorus of protest against the deficit spending. It is apparent that the Republican party will contest the November elections by campaigning against the emergency policies and spending.



In our view, the bull market that began in March 2009 will continue at least for the rest of this year, and probably for longer. We have had brief bouts of selling since last March--in June and July and in October last year, in January this year, and now again. We expect this present round of selling to come to an end and for the stock market to continue its advance. Other bouts of selling will emerge in the course of this cyclical bull market, but the favorable conditions that now exist will continue to support the stock market. These favorable conditions include the Fed's very accommodative monetary policy, the improving economy, growing corporate profits, and the continuing economic stimulation by the federal government. As discussed below, probable future actions by the ECB may enhance all of this.

Greece and Europe; Democracy and Inaction. The sovereign debt problem facing Greece has been quite apparent for some time. The risks of inaction--namely that the crisis would spread beyond Greece to Portugal and Spain and would become much less amenable to resolution--have likewise been apparent. The solutions, too, have been fairly obvious. Because the world has so recently suffered through a banking crisis, the playbook for handling this is well known and at hand. I wrote about this in a letter in March and there is little new to say, except about the long delays in putting a plan in place and a discussion of possible outcomes. (The March letter may be found on Core's website at http://www.coreasset.com/publications/archive/mar2010corecomments_march112010.pdf.)

The plan on the table and being enacted in various European capitals involves

A political consensus on how to handle the sovereign debt of the southern European countries has been impossible to achieve. While the debate has gone on, market forces have shown the conditions to be unsustainable.

Something must give.

funds from the Euro-zone countries and from the International Monetary Fund (the “IMF”). The deal will put Greece in a terrible fiscal straitjacket, involving much higher taxes and much lower spending by the Greek government. Because the rolls of public employees in Greece are so large, the cut in spending translates into far lower pay for Greek workers. In return, the government of Greece will not have to borrow money on public markets for about three years and, for now, at least, there will be no default and re-structuring of existing Greek sovereign debt, mostly held by European banks. If this all comes about, then the Greek economy will suffer an enormous deflationary shock and a terrible recession. Economic output and income will fall sharply.

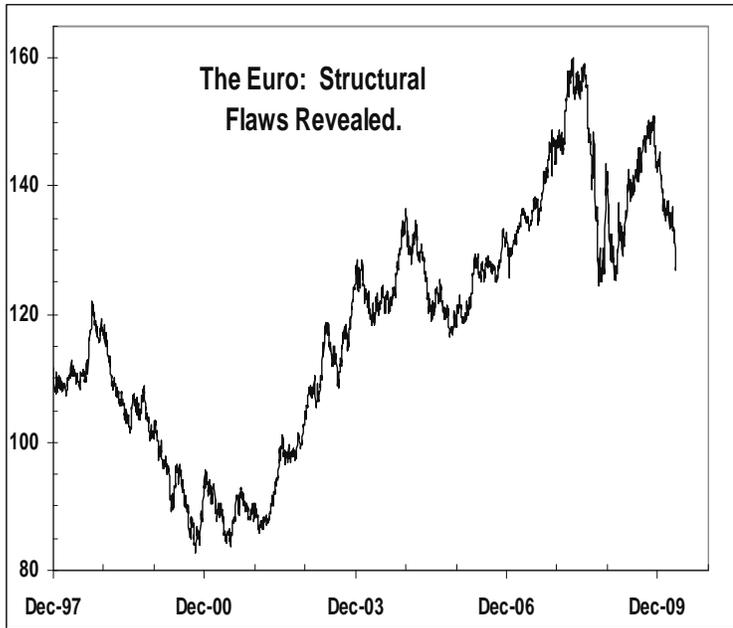
Because of fierce political opposition in Germany to the ‘bail out’ of the Greeks, the plan has existed solely in the realm of imagination for the last couple of months, during which time the financial markets have measured the likelihood of default on existing debt and the improbability of this working. The result is much higher borrowing costs for Greek, Portuguese and Spanish debt. A former French finance minister, Alain Madelin, summed up the situation succinctly: “Politicians are saying that markets are acting irresponsibly, but instead what is really happening is that markets are starting to ensure that politicians act responsibly.”

