CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

October 29, 2013

Brinkmanship in Washington, But Markets Move Higher

The country endured an utterly unnecessary and costly shut down of the federal government and an utterly unnecessary and very, very damaging walk to the precipice of default. The result was another eleventh hour deal that re-opened the government and raised the debt ceiling to permit the Treasury to sell more bonds to finance obligations of the United States. However, in typical fashion, nothing was really resolved and we face unappealing deadlines in December, January and February, deadlines that threaten to give rise once again to this mad display of failed governance.

And, the response to all this from financial markets? Misguided insouciance? The stock market trembled at little--but only a little--during the latter part of September and early in October, but the general expectation was that default would not happen. Indeed, in the early days after the shutdown began on October 1, it was reported that House Speaker John Boehner had told his caucus that he would not permit a default on US debt.

Perhaps it was not unwarranted optimism that pushed the US stock market higher in September and October. Although default by the United States would have been a disaster for economies and financial markets around the world, it was a reasonable bet--one in which Core joined on your behalf--that not even the House Republicans would permit such an outcome. Core held its stock market positions through the debacle; we have been rewarded for it with very strong results for September and October.

What next? It is foolhardy to guess what may unfold in Congress in coming months. The Republicans play a weak hand effectively. Although the party only controls the House, it has imposed its brand of shrink-the-government with shrewd strategic and tactical moves. It uses a combination of irrational and destructive threats from its Tea Party wing with implacable opposition to all things put forward by the administration and the Democrats in the Senate. This strategy gives us the damaging chaos of early October, but it also forces the spending cuts that Republicans want and a refusal to countenance increased spending on education, public works, medical research and the like. However one views the merits of these goals--it is probably clear that I think them poor--one must admit that the Republicans are accomplishing the fiscal austerity they relish.

By

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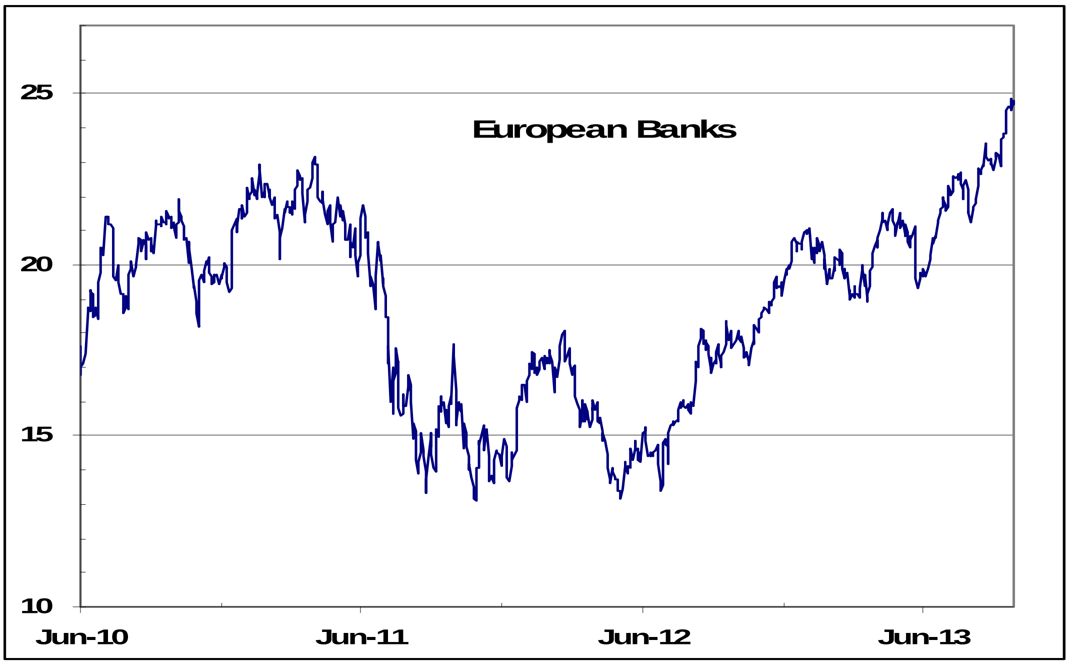
The estimates are that the government shutdown will have cut economic growth by 0.6%--a meaningful shortfall when growth is only around 2% per year--and perhaps 120,000 jobs. Despite the real economic costs of the shutdown and the threat of default, there is an ironical benefit to the owners of capital in all this, namely that the Federal Reserve is quite likely to keep buying treasury bonds and mortgage-backed securities for a longer period than had the DC debacle been avoided. For many months, the Fed has been purchasing $85 billion per month of these securities. In May, Fed chairman Ben Bernanke been to discuss the 'tapering' of these purchases. It had been expected that the 'taper' would begin in September. As discussed in our last letter, at its September meeting the Fed decided to continue the $85 billion per month pace. The shutdown and deficit-ceiling mayhem, with the slowdown in growth that it appears to have engendered, makes it more difficult for the Fed to begin to reduce its rate of asset purchases. Although these purchases seems to have only a modest effect on the real economy, they have a very salutary effect on the prices of assets--including stocks, bonds and real estate.



The Fed's dual mandate concerns inflation and employment. The recent employment report for September, i.e., before the partial government shutdown, painted a picture of weak job growth in recent months, notably weaker than in the months preceding Bernanke's first comments about tapering. Moreover, recent inflation reports suggest that deflationary forces are stronger than inflationary ones. Both factors suggest that the Fed will be slow to reduce its rate of asset purchases. This is a distinct benefit to investors in equities. The party goes on.

Europe. We have written in recent letters that we expect the stock markets in Europe to do better than the US market and that we have increased our equity investments in Europe to capture some of this. Europe's outperformance is underway. Strong as US markets have been recently, German and other European markets have been stronger still. The nearby chart shows price action of the European banking sector in the last three year, and the strong gains since the summer of 2012 at one of the crisis points in Europe. Our expectation is that this process will continue; we believe that the portfolios we manage will benefit from the larger investments in European stocks.

In short, the combination of these and other factors--that the Fed will continue to provide enormous liquidity to asset markets, that economies in Europe will continue to recover, that the US economy will grow modestly, that asset prices are not yet at dangerously high levels--suggest the strong stock markets in Europe and the US will continue. We are alert for changes but optimistic.

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