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

November 27, 2013

Fiscal Squabbling on the Back Burner...
...Markets Placid and Positive

By

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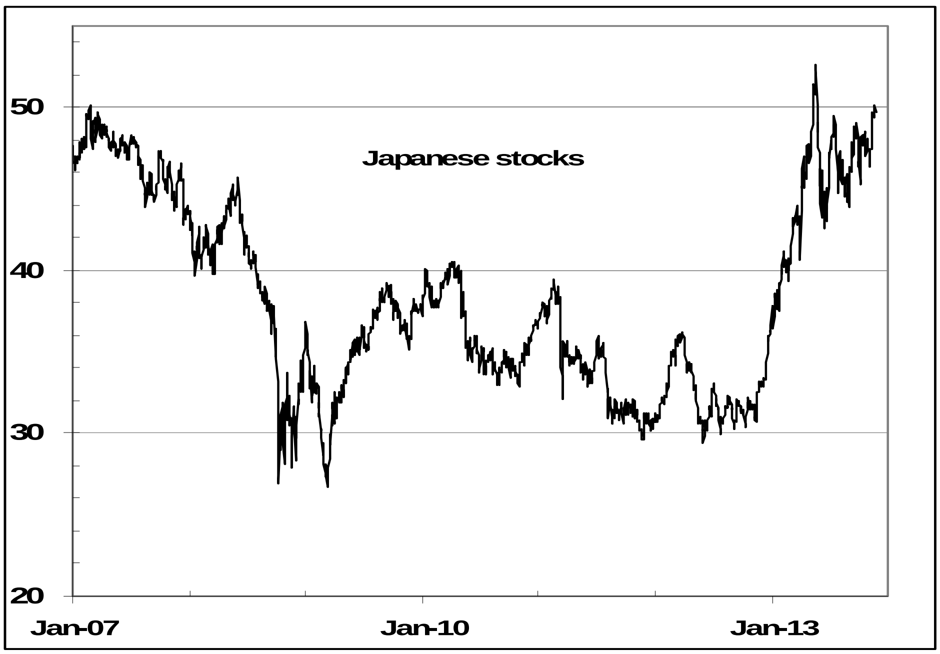
Since last month's letter, written after the end of the government shut down, things on the fiscal front in Washington have been quieter, especially with attention focused on the utterly botched health care website. The deal to end the threatened debt default and shutdown provided for, among other things, negotiations between the House and the Senate on a federal budget. There are indications that something constructive may emerge from those talks, and, given the bruises from the debt default farce, it seems likely that the new year will not bring another round of that. Meanwhile, President Obama's nomination of Janet Yellen, Vice Chair of the Federal Reserve, to succeed Ben Bernanke as Chair was approved by the relevant Senate panel with some Republican support, suggesting that her approval by the Senate as a whole is likely. Given that Ms. Yellen is fully in support of the Fed's policies and, perhaps, even somewhat more 'dovish' than Mr. Bernanke, the expectation is that the Fed will continue with the policies that have been so supportive of asset markets, especially the stock market.

Recently, some prominent economists, including Larry Summers, the former Treasury Secretary, and Paul Krugman of Princeton (and the *New York Times*), have discussed a disturbing idea, namely that low economic growth is not just a function of the aftermath of the fiscal crisis, which induced individuals and companies to save more and invest less and spend less. Rather, Professors Summers and Krugman put forward the notion that relatively low growth and low capital spending began a few decades ago, suggesting that these are not just the problems of this business cycle, but of a longer-term ('secular') nature. Add to this the inclination of governments in developed countries also to invest less (in infrastructure, public works, education, research and the like) and to restrain discretionary government spending. This combination of fiscal austerity in the public sector and less investing and spending in the private sector may cause economic growth to remain quite weak for a long time. If that is so, then we may expect the central banks of the US, Europe and Japan to continue their exceptional monetary policies, which policies clearly benefit financial and real estate markets, whatever is their effect on the 'real' economy.

Low growth, high rates of private sector savings, and the concomitant disinflationary--if not deflationary--effects have produced an environment in which financial assets have flourished. From the perspective outlined here, a continuation of favorable stock market action is quite likely. As a result, Core is maintaining its fairly high level of equity investments. As we have discussed, among these are some hefty investments in Europe and Japan. (On the next page is a chart of Japanese stocks.) After the seemingly endless episodes of crisis and temporary resolution in Eurozone matters, calm has prevailed and most Eurozone countries are returning to modest growth. (We are not arguing that Europe has resolved its problems with its common currency, merely noting that in the calmer environment, the economies of most Eurozone countries have stabilized and turned to modest growth.) We expect our European and Japanese investments to continue to appreciate. We have avoided equity investments in developing countries, in large part because of the expectation that the Fed's planned decrease in the rate of its asset purchases, now running at $85 billion per month, will and is hurting such investments, by inducing investors to withdraw capital from those countries.

Japanese stocks began to climb late last year, as Shinzo Abe's victory came into prospect. After some fallow months recently, markets see further actions by the government and the Bank of Japan, its central bank, to stimulate the economy. Another leg up appears to have begun.

In this connection, we recently sold a portion of the emerging market debt fund investment, precisely for the reason that the Fed's anticipated actions are causing investors to shun the region. We may sell more of that position, despite its large and safe dividend. Similarly, we recently sold Starwood Property Trust, a REIT that holds mortgaged-backed securities. About half of the enormous monthly Fed asset purchases have been of mortgage-backed securities; Starwood appears vulnerable to the coming reduction in the rate of these purchases. We have invested a portion of the proceeds of these sales in the Loomis Sayles bond fund and another portion is a fund that holds US companies that consistently increase their dividends.



Dissonance at Thanksgiving. Winter descends upon New York, where I write this. It was close to 20 degrees and quite windy as I began composing this. A storm is threatening. There is an uncomfortable irony in describing the ways in which the present is favorable for investors, in that globalization and other forces have given rise to a situation in which labor--work by people--constitutes a smaller portion of the expenses of businesses. This 'increased productivity' means that a greater proportion of corporate revenue flows to owners of businesses than to those working in those businesses. This favorable setting for investors spells hardship for people. As the season turns cold, people suffer. Fiscal austerity, which manifested itself recently in an effort by Congressional Republicans to cut food stamps very sharply, may have a favorable outcome for investors of capital, but…. We are investing fairly heavily in Europe as the crisis recedes. But the management of the Eurozone crisis has given rise to terrible levels of unemployment--27% in Spain and in Greece, and 12% in the Eurozone as a whole. Income inequality is the rather dry phrase used to describe the situation in which economic benefits flow disproportionally to capital at the expense of labor. That all is well for those with money does not seem quite enough with Thanksgiving at hand and the year-end holidays immediately ahead.

Core's business is managing the capital for its clients and we seek to earn a decent return on capital while subjecting our clients' assets to as little risk as reasonable. The environment for capital is fine; increasingly the same environment is a hostile one for many people.

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