CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

September 29, 2014

'Whatever it Takes,' Part II…
...Will it 'Be Enough?'

The European Central Bank is at the point of taking action to foster growth and resist deflationary forces in Europe.

We can expect these actions to have powerful and positive effects, including on prices of European stocks and bonds. The actions are likely also to depress the value of the Euro further, calling for a hedging strategy so we may earn the gains in European stocks and avoid the currency depreciation. (We have put into place this strategy.)

In the same speech in the summer of 2012 in which he made his 'whatever it takes' comment, Mr. Draghi also remarked 'and it will be enough.' Bold. And, although the ECB actually did nothing, it was enough. (Whence come these magical rhetorical powers? I wish I had some.)

By

Jack Mayberry

Early in the summer of 2012, when the Eurozone crisis was at its (then) nadir, Mario Draghi, the president of the European Central Bank (the 'ECB'), made his famous undertaking to do 'whatever it takes' to meet the sovereign debt crisis that threatened the Euro and the European Union. As it turned out then, his rhetorical undertaking was enough. Within a short time, the interest rates that the worst-afflicted countries--Spain, Italy, Portugal and Greece--had to pay to borrow fell dramatically. (Spain can now borrow money at a lower interest rate than the United States. Go figure. This has to do with prospects for general economic weakness and the risk of deflation in Europe, a discussion for another time.) Stock prices in Europe recovered as well.

Unfortunately for many in Europe, their economies did not revive along with their bond and stock markets, nor, alas, did their labor markets. Unemployment remains very high throughout Europe as a whole (the latest reading in the Eurozone is 11.5%) and appalling high in Spain and Greece (24.5% and 27%). Unemployment rates for the young are higher still. Overall economic growth in Europe is expected to be less than 1% in 2014; many countries oscillate around zero, by turns contracting slightly and growing slightly. As we have written in these pages before, those that set policy in the European Union--namely Germany and its credit-worthy northern allies--demand fiscal restraint and refuse to open government purses to stimulate growth. The fiscal policy of 'internal adjustment' that imposes lower wages and lower government spending on indebted countries continues to keep Europe locked into an environment of no growth, high unemployment, and the very great risk of long-term deflation.

In the absence of helpful fiscal policy in Europe, the burden of ameliorating this mess falls upon Mr. Draghi and the ECB. Near the end of August, Mr. Draghi spoke in Jackson Hole at an annual meeting of central bankers. He noted the failures of European governments to revive European economies through fiscal policies and foreshadowed plans for new monetary policies to attempt to fill the void. (Recall that 'fiscal' policies refer to governments' spending and taxation actions and that 'monetary' policies are those of the central banks.)

The expectation is that the ECB will expand its balance sheet by buying securities of European banks and perhaps by buying bonds issued by European governments. This happens against the ending of the enormous bond-buying program of America's central bank, the Federal Reserve Bank. Thus, the Fed and the ECB are moving in opposite directions, reflecting the relatively strong and apparently strengthening economic growth in the United States, as against still-ailing Europe.

The investment thesis is that Mr. Draghi's forthcoming actions will foster growth in Europe and that his monetary policies will support stock and bond prices in Europe, just as the Fed's extraordinary policies have supported prices of US assets. However, the ECB's policies will likely depress the value of Euro in dollar terms. (Since his Jackson Hole speech, the Euro has fallen by four percent against the dollar, accelerating a decline that began earlier as the expectations of differing monetary policies in Europe and America came into focus.)

Despite Mr. Draghi's speeches, then and now, the question looms: will it be enough this time? Anti-Euro, anti-European Union and anti-ECB parties have arisen in most European countries in recent years, including in Germany. Similarly to the Tea Party in America, these have pushed politics to the right and against the ECB. (The Fed in America's case.) Recall Texas Governor Rick Perry's comments in the 2012 presidential campaign, in which he warned that physical violence might befall then-Fed Chairman Ben Bernanke should Mr. Bernanke chance to visit Texas. Observe the rhetoric from some important German politicians-- not Angela Merkel-- who have felt themselves obliged to criticize the EU and the ECB in strident terms. From these comments one sees the potency of the rising right wing in Germany and elsewhere in Europe.

It appears from here that this is the phenomenon that causes the recent volatility in asset markets: Against such opposition, how will Mr. Draghi effect his plans? Core's confidence arises from the belief that Mr. Draghi and Ms. Merkel are exemplary and very highly skilled politicians. If there is a rabbit to be pulled from the hat, Ms. Merkel and Mr. Draghi know how to find it and pull it out.

We wish to maintain our European stock positions to benefit from the appreciation that Mr. Draghi's actions will foster. To counter the effect of a declining value on our European stock investments, we have swapped most of our European equity positions to securities that hedge the exposure to the depreciating Euro. (You will have seen trade confirmations relating to this.) Since early in 2013, Core has effected a similar strategy with our Japanese equity investments for the same reason. When Prime Minister Shinzo Abe won his position in Japan, he made clear that his policies would depreciate the yen against dollar as part of his "Three Arrows" policy to revive the Japanese economy and end the long period of deflation there. Core made its Japanese stock investments in a security that hedged away the problems of the falling value of the yen. This has been a good strategy for Core's clients, as the yen has fallen while Japanese stocks have risen. Since Core made its yen-hedged positions in the Japanese stock market in January of 2013, the currency-hedged position has appreciated by about 35%, while an unhedged position in Japanese stocks has appreciated by somewhat more than 20%. May we enjoy such success with our Euro-hedged investments.

