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

September 11, 2015

Stock Markets Awaken from Slumber…
...With a Growl

The insouciance demonstrated by investors who kept the stock market in a very narrow range gave way in mid August. Waves of selling succeeded by spurts of buying have made investors dizzy.

Slowing global economic growth, uncertainty about Federal Reserve plans to raise interest rates and confusion from China have unsettled the formerly quiet markets.

By

Jack Mayberry

Only a couple of days after writing the last *Core Comments*, which discussed the placidity of the US stock market this year, came an enormous burst of volatility in which prices fell sharply, then rose, then fell again. The calm that enveloped US markets through the middle of August came to an abrupt end. Explanations for the selling involve conditions quite apparent to observers as the summer progressed. But those factors did not disturb the market's equanimity until mid August--and then ....

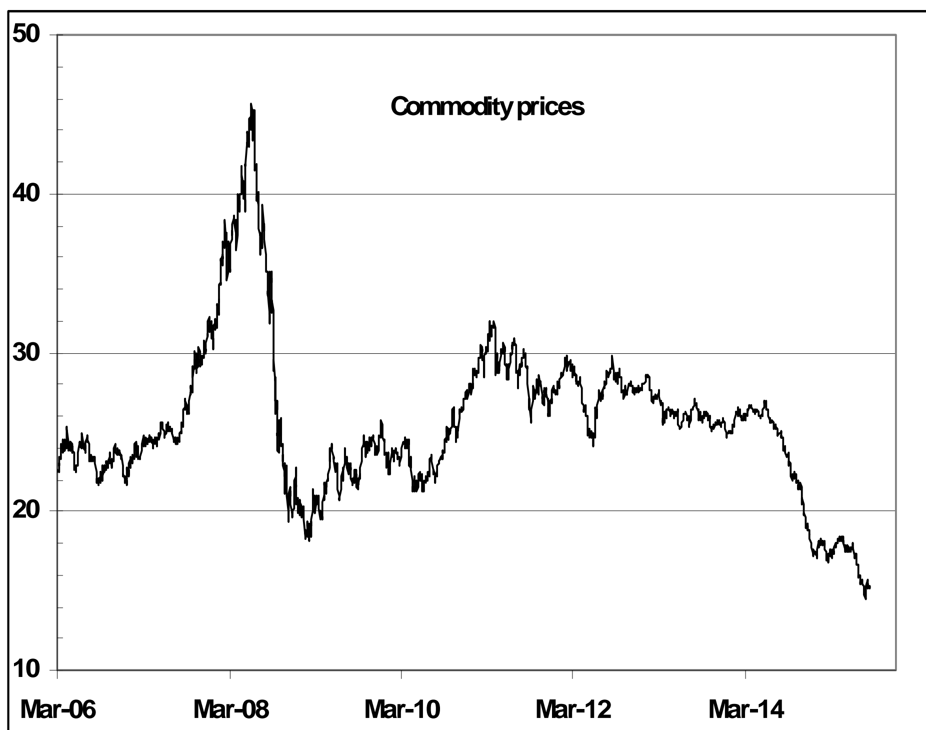
Slowing Global Growth. The overriding cause of the weakening stock markets is the realization that economic growth around the world is slower than had been expected. This is not 'news' and provides no explanation for the timing of the sharp and sudden selling, but does give it context. Although economic growth in the United States has been reasonably robust for the last few years, the other developed economies--Europe and Japan--have been quite weak, sometimes contracting slightly, sometimes growing slightly. Equally significant has been the weakening of China's growth. For years, China has grown very strongly based upon manufacturing for export and upon infrastructure development, the building of roads, bridges, railroads, ports, apartments, office buildings, and all the rest. China's growth during the first decade of this century was so rapid and so enormous that its growth alone constituted most of the total economic growth in the world. Moreover, China's growth depended upon a huge use of commodities of many kinds and its demand drove up world-wide commodity prices. China's response to the global financial crisis and recession of 2007 to 2009 was to pour even more funds into infrastructure development, causing oil and other commodities prices to rise again after the sharp but brief selling in that crisis. But as China's pool of cheap labor from its countryside began to shrink, as its currency rose in value, and as its per-capita income rose, its price advantage in manufactured goods began to erode. In response, China has been changing its economy in recent years from an export-driven one to one based more on domestic consumption and spending.

