

CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

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An Update on the Developing Crisis

The Euro-zone crisis grinds on; Washington girds for more partisan fights; economies in the US and Europe weaken markedly. For the next few months, we may expect to see more rounds of sharp selling in stock markets. We will maintain our large and safe bond positions during these storms.

I write a brief note to express my views on the unfolding drama that threatens the banking system--again--and that afflicts financial markets. Since my letter of two weeks ago, there has been another severe bout of selling in stock markets, but, differently from the several waves of panic in the last months, the recent action saw very sharp declines in assets that have acted as safe havens. Whereas gold and various foreign currencies afforded shelter and gains in the selling from May through August, in last week's turmoil they mirrored the selling in stocks. In fact, the action in currencies, commodities and stock markets resembled the waves of panic unleashed three years ago when Lehman Brothers collapsed.

The elements behind the chaos in markets are those discussed in several letters throughout this year:

The Euro-zone crisis. The complexities involved in limiting the damage from the solvency crisis in Greece arise from the absence of a central fiscal authority in the Euro zone. There is a central monetary authority, the European Central Bank (the ECB), but the power to tax and spend is retained by the seventeen nations that use the Euro. The crucial, necessary, and time-sensitive decisions required to limit the crisis to manageable size involve actions by each of the national parliaments. The series of well-meaning partial solutions to the crisis have merely drawn things out and permitted the damage to widen and worsen. Sovereign debt problems involved only Greece, Portugal and Ireland fifteen months ago, small countries whose problems could easily have been handled. By not solving the problems when small, the problems now afflict Spain and Italy. Because major French and German banks hold very large amounts of government debt issued by these countries, their capital is impaired, probably by several hundred billion Euros.

There is widespread recognition by European governments, the ECB, the IMF, and the European Union of the gravity and risks of the situation. Alarming, however, the very slow process of decision making necessarily means that the crisis will remain unresolved for at least a couple of months. During these months, markets will again suffer bouts of panic.

By

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Economic weakness. The European crisis unfolds in the context of very weak economies across Europe and in the United States. Nine months ago, it appeared those economies were recovering reasonably well from the deep recession of 2008 and 2009. We now realize that economic growth essentially stalled in the second quarter of this year and that the weakness has persisted--probably worsened--in this third quarter.

Political dysfunction in the United States. The nearly unbridgeable gulf between the goals of the Republicans running the House of Representatives and the aims of the Obama administration and the Democratic-controlled Senate presents us with the likelihood of a series of angry episodes, again threatening the functioning of the federal government. In the '90s, when Clinton was president and Republicans controlled both houses of Congress, there was 'gridlock' in which little meaningful new action by the federal government was possible. By contrast with today, that 'gridlock' occurred during benign conditions: the economy was expanding very robustly, jobs were available to almost all who sought work, government revenues (tax receipts) were strong and rising, and spending was moderate. For a time, the federal government ran a surplus. Such is not the situation today.

Given these factors and the likelihood that they will persist in the coming weeks, we must expect further bouts of widespread selling of many investment assets. In the 2008-2009 crisis, governments and central banks acted very forcefully and in a co-ordinated way. Riot in financial markets may well force similarly decisive and co-ordinated response in the coming months, despite what appear at present to be insurmountable obstacles to co-operation and co-ordination.

Core's investment approach. We continue to adjust portfolios in response to the evolving situation. As we have remarked before, high-grade corporate bonds and US treasuries will continue to do quite well in an environment of weak growth or mild recession. Because we expect these conditions to persist, we will focus our investments in such things. It seems ever more likely that the Euro-zone crisis will find a good resolution. When this is in prospect, it is reasonable to expect that equities will offer very good value. We have now and will have plenty of capital available to invest then. Meanwhile, we think it best to safeguard your capital during these tumultuous months.

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