The longer-term view. Although the Fed's quantitative easing is coming to an end, Janet Yellen, the chair of the Fed, has been at pains to indicate that the Fed will be slow to raise the short-term interest rates it sets, rates that have essentially been at zero for nearly six years. The timing of the Fed's actions are, in her words, 'data dependent.' That is, members of the Fed will observe the level of economic activity closely, especially the condition of the labor market. To the extent that the US economy remains reasonably strong, the Fed will act in a deliberate fashion to return to more normal monetary policies.

Meanwhile, the two other major Western central banks, the Bank of Japan and the European Central Bank, maintain exceptionally accommodative policies. The very weakness in Japan and Europe calls for such polices and these monetary policies are very supportive of stock and bond prices. Thus, although we are now more than five years from the bottom of the stock market crash brought on by the financial crisis and the great recession, the stock and bond markets will likely continue to be favorable at least for the next year. In recent weeks, there has been a good deal more volatility in stock markets, but these increased price swings, up and down, do not mean we are on the point of another bear market.

Of course, there are some very unappealing geo-political events unfolding. Russia's revanchist adventurism in Ukraine is the most threatening to the political order. It is damaging to Europe's economy. China's display of force against peaceful demonstrators in Hong Kong is unsettling, to say the least. Such things rattle investment markets, but unless Mr. Putin or Mr. Xi does something really awful, the actions of the big central banks will have much more impact on investments. The central bank actions are quite helpful for the investment markets. There is very good reason to expect their continued help.

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

August 6, 2014

Threading the Needle

The interplay of various factors has given rise to a selling squall in stock markets. Russian belligerence is one factor; questions over monetary policy of the Federal Reserve is a second.

Financial markets turned sharply lower for several days last week and again yesterday, after a long period of very quiet markets with modest gains. The factors involved are several, notably including the Russian and Ukraine matter, and signs of strengthening economy in the United States. To begin, the Russian matter: After the loss of the Malaysian flight over eastern Ukraine came two notable developments: firstly the increased flows of Russian arms into Ukraine and a large-scale build up of Russian military forces at Ukraine's border; secondly the rather strong economic and financial sanctions against Russia imposed by member states of the European Union. This latter is striking because several important European countries, including Germany, France, Britain and Italy, have previously been reluctant to impose significant sanctions in light of their various different but substantial economic ties to Russia. The Russian military build up is worrisome in suggesting that, despite the world-wide outrage at the shooting down of the Malaysian flight and despite the already-apparent economic damage that US and European sanctions are causing, Vladimir Putin is not looking for a diplomatic way out of the problem he has created. Rather, he seems to be escalating Russian aggression against Ukraine, with all the unknowable mayhem that may ensue

The rather severe sanctions imposed by the Europeans on Russia will likely curtail European economic activity to a degree--putting aside for now the more serious damage that will be done to Russia's. Because European growth has hardly been robust and because inflation is dangerously low (at 0.4% per year at the most recent reading) and apparently still falling, the sanctions might stop Europe's modest recovery, depress the profits of European companies, and slow the recovery of European stock markets.

As for the American economy, US sanctions on Russia will have a much milder effect, because America's trade with Russia is rather small. Instead, the market's recent ructions may flow in part from the very strengthening of the US economy. After the severe winter weather that caused the US economy to contract in the first quarter, the spring quarter showed very smart economic growth. Recent corporate earnings reveal faster profit and revenue growth by US companies than in the last few years, and job growth has been solid.