Falling Levels of Inflation. China's recent slowdown reduced demand for commodities precisely at the time when the exchange value of the US dollar, discussed in the last *Core Comments,* began to rise. Because commodities, with few exceptions, are priced in US dollars, there began a sharp decline in commodity prices. The collapse in demand for oil and other commodities has produced two significant effects: It has weakened the economies of big exporters of these commodities--Russia and Brazil among many others--and has caused disinflationary pressures. In Europe, the US and Japan, inflation is running well below levels deemed healthy, namely at or near 2 percent. (The nearby chart

shows the sharp decline in commodity prices in the last 18 months.)

The chart below shows a broad index of commodities, showing the very sharp but brief decline in commodities in the financial crisis and the subsequent recovery. The relentless decline from 2014 both reflects and (to a degree) causes economic weakness.

China's mismanagement. There has been a longstanding belief that China's government has the skills to manage its economy effectively. China is not 'burdened' by the messy political decision-making practices of the democracies; its leaders include engineers and technocrats thought able to plan and execute sensible economic practices. In the last several weeks, this belief has been exposed as a myth. China's blunders in two matters have been unsettling to financial markets. The first has to do with China's stock market. China's markets had a huge rally into June of this year, a rally not terribly well supported by fundamental factors. The Shanghai Composite rose from around 2000 in mid 2014 to more than 5000 in June 2015. Then came the selling and the index fell below 3000 by late August. As it fell, the Chinese government took a series of futile but quite extraordinary steps, banning certain institutions from selling, forcing others to buy, and making outright government purchases. It appears that China has spent more than $200 billion in a couple of months in a vain attempt to stem the selling.



Currency missteps are the second of China's recent blunders. China would like its currency to have the status of the dollar, the yen, the euro and the British pound. It is likely that China aspires to have its currency supplant the US dollar as the world's reserve currency. To accomplish its aspirations, China must sever the renminbi's peg to the US dollar and permit it to trade freely within and outside China. A few weeks ago, China loosened its dollar peg by a little and let the currency decline in US dollar terms. The action came as a shock and the after-the-fact explanations by Chinese officials were confusing and inept. The fact of the slight devaluation itself was not terribly significant, but the explanations put forward were unclear. China's actions with respect to its stock market decline and its currency adjustments undercut confidence in China's economic management skills, no small matter for such an important country.

What lies ahead? The future is unknowable. The squall of selling brought the S&P 500 down 12 percent from its May high. (Because of Core's conservative actions, clients' equity-oriented portfolios only fell by one half that amount in that period.) US stocks are slightly expensive and vulnerable after a six-year bull market, but our economy grows steadily and a recession is unlikely in the next year. Uncertainties about the timing of interest rate hikes by the Federal Reserve and the confusion about China are negatives. The quite dramatic price swings themselves are indicative of uncertainty and doubt. Given these factors, our investment approach has been and remains quite cautious. Clients' accounts hold a fair amount of cash and a large amount of bonds. We cut equity positions a few months ago and we will await events before reinvesting the cash. If a more significant bout of selling unfolds, stock prices will become more attractive.