With the entry of the Greece and others into the Euro zone some years ago, the borrowing costs for the governments of Greece and Portugal became essentially as low as for Germany. This caused a large-scale misallocation of capital. Greece and Portugal were nowhere close to being as credit-worthy as Germany, but they could borrow as if they were. Capital flowed to Greece, Spain and Portugal at very low cost and in high volumes. This resulted in high wages for Greek public workers and way too many new houses in Spain. It was a poor use of capital and it seems quite likely that a good deal of it will not be recovered.

The outcome for the Euro is very uncertain; some ‘peripheral’ countries may leave the Euro. The entire single currency experiment may end. The inherent structural flaws with the Euro, about which I wrote in March, are now in plain view, and the Euro’s status as a reserve currency is in serious doubt. (Central banks are estimated to have lost \$300 billion in the value of their Euro holdings so far this year.) Over the next several months, the European Central Bank will likely be forced to adopt the kind of quantitative easing undertaken by the Fed beginning in the latter part of 2008, in order to offset the deflationary shock in Europe. This will probably stimulate economic activity, at least in the ‘core’ northern European countries like Germany and the Netherlands, and it may well bring about a sharp rally in European assets.

More Chaos in Financial Markets. After months of calm and rising prices, volatility and selling came back to the markets in the last two weeks. The deterioration of conditions in southern Europe was the prime cause, and it seems quite likely that the Greek problem will continue to unsettle the markets in the weeks and months ahead. Could turmoil in southern Europe evolve into a global financial crisis, akin the one that unfolded after the collapse of Lehman? I very much doubt this. When Lehman collapsed, the economy was already in recession and monetary conditions were far less accommodative than now. The backdrop to the Lehman collapse was the bursting of the US housing market bubble and the credit bubble. The southern European problems are of a far, far

smaller scale. The global economy is now expanding robustly and the policy tools to handle the crisis are tested, understood, and ready to be deployed. The European Central Bank has been slow to act, but it seems probable to me that the crisis will force action. The monetary actions needed to offset the deflationary aspects of the Greek 'rescue plan' will be very stimulative to the European economy and to financial markets. Add to this the likelihood of a still weaker Euro and it is not hard to imagine an export-led boom for France, Germany, and the Netherlands.



Market dislocations. The stock market action on Thursday afternoon was quite disturbing. The US stock market broke down in what seems to have been a failure of systems, most likely related to so-called 'high frequency trading', in which computer-generated algorithms trade on the slightest movements and for the shortest duration. In a few minutes, the Dow fell by 700 points, then regained 600 of those points shortly thereafter. Many individual stocks and funds experienced inexplicable and extreme losses.

We took advantage of this chaos, by buying more of the emerging market bond fund we hold in most client accounts. For the last several months, this fund has traded quietly between 12.60 and 13. On Thursday it began to fall from 12.60, and traded below 11.40 during the mid-afternoon tumult. This is for a fund that pays a dividend of \$1 per year as it collects interest from its bonds. On Friday, we increased our investment from about 3% to

6% at an average price of about 12 even. We have been hoping that we could buy this fund at a lower price, and this week we took advantage of the temporarily low prices. We will be happy if we can make other attractive investments in coming weeks; we have our eyes on a German stock fund, which has fallen by about 20% in the last few weeks. As discussed above, we think the southern Europe problems will have a good result for many German companies.

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Notwithstanding opportunities that market dislocations create, Thursday's trading problems leave a very sour taste, particularly coming so close to the unsavory news about Goldman. If these events do not make a compelling case for restructuring and regulating the banking and trading systems, I cannot imagine what can. However, the sheer complexity and the opacity of existing systems make it quite hard to know what structure and what regulations will work. Then, assuming that we articulate an effective and intelligent set of reforms, politics comes into play. The banking industry lobbyists are tenacious; they command the attention of many legislators of both parties. In addition, the avowed interest of Republicans to thwart any and all legislative initiatives of the administration make the enactment of good financial reform quite tricky, to say the very least.

This story will continue.

COREComments



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