

# CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

September 23, 2013

## The Fed Waits to ‘Taper’

*The economy in Europe is finally improving and its long-dormant stock markets are reviving from their long (and well-deserved) slumber. We are directing a larger portion of your capital to Europe. Our earlier investments in Japan continue to thrive. The world's developed economies are acquitting themselves nicely when compared to the emerging, developing economies.*

*Have emerging markets been feeding at the Fed's trough longer than warranted? So it seems.*

The Federal Reserve surprised the markets last week and confounded consensus expectations that it would begin to decrease its rate of purchase of treasury and mortgage-backed securities. Although no Fed official had said that in September these purchases--\$85 billion per month--would begin to lessen, although every Fed official who spoke on the subject declared that the onset of ‘tapering’ was dependent on the strength of economic data, although recent economic reports had been weaker than expected, nevertheless, a consensus had developed that at last week’s meeting of the Fed’s Open Market Committee would come the announcement that the Fed would buy \$10 billion fewer of such securities. When we next hear reference to the ‘wisdom of the markets’, we should remember this episode of willfully blind unwisdom.

The result in the markets was an upsurge in buying of stocks and bonds across the board, erasing some of the losses in bonds that followed the Fed’s discussions about the taper and sending US stocks to new highs. From our perspective, it appears that the recent weakness in some US economic reports, notably the early-September employment report, is a temporary interruption in the trend of more rapidly growing economies world wide. Economic growth is hardly robust and there are certainly risks, discussed briefly below, even to the modest levels of growth that we foresee. Consistent with this view, we have increased our investment in stocks, particularly in Europe as it emerges from its long Eurozone-crisis funk and recession. As a result of disruption in bonds, occasioned by the delayed but inevitable reduction in the Fed’s securities purchases, we have also rearranged our bond portfolios. We address these below.

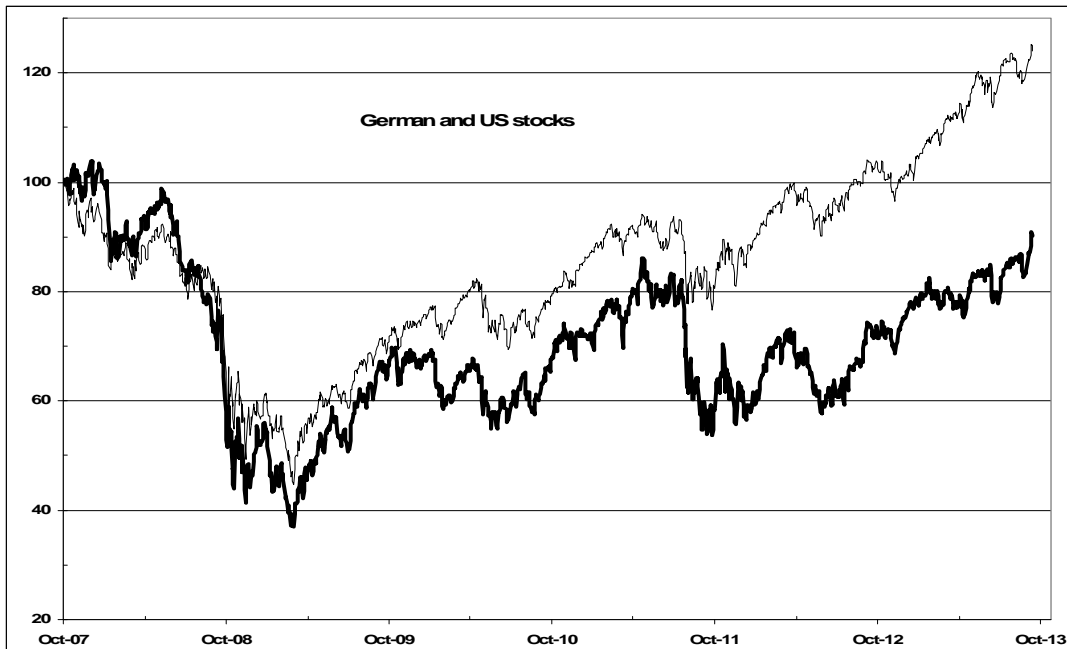
**Dysfunctional governance.** The immediate threat to global growth and investment markets is located in the US House of Representatives, where the Republican majority is in thrall to its utterly irresponsible Tea Party wing that threatens to shut down the government and to prevent the United States from meeting obligations to its creditors if ‘Obamacare’ is funded. A discussion of the causes of this insane threat is beyond the scope of this note and I am quite sure that readers are well informed on this subject. For those who care to read more, I direct your attention to an article by Elizabeth Drew in the recent New York Review of Books. <http://www.nybooks.com/articles/archives/2013/sep/26/stranglehold-our-politics/> Should the benighted House Republicans persist in their threat, the global economy, America’s standing in the world, and the vast but immeasurable financial advantage that America has possessed for nearly a century as the issuer of the world’s reserve currency will be damaged. (We will discuss the value of *seigniorage* in another letter, if the worst comes about.) Financial markets will appreciate none of these outcomes. One hopes that saner Re-

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publicans will manage to pull their nutty colleagues back from the brink. They may not accomplish that.

**Buying Europe.** In these *Core Comments*, we have expressed more than our share of pessimism on Eurozone matters in recent years. The debilitating crisis has been terribly costly to Europeans in the so-called ‘peripheral’ countries, Italy, Greece, Portugal, Spain and Ireland. It has been particularly costly to the vast numbers of unemployed young people. In the Eurozone as a whole, unemployment exceeds 12 percent; in Spain and Greece the unemployment exceeds 25 percent. But finally, conditions in Europe are improving; the latest recession appears to have ended; recovery is underway.



For good reason, European stock markets underperformed US markets miserably in these last few years, but, as things turn in Europe, we expect recent strength in European markets to continue. Anticipating this, we have been making large investments in European markets, including in its banking sector. In the adjacent chart, we show a comparison of performance of US and German stocks since the pre-crisis peak in October of 2007, having rebased both indices (the S&P 500 and the DAX) to 100 at that point. The German market is shown in bold;

it has trailed the S&P by an historically wide margin. The Eurozone crisis is entirely the cause of the weakness in European stocks. An astute colleague points out that it is quite enough for terrible conditions to turn slightly better for financial markets to sniff out the trajectory. Improving conditions, in Europe’s banks and in Europe as a whole, are with us. (Does this contradict my derisive comment about the ‘wisdom of the markets?’ No.) We expect European stocks to produce better returns than American ones.

Germans voted yesterday in federal elections and Angela Merkel and her Christian Democratic party nearly won an absolute majority in the Bundestag. After a coalition is formed, Angela Merkel will begin her third term as Chancellor. Ms. Merkel’s re-election provides some assurance that the recent economic recovery Europe will be sustained and grow. Financial markets will approve this outcome.

**Investments in bonds.** In our last letter, we discussed the bond market and what appears to be the end of the three-decades long bull market in bond prices. Given what seems to be the likely increase in bond yields and decrease in bond prices in the years ahead, we have decided to place most of our bond investments into the hands of specialist fixed-income managers via two mutual funds, DoubleLine Total Return and Loomis Sayles Bond. We have had investments in both for some time. These are fine funds, run by managers with the skill and experience to navigate the newly-tricky fixed-income markets.

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