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

September 7, 2010

Bonds and Stocks in a Weak Job Market

Yields on long-term treasury bonds have fallen like a stone since late April, when economic recovery began to falter. Since then, economic reports have been bad and getting worse, especially the employment reports. Because of political opposition to further spending by the government to stimulate the economy, it has fallen to the Fed to use its tools. It is almost a certainty that short-term rates will remain low for a very long time, and the Fed has begun again to buy long-term treasury bonds.

Whether the Fed's actions will stimulate the economy may be doubted. What seems clear is that high-grade, long-term bonds--especially treasuries--will be very strong in price. Their yields are likely to fall to still lower levels. Core will buy more treasury bonds.

By

Jack Mayberry

I write after the first three days of September. Stocks bolted from the September 1 starting gate like Secretariat at Belmont. The economic reports of the last few days have not reminded anyone of famous race horses, but they have been better than feared. So, is all right with the world? Not quite.

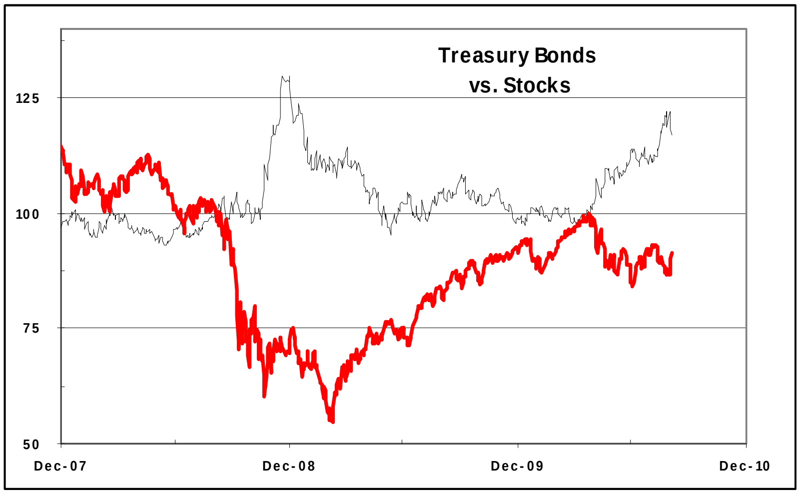
"Green shoots", presaging economic recovery, began to appear in the spring of 2009 and the stock market began its recovery from the tremendous declines into March 2009. The stock market climbed robustly until April of this year, and, for much of that time, the economic reports were consistent with a vigorous recovery. No longer. As discussed in recent letters, the stock market has fallen sharply and economic reports have revealed an ever-slower economy. The worst aspect of this has been the very poor growth in new jobs. The temporary hiring for the census provided some big headline numbers for a couple of months, but it is quite clear now that few of these temporary workers have found jobs in the private sector. On Friday was the employment report for August; it was not as awful as expected, but the growth in private sector jobs was only about 60,000, a rate far, far lower than needed to make a dent in the 8 million job losses in the recession. At present, there is little prospect for robust hiring in coming months.

The growing awareness that economic recovery is halting and sluggish and that political opposition to another dose of economic stimulus is quite powerful leads to the conclusion that the Federal Reserve will maintain its very easy monetary conditions far into the future. The Fed has affirmed this and has begun to buy long-term government bonds again in an effort to keep rates low and to stimulate economic activity. All this has caused interest rates to decline very sharply since the spring and for bond prices to rally very vigorously. (The chart on the next page illustrates this.) Our very large bond positions and quite small equity positions have served us well during this period. In August, for example, when the US stock market fell by more than 4%, Core's accounts overall rose in value by more than 1%.

Assume that the US economy will remain rather weak, or even contract in this and future quarters. Assume further that job growth will be very poor and that the unemployment rate, most recently measured at 9.6%, remains high. Does this mean that the stock market will be weak? I do not believe so. Monetary policy, especially the very low interest rates and the near certainty that rates will remain very low for a long time, is very favorable for stocks. Corporations have strengthened their balance sheets enormously since the 2008 financial crisis, partly out of fear that another disruption in the credit markets would close the usual markets through which companies meet their

The chart below shows the total return of the S&P 500 and of long-term US treasury bonds, 'rebased' to show each with a value of 100 on April 23, 2010, the top of the stock market's recovery and the beginning of the realization that 'green shoots' were turning brown.

short-term funding needs. Companies have lowered costs--in part by cutting staff--and raised profits. These forces are a restraint on job growth, but it is clear from the historical data that periods of high unemployment produced far better returns than did periods of low rates of unemployment. (Stocks fall as recessions unfold and generally begin to recover before the recession ends. Those recoveries--like the one from March '09 to April '10--are generally very powerful. In the later stages of the economic cycle, when jobs are abundant and unemployment low, stock market gains have typically been mediocre.) The human cost of high unemployment is awful; for better or for worse, the stock market looks to the improving corporate profits during those periods and tends to perform well.



Core foresees an environment in the coming year in which US economy is weak, unemployment remains high, monetary conditions are very favorable, and the political stalemate in Washington paralyzes new policy initiatives. We foresee a very strong bond market and expect that our fixed-income investments will continue to thrive. We intend to use periods of weakness in the stock market to make investments in the portions of the equity markets that have the best prospects. Among other things, we will build on our existing investments in stocks and bonds in developing countries.

The heavy line is the S&P. As it collapsed in the financial crisis in 2008, treasury bonds soared in price, as a safe haven investment. As the markets and economy recovered, stocks rose and bonds fell. In April of this year, the course reversed: Treasury bonds are gaining in price, against the risk of deflation, and stocks have fallen. Bonds will go still higher in price, but stocks should gain again, as well.

A Mutual Fund Settlement

We receive the occasional notices of mutual fund litigation and announcements of settlements of class actions against funds. Often the settlements are tiny (and appear to benefit only the lawyers bringing the litigation). However, we and many of you have recently received notice of a settlement involving a mutual fund family, in one of whose bond funds Core's clients had an investment in the early years of this decade. The fund is the Strong Government Securities fund. In this case the settlement is meaningful. We have looked through our records of investment in this fund and can see that the settlement will pay hundreds of dollars to a number of Core clients who held the fund. In speaking to the organization handling the settlement payments, we have learned that we can act on behalf of our clients to prepare the necessary paper work. We will send to clients who had investment in the fund a letter for your signature, which will authorize Core to act for you in submitting the information relating to the claim.

The claim in this action against the Strong mutual fund group related to the rather egregious mutual fund scandals that were uncovered several years ago, involving so-called "late trading" and "market timing". I wrote about this in *Core Comments* in late 2003; I include a copy of that letter with this one. The Strong group does appear to have been one of the 'bad apples'. Without having studied this closely, I very much doubt that the government bond fund in which Core made investments for you was a participant in the shenanigans. It was stock funds in which the bad actors went to work. We are looking into a similar class action claim against another group, Invesco, in whose funds Core had investments for clients. We will report on that if there is any recovery available to Core's clients. Please contact us, if you have any questions.

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CORE ASSET MANAGEMENT
PO Box 1629
108 Caledonia Street
Sausalito, California 94966
(415) 332-2000 • (800) 451-2240
fax (415) 332-2151
www.coreasset.com
info@coreasset.com