By

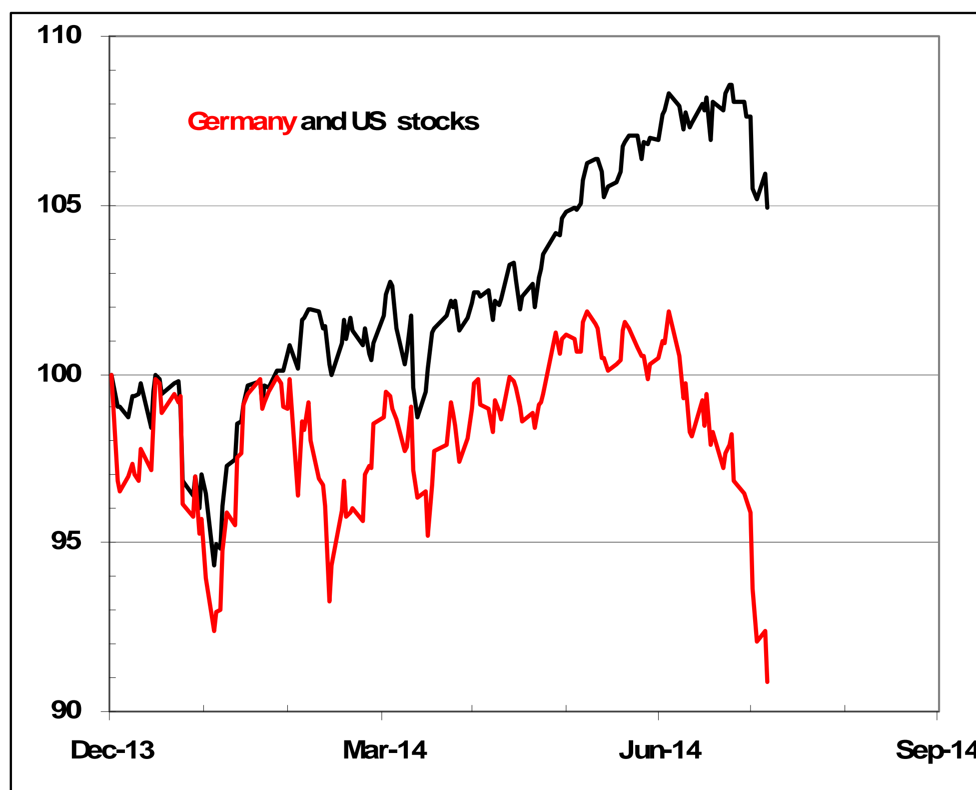
Jack Mayberry

The Federal Reserve has been reducing by $10 billion per month its asset purchases and these will almost certainly come to an end in October. Fed Chair Janet Yellen has been insistent that the Fed will not begin to tighten monetary policy by raising interest rates for a good long time. But, in the fullness of time, the Fed will tighten. Because the Fed's extraordinary monetary policies since

2008 have been such a support for stock and bond markets, suggestions of stronger economic activity gives rise to fears of earlier Fed tightening.

The investment considerations of these matters have several strands. First is the general question of the impact of uncertain future actions by Russia on the markets in which we invest. Of course, we cannot know what Mr. Putin will do. But, if we assume that he will not bring his nuclear arsenal into the picture and will not invade other European countries, then, as investors, we can take a fairly relaxed view of Russia's quite appalling adventurism. Localized conflict around the world rarely has a lasting impact on financial markets.

The chart below shows US stocks and German both rebased to 100 as of the end of last year. The weight of Russian and Ukraine problems lies much more heavily on Germany because of its deeper economic ties with Russia.



The second thread in investment considerations concerns Europe. Because the sanctions already imposed on Russia are likely to depress Europe's economy to a degree and because further and more stringent sanctions must be considered somewhat likely given Mr. Putin's provocative actions, we can expect an adverse effect on European corporate profits. Mario Draghi, the resourceful and shrewd president of the European Central Bank, is likely to take actions to counter this European weakness. If so, the negative effects on Europe's financial markets may be muted.

The third thread is the strengthening picture in the US, in the broad economy and in the corporate sector in which we invest. At last week's meeting of the Fed's Open Market Committee, its policy making arm, one member dissented from the FOMC actions. This dissent, the first in Janet Yellen's term as Fed chair, heightened fears of earlier tightening of monetary policy. Core does not share the view that this single dissent is a harbinger of monetary tightening. But growing economic strength in America, even if it does shorten the time before the Fed begins to raise short-term interests rates from zero, suggests faster growth in corporate profits, for which recent results provide evidence. Thus, the situation in America looks favorable: either the Fed continues its very favorable monetary policies for a good long time--a factor that clearly supports stock and bond prices--or stronger growth presages higher profits that justify higher asset prices.

Core's conclusions. Disturbing, not to say frightening, as Mr. Putin's actions are, Core's expectation is that they will not plunge stock and bond markets into a new bear market. The stronger force for financial markets emanates from the major central banks, whose actions will continue to foster economic growth and support asset markets. Given the different rates of growth in the US and Europe, it is sensible to tilt our portfolio allocations back toward American assets, by withdrawing a bit from Europe.

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

July 6, 2014

Into the Second Half of 2014…
...European Stocks Will Lead the Way

At the halfway point of the year, we report more of the same. Stock markets in the advanced economies continue to improve modestly. Bond markets are favorable. Inflation in developed countries is very subdued--dangerously subdued, think many, raising fears of deflation, especially in Europe. Modest economic growth continues. (The astonishing economic contraction in the United States in the year's first quarter--a decline of nearly 3% annualized--appears entirely the result of the very severe winter weather in the Midwest and the Northeast. Growth has picked up in recent months.) Price volatility in asset markets remains very low. The major western central banks continue their very accommodative monetary policies and promise to continue them for the foreseeable future.

The combination of friendly central bank policies, subdued economic growth, and very low inflation provides the foundation for favorable stock and bond markets. There are risks, as always, in part because of the duration of this bull market in stocks. It was in March 2009 that stock markets made their bottoms in the extreme bear market that characterized the financial crisis. Thus, we are now well into the sixth year of this bull market. In another letter, we will address the present risks, for now, our view remains positive and we retain our substantial equity investments. Instead, let us turn in this letter to European equities and set forth our reasons for retaining--and building further--our large equity investments there.

European travails. Despite the many similarities between the economies and markets of Europe and the United States, one important difference has been the crisis in the Euro. In these letters, we have written extensively about the Eurozone crisis, particularly from 2010 through 2012. At its worst in 2011 and until the summer of 2012, the crisis with the Euro seemed likely to cause another widespread banking and financial crisis. As it turned out, Mario Draghi, the president of the European Central Bank (the ECB), very deftly managed to contain and damp down the crisis, both by the provision of massive and inexpensive loans to European banks and by artful public undertakings 'to do whatever it takes' to prevent the threatened collapse.

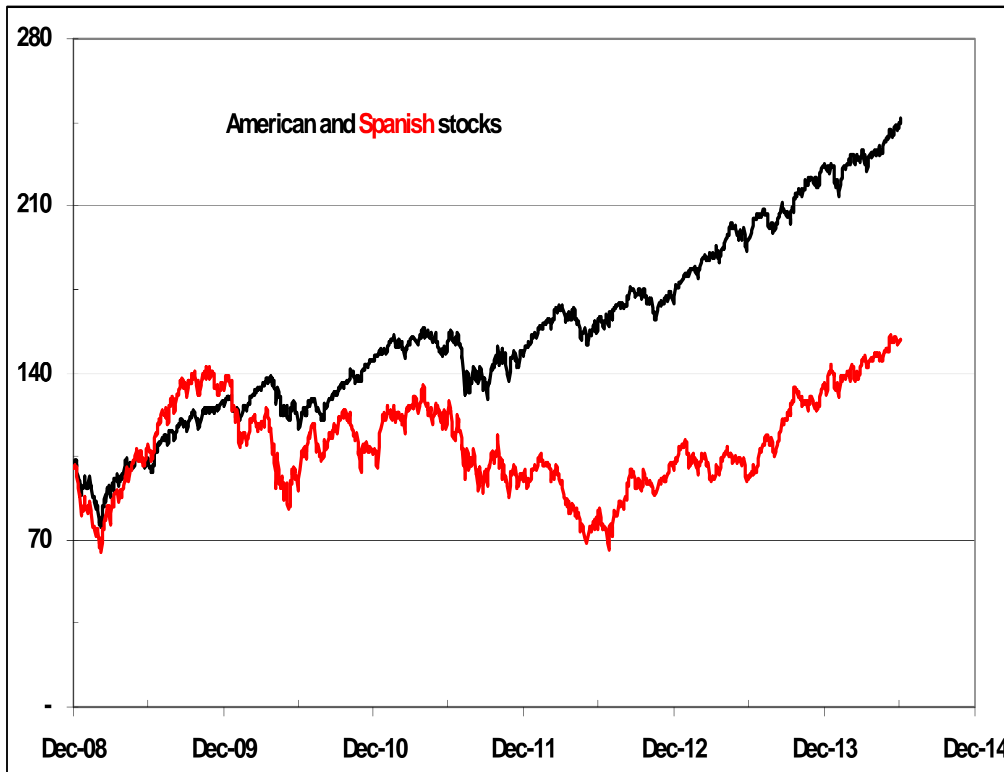
By

Jack Mayberry

A world-wide panic was avoided and from the middle of 2012 onwards the crisis in Europe abated. The damage that did occur was concentrated in Europe and fell most harshly on the so-called 'peripheral countries', Greece, Italy, Spain, Portugal and Ireland. These countries suffered very sharp economic declines and Europe as a whole fell into a second economic recession. Most hard hit were the workers in these countries, where unemployment

soared and wages for those still working fell. At this point in 2014, Europe as a whole is recovering from this ‘double-dip’ recession. Economies, even in the periphery, are improving and stock markets are recovering. Unfortunately, unemployment remains extremely high in the Euro-area generally at 11.6%, and especially in Greece at 26%, Spain at 25%, and Italy at 13%. By contrast, last week’s US employment report showed unemployment fell to 6.1%.

The case for European stocks. We have remarked often that macroeconomic problems that are bad for working people, e.g., high unemployment and low wages, may well be favorable for investment capital. The situation in Europe presents another instance of this sad phenomenon.



For several reasons, European stocks generally and Spanish and other ‘peripheral’ markets in particular are more attractive than US stocks now. By virtually any valuation standard, Eurozone stocks are considerably cheaper than US stocks; by some measures Spanish stocks are 50% cheaper than US stocks. As Europe moves out of its second recent recession, corporate profit growth will almost surely rebound strongly, supporting higher stock prices. Additionally, the Eurozone has very low inflation, about 0.5% per year, and is at risk of slipping into deflation. The ECB will very likely maintain its accommodative monetary policies, indeed, it is reasonably likely that it will undertake further ‘quantitative easing’ in coming months. Such actions by the ECB would probably result in a lower value for the Euro and higher Eurozone stock prices. By contrast, the Federal Reserve has been cutting its asset purchases all year and is probably closer than is the ECB to raising short-term interest rates.

We have had ever larger equity investments in the Eurozone since September 2012, beginning with Germany. Among other investments, we have added European banks and, more recently, Spanish stocks to our holdings. These have generally done quite well. Indeed from the low point in the summer of 2012, when Mr. Draghi made his famous whatever-it-takes comment, Spanish stocks have doubled and most things European have appreciated faster than US stocks.

The chart on this page shows US stocks and Spanish ones rebased to 100 since the end of 2008, a few months prior to bear market low for US stocks. At the worst of the Eurozone crisis in 2012, Spanish stocks fell back to their early 2009 lows, but have since rallied very strongly. For the reasons discussed above, we expect Spain to continue to outperform the US. We may soon add to your investments in Spanish stocks.

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CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

May 26, 2014

Low Growth, Low Inflation, Loose Monetary Policy and Turbulent Politics around the Word

In the very recent elections for the European parliament, fringe parties opposed to the European project drew more votes than the traditional parties in several countries. One might read this as popular backlash against the very undemocratic actions taken during the Eurozone crisis.

Very consequential decisions affecting people in Greece and Italy, for example, were taken by EU heads of government (and were largely dictated by Germany). These policies were then implemented by unelected 'technocrats' who replaced the elected heads of government in Greece and Italy.

This process is hardly a demonstration of the beneficence of the European Union.

By

Jack Mayberry

As summer approaches, we are presented with a world of geopolitical tension, most notably the adventurism of Russia, and political activity in three spheres: First is India's recently concluded and decisive election of the Hindu nationalist BJP party, lead by Narendra Modi--who presided over the massacre of at least two thousand Muslims in his home state of Gujurat in 2002 and whose travel ban to the United States has only been lifted very recently. Second is the disheartening military coup in Thailand, yet another in the long series of military interventions in a country that pretends to be a parliamentary democracy. Closer to home is the third, the spectacular success in European parliamentary elections of the 'Eurosceptics'.

These latter are mostly a bunch of right-wing, anti-immigration parties hostile to the European Union (with a few left-wing parties among them) and they surpassed the traditional parties in France, the United Kingdom, and Greece, among others. Little to cheer in any of these results. We have discussed in these letters for a few years the anti-democratic policies of the European Union, directed by Germany, in the Eurozone crisis. The imposition (by Germany and by unelected 'technocrats' in Brussels) of terrible fiscal strait-jackets on the people of Greece, Italy, Spain, Portugal and Ireland has not gone unnoticed by voters in those and in the less troubled and richer European countries. The European Union evolved from the European Coal and Steel Community, established in 1951 among the core countries of Europe, largely in response to the series of terrible wars of the nineteenth and twentieth centuries between European countries. While the founding impetus may have been recognition that European countries ought to cease trying to destroy each other time after time, the progress of European unification has been the based on the promise of improving living standards and growing economies. Whoops.

The fiscal crisis of 2008 and 2009 and its deep recession, followed by the sovereign debt crisis of 2011 and 2012 and its 'second-dip' recession put to an end, well and truly, the premise of economic betterment for the people. The resolution of the Eurozone crisis saw the removal of heads of governments in 'peripheral' countries and the transfer of leadership to unelected technocrats who would impose the Berlin and Brussels line of fiscal austerity. Even today, when Spain, Italy, Greece and the rest have ended their economic contraction, unemployment remains above 25% in some countries, wages have fallen, and economies have shrunk drastically. Whether or not the German prescriptions have been the right ones is, perhaps, less important for the political future of

Europe than has been the imposition of these policies by utterly undemocratic methods. The sixty-year project of European unification, tolerance, and peace appears to have cracked. These elections bode ill.

Economic growth in developed countries ranges from unremarkable in America and Britain, to almost non-existent in Europe. But, there is growth, not contraction.

What will be the source of strong, synchronized global growth? It is hard to see it. One concludes that there will be no one strong engine.

As these political dramas unfold, the economies of the world's developed countries plod forward unremarkably, exhibiting the most modest growth and very little vibrancy. Developing country economies, ablaze with vitality in the first decade of the century, have almost all slowed markedly since then. In previous decades, a single source of economic dynamism was present to lead the world to higher levels of growth. Now one searches in vain for that leading player. In the last decade, China's insatiable appetite for commodities and exceptional growth lifted many other economies. For decades, the American consumer was the reliable engine of world-wide economic growth. Neither plays that role now; China's growth has fallen sharply and its economic activity has a large domestic component, as compared to the earlier era of high imports and exports. The American consumer faces low wage growth and is still seeking to recover from the calamities of the bursting of the housing bubble and the associated subprime mortgage crisis. This recovery is manifesting itself in higher personal saving and lower personal spending, a situation that restrains economic growth.

Thus, we can expect the continuation of low inflation, low growth, and central bank largesse. This may be the prescription for the development of asset bubbles, a phenomenon that rarely ends well.

What can upset the Fed's explicit determination to maintain low interest rates and expansionary monetary policy? There is vocal opposition to Fed policies and even to its very independence on the political right in Washington. Janet Yellen and the Fed governors need to hone their diplomatic skills in order to maintain the independence of the Federal Reserve.

Meanwhile, exceptionally low inflation in all the developed countries gives rise to persistent fears, especially in Europe, of a descent into the realm of deflation, i.e., falling prices. The sharp decline in the interest rates on US government bonds this year--the ten-year treasury yielded 3% at the beginning of the year but recently less than 2.5%--reflects expectations of low economic growth and of very low inflation. The same phenomenon obtains in the Eurozone countries, where the underlying inflation rate is barely positive and government bond yields are exceptionally low.

All developed countries have engaged in fiscal policies of austerity, characterized by restrained government spending, despite the sharp decline in private sector spending. Government budget deficits have fallen markedly. The countervailing forces have been the central banks, especially the Federal Reserve, which have pursued previously-untried policies of monetary easing. Whether these policies have promoted economic growth and stimulated employment is not entirely certain. What is quite clear is the very salutary effects on asset prices, including prices of stocks and bonds. The Fed explicitly promises to maintain its extremely 'accommodative' policies for a long time to come.

The result, in the backdrop of modest economic growth and the 'resolution' of the Eurozone crisis, is an extended bull market in bonds and stocks characterized by generally low volatility. That is, sharp price swings in financial markets have become more rate. Given that economies of developed countries will probably continue to grow modestly, given that ongoing central bank largesse is in the cards, it is certainly possible that stock prices will continue higher. Given the extremely low inflation and the likelihood of only modest economic growth, bond prices will probably remain stable. Asset bubbles--unwarrantedly high prices of stocks or bonds--are a possibility, more than a trivial one. What can derail the quiet march higher in stock prices? The unpredictable and dangerous Mr. Putin can upset things; other geopolitical ructions always present risks. Another risk is political pressure on the Fed, causing it to restrain is monetary policies. Many on the political right in America (notably Rand Paul) who favor fiscal austerity aim to bring Fed policy under the control of Congress and to end its independence. Stay tuned.

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

April 11, 2014

Beyond Revanchism

There is nothing to excuse or to justify Russia's invasion and seizure of Crimea from Ukraine. Crimea had, indeed, been part of the Russian Soviet Federative Socialist Republic of the Soviet Union until 1954, when Nikita Khrushchev turned it over to the Ukrainian Soviet Socialist Republic. And, of course, Kiev was a major Russian city since at least the seventeenth century and was ruled by Russia's Tsars prior to the Soviet period. Only Petersburg and Moscow were more important cities in Russia. In 1991, when the Soviet Union collapsed, Ukraine became an independent state. Kiev was and is its capital.

In the last few days, we again read reports of masked soldiers without insignia in various cities of eastern Ukraine and of seizures by these forces of government buildings. Russian troops are massed at the border of eastern Ukraine, but it is quite clear that the Russian invasion of Ukraine is well underway even as these troops remain on the Russian side of the border. The fledgling government of Ukraine is scarcely able to oppose the Russian invasion, nor is it able to assert control of these parts of Ukraine overrun by Russia. It seems quite likely that the Russia's covert invasion will destabilize Ukraine and prevent or utterly screw up the presidential election scheduled for next month.

The United States and the western European countries have foresworn military action against Russia. This probably emboldens Vladimir Putin and leads him to think he is free to carry out his covert invasion. An initial set of sanctions against Russia has been put in place by the United States. President Obama has promised increased sanctions should Russia continue. Despite the very alarming news in the last few days, nothing further has been announced by the United States. Russia is now demanding immediate payment for natural gas to Ukraine, demanding higher prices for its deliveries, and threatening to cut its deliveries to Ukraine. As mentioned in my last letter, Germany and other western European countries import large amounts of natural gas from Russia, which gas flows through pipelines that pass through Ukraine.

These natural gas threats are tactics that Russia has employed more than once in recent years; they point to Russia's strength in the contest--but also to its weakness. Russia's economy is overwhelmingly dependent upon oil and natural gas; the theft of those resources by Vladimir Putin and his cronies, the 'oligarchs,' is what has enriched them to such a degree. However, the cost of production of Russia's oil and gas is quite high. If world oil prices were only 10 percent lower and if Europe could import natural gas from the United States, Russia's income would be cut enormously and its political power, deriving from its natural gas exports to Ukraine and the west, would evaporate. The United States could release oil from its huge Strategic Petroleum Reserve,

By

Jack Mayberry

which, at the end of 2013 held 695 million barrels of crude oil. Even the announcement of a substantial release would caused a sharp drop in global prices for oil. America could also export huge amounts of natural gas to Western Europe to replace the Russian gas (and Russian leverage over Germany and other countries). Moreover, banking and financial sanctions could become much more harsh than those of the first round.

Putin's Russia is in the active phase of restoration of its control of the former dominions of Tsarist Russia and the Soviet Union. It is entirely appropriate that America recognize that it will not oppose these actions by tanks, bombs and troops. The policy of containment served well during the Cold War; a related strategy is now needed to put a stop to Putin. This will necessarily be a long game and Putin's willingness to disregard norms of state behavior will likely give him short-term advantages. But let John Kerry and Barack Obama speak clearly about what is going on: Russia has invaded Ukraine. Suggesting that, so long as Russia's troops stay within Russian territory, Russia has not 'invaded' Ukraine is disingenuous. America knows this: America goes to war fairly often. For example, in Iraq and Afghanistan, the sending in of troops followed a period covert action by special forces. To a degree, Russia is following America's play book.

The Economy and Markets. So far this year, a cold winter in much of America restrained economic activity to a degree, but has not upset the trajectory of modest growth. Last week's employment report for March, was reasonably strong and included upward revisions in the prior estimates of employment in January and February. Various factors, including Russia and slowing growth in developing countries, have disturbed financial markets and increased price swings. The net result since the beginning of the year for stocks and for bonds is essentially nil. It seems likely that corporate profits for the first quarter, just now beginning to be announced, will show very modest growth. Prospects look better for later in this year, because of synchronized improvement in economic growth in most developed countries. Core has maintained its greater weighting to European stocks and only a very small allocation to developing economies.

Russian actions in Ukraine have had so far only transitory effects on financial markets. The sense is that the direct economic consequences of Russia's acts to the United States are very small. The shorter-term consequences are greater in Europe because of its dependence on Russian natural gas and the somewhat greater level of exports to Russia, particularly from Germany and France. Moreover, there appears to be the view that restraint by the West in response to these actions will prevent a huge crisis. Putin's ominous actions may explode into something far worse. The Baltic states are concerned, unsurprisingly. We will attend to these developments closely, while hoping that the United States will use its oil and gas reserves effectively and will tighten the constraints on Russia's participation in the world's financial and banking systems.

Tax Matters. We have had a number of discussions with clients and their accountants about the K-1s issued by KKR Financial and Brookfield Infrastructure Partners. Both sets of K-1s were issued rather late, to the consternation of many. Note that we sold both those positions in 2013, so that this year is the last in which we have to deal with these. Happily, both investments were quite successful from the investment point of view; they proved to be a bit unsuccessful from the tax preparation point of view, particularly because the rules about reporting K-1s changed and became somewhat more complex than previously.

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CORE Comments
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March 18, 2014

Russia and Crimea

Geopolitics once again presents obstacles for financial markets, markets that for a long spell have looked only at macro-economic issues. While the questions remain about sources of growth in developed economies, in China and in other emerging markets, into the mix come the brazen acts of Vladimir Putin. It is amazing to contemplate a possible military encounter with Russia more than fifty years after the Cuban missile crisis. The rather mild market response to matters in Ukraine suggests the belief that the United States will not confront Russia militarily. Of course, the Russian occupation of Crimea presents far less risk to the United States than the early 1960s installation of Russian nuclear-armed missiles in Cuba. However, Putin's startling invasion of Crimea warns us that he might be willing to undertake further incursions into Ukraine and perhaps into other former Soviet republics. Further steps could certainly offer to the United States a much more serious challenge than is presented now in Crimea. How does one calculate and assess such risks?

As an economic matter, Crimea and Ukraine are utterly insignificant to the United States. Russia is only slightly more important to the US economy. By contrast, the financial sanctions and visa restrictions that the US and Europe might impose upon Russia and the circle of individuals around Putin might be quite hurtful to Russia and those individuals. During the Soviet era, the Soviet Union did not participate in the banking and financials systems of the West. Since that time, however, the very rich Russians and the Russian state are deeply embedded within the global financial system and enormous amounts of assets, including real estate and financial assets, are owned by Russia and its 'oligarchs.' An indication of the scale of these assets was provided late last week in the weekly report the Federal Reserve makes of its holdings. More than $100 billion of 'foreign-owned funds' on deposit in the New York Federal Reserve Bank were withdrawn. Typically there are large weekly inflows of foreign assets to be held by the Fed. It is quite likely that these assets were Russian and removed against the risk that the US would freeze such Russian assets.

In contrast to the willingness of the United States to sanction Russia for its actions, Europeans are far less keen. Germany's trade with Russia is substantial. Moreover, Germany and other Western European countries depend upon deliveries of Russian natural gas that flows through pipelines crossing Ukraine. Russia has long demonstrated a willingness to turn off the taps to threaten and to enforce discipline. The dependence of Germany and others on Russian gas may speed some changes in the United States, which, since the oil embargoes of the 1970s, has had laws strictly constraining US exports of petroleum products. Within the last few years, the US has become a huge and very low-cost producer of natural gas and an ever larger producer of oil. There is now an ex-

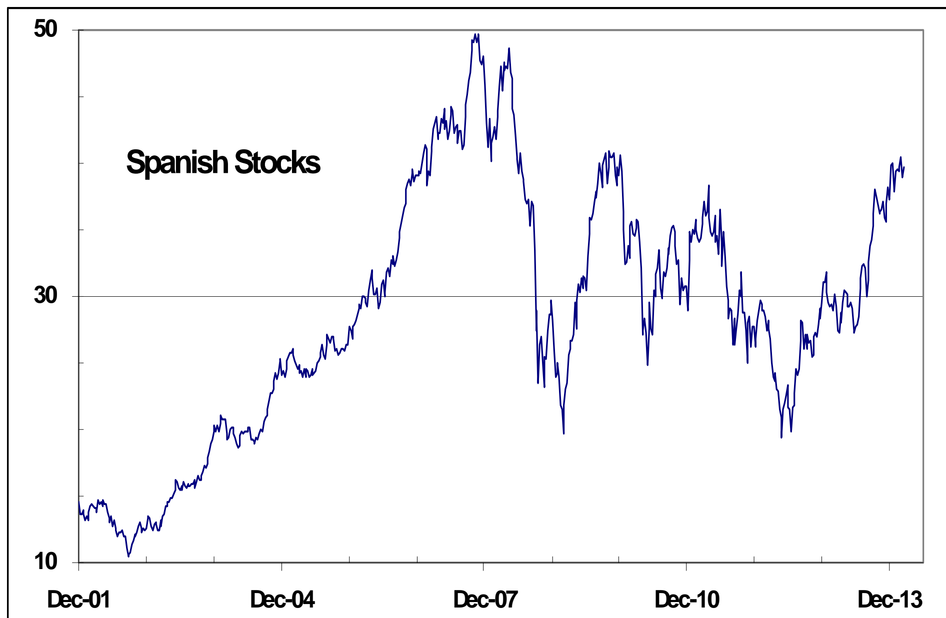
By

Jack Mayberry

cellent geopolitical reason to amend that law and lessen Russia's sway over Europeans. One hopes that the United States and the European Union will be firm and patient with Russia and supportive of the new government in Kiev.

Spain flourished in the early years of the last decade after joining the Euro, with strong immigration from Latin America and a housing boom of startling magnitude. Came the crisis in 2008-09 and its housing market collapsed, its high level of private debt weighed on its people, and a deep recession engulfed it.

Economic growth appears to have continued at a modest pace in the US this year, although the exceptionally severe winter weather in the Midwest and the eastern part of the country has rendered economic reports a little a bit less meaningful. It is quite likely that the cold and the storms restrained some activity and caused greater spending in other sectors, like home heating and electrical power generation. We will have a clearer picture of the state of the economy after winter finally loosens its grip. Meanwhile, after a bit of selling in January, stocks recovered smartly until the Crimean wobbles.



The crisis in the euro hit very hard; unemployment soared to 25%. Spain was nearly strangled by fiscal austerity. Unemployment remains very high and growth is very slow, but the ECB promise kept it from collapse. Now its market recovers.

Europe is more vulnerable to the problems flowing from Russia, as discussed above, and selling connected with this hits Germany harder. External shocks to Europe's economies are less easily absorbed than in the United States. Economic fragility, high unemployment, recession followed by very slow growth and the peril of deflation flow from the handling of the Euro-zone crisis. That crisis and the solution preferred by Germany and the other northern creditor nations--namely cutting wages and government spending in the 'peripheral' countries--puts pressure on prices and wages and tips the weak toward a self-reinforcing spiral of contracting economies, lower prices, high unemployment and low wages. The cushion protecting these countries against a shock from Russia or from China's slowing growth is thin indeed.

The acute phase of the Euro-zone crisis caused recession throughout Europe and significant selling in European stocks. As discussed previously, European Central Bank President Mario Draghi made his famous declaration in the middle of 2012 that the ECB would do 'whatever it takes' to keep the Euro intact. His promise was sufficient and he was not required to take action. From that time, the fear of Europe's collapse ended. Slowly economies began to stabilize, then slowly to grow. But much more rapidly, the deeply depressed European stock markets began to recover. Over the last two years, Core has been building a fairly large position in European stocks and earlier this year, when markets were selling off, we took a position in Spanish companies. Spain is one of the countries hit hardest by the crisis with the Euro. Its economy has begun to recover, as has its stock market.

There is, as always, plenty to worry about in investing and Russia's nastiness is an unwelcome and distasteful intrusion. The Europeans and Americans are cool headed and unlikely to press Russia to something truly drastic. Hence, for now, we are investing in the expectation of continued slow growth and favorable monetary policy from the major central banks.

CORE Comments

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ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

February 3, 2014

Tremors in Emerging Markets Spill over to Developed Countries

By

Jack Mayberry

After a fine year for stock markets in the United States, Europe and Japan in 2013, markets stumbled in January. In particular, most emerging markets--that is, the stocks, bonds and currencies of developing countries--fell sharply. This turbulence raises fears that crises in emerging markets could cause selling in developed markets, where stock markets rose so briskly last year.

Apart from emerging markets contagion, economies of developed countries face several other risks as 2014 begins:, including the Federal Reserve's beginning in January to cut its rate of asset purchases (the 'taper'), the specter of deflation--falling prices; and stagnant economic growth (arising from weak demand in the private sector (households and companies) and fiscal austerity on the part of governments).

Changes at the Fed. After several years of expansionary and radical monetary policies at the Fed, we are probably in early stages of the process of 'normalizing' monetary policy. As Janet Yellen begins her role as chair of the Fed, the Fed will probably continue to reduce the rate of its asset purchases and, in time, to bring them to an end. Then, should the economy continue modest growth, the Fed will probably start to raise short term interest rates, which for more than five years have been essentially zero. These Fed actions will be consequential. Note that the Fed's aggressive monetary policy commenced in 2008 as the financial crisis began served two principal functions: firstly to prevent the collapse of the financial system, and secondly to stimulate economic recovery by supporting prices of real estate and financial assets. The withdrawal of monetary support may adversely affect financial markets and the real economy.

The risk of deflation is especially acute in Eurozone, where the year-over-year change in consumer prices is alarmingly close to zero (0.8%) and well below the target rate of inflation, defined there as 'close to but below' 2%. Christine Lagarde, the head of the International Monetary Fund (the IMF), has recently begun to warn of the problem, noting that central bankers are wary even of using the term 'deflation' for fear of the self-fulfilling consequences of discussing it. We may expect the European Central Bank to expand its monetary policies if deflation risks rise further. The Eurozone recession has come to an end and modest economic recovery is underway. With the exception Greece, the hard-hit 'peripheral' economies, including Spain and Italy, are growing, although unemployment remains extremely high in those countries, especially for young people.

Stagnant economies in the developed world seem increasingly to be the rule. The United States is several years into recovery from the Great Recession, but demand is low and wages are not rising despite modest job growth. Because jobs being created are often part-time and ill-paid, economic activity is stuck at a low level, without the vigor that we would expect after such a recession. As we have discussed several times before, Japan is taking forceful steps of co-ordinated monetary and fiscal expansion in a concerted effort to bring an end to the deflationary period stretching back well over a decade and to stimulate economic growth. It is far too early for the Japanese to declare victory, but the actions are likely to provide further support for Japanese stock market.

Spillover effects from Turkey. Because of deflation risks in Europe, the still-unresolved sovereign debt crisis there, and paltry economic growth, the new currency crisis in several emerging markets threatens Europe's economy and its financial markets. Turkey is one of the countries whose currency has declined most sharply. Poor Cyprus and Greece, ravaged in the eurozone crisis and slowly rebuilding in tourism. Turkey's much devalued currency is likely to crush tourism in these countries, which, burdened with the strong euro, can hardly compete against their Eastern Mediterranean neighbor. Emerging market currency crises have created severe problems in developed countries in the past--recall 1998. In this context, the volatility and selling in US, European and Japanese markets in January is unsurprising.

Despite January's declines in stocks--3.6% in the S&P 500, 3.4% in the UK, 1.9% in Europe, and 8.5% in Japan--these markets are likely to appreciate this year, as the underlying economies in these developed markets grow modestly. Stock markets are vulnerable to a bout of selling, not having experienced even a 10% decline since the summer of 2011. We raised some cash in Core's clients' accounts in January by selling a position in French stocks. We expect to wait until this turmoil runs its course, and then to make a further equity investment in one of these developed market countries.

Strength in bonds. Apart from substantial investments in stocks in these markets, we also have meaningful bond investments. For these investments, the deflation risk and sluggish economies are a boon and cause prices to rally. Our US bond investments rose in value in January. The benchmark ten-year US treasury bond yield fell from about 3% to 2.7% as January ended. Further reports of slowing economic activity and declining inflation will drive the bond prices up and yields down. Our bond investments and the cash we hold now provide a cushion as the market attempts to find sound footing again.

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