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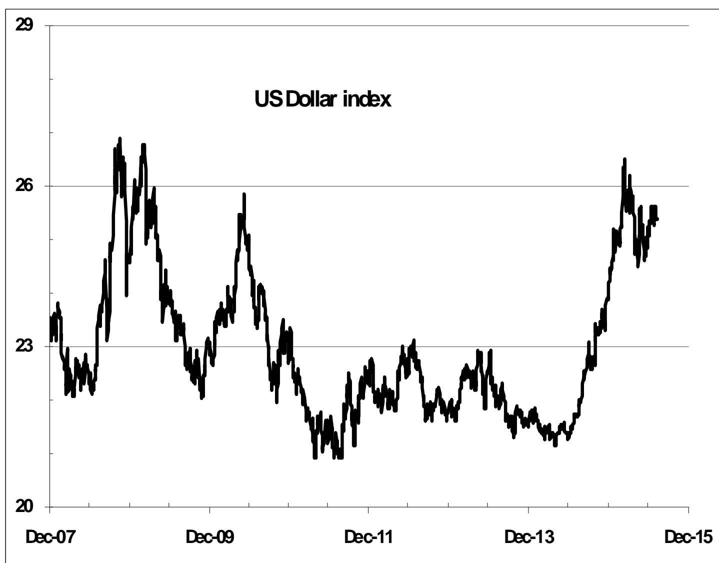
CORE Comments
ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

August 15, 2015

The Fed, China... and the Failure of the European Project

The US dollar rose sharply from the middle of 2014 through March of this year, largely because of the relatively stronger US economy and the Fed's move toward tighter monetary policy. The repercussions of a rising dollar are felt around the world.

The time approaches when the Federal Reserve begins to raise short-term interest rates. These have stood near zero since the early stages of the financial crisis and have not been raised in almost a decade. Given recent comments by Fed officials, there is a fair chance that at its September meeting, the Fed's Open Market Committee will make the first rate increase. US short-term interest rates will still be very low after the initial increase and the process of raising rates to 'normal' levels--perhaps two or three percent--will take many months, even years. However, the very fact that the US is considering raising rates and tightening ultra-loose monetary policy shows the difference in economic conditions between the US and those in Japan and the European countries that use the euro. Those economies remain weak and their central banks are nowhere near consideration of tighter monetary policy.



The very long period--since the beginning of 2008--of radical monetary policies during and after the financial crisis leaves financial markets vulnerable. To date we have seen some significant effects; almost certainly there will be more over the next year or two. The principal direct effect of the prospect of tightening policy has been the appreciation of the US dollar. During the long period when the Fed was buying huge quantities of US assets, increasingly its balance sheet five fold to four trillion dollars, many developing economies experienced huge inflows of foreign capital. They took advantage of ready and cheap money by issuing enormous quantities of new debt. Now with their currencies falling against the dollar and with slow economic growth around the world, there is growing risk of crisis in some developing countries.

By

Jack Mayberry

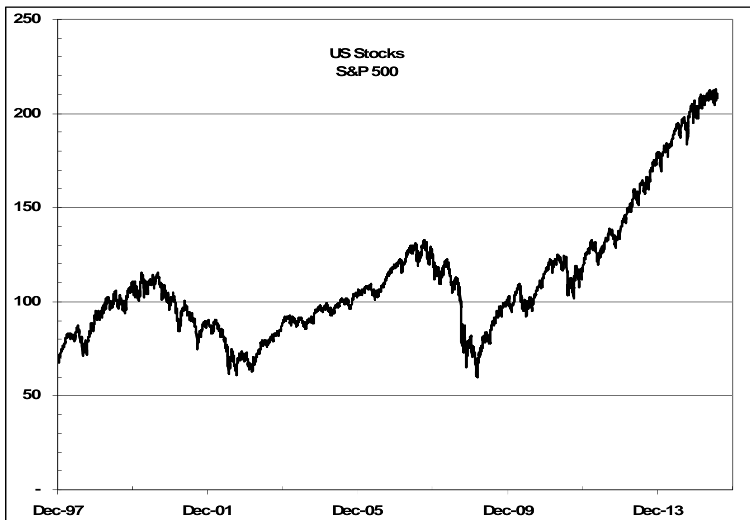
China and the dollar. On Tuesday, China delivered a shock to financial markets, by allowing the value of its currency to decline by about 2% against the dollar. A slightly smaller decline came on Wednesday, then another lower fixing on Thursday, followed by a press conference to give assurance that China was not beginning a large devaluation of the renminbi. The actions occasioned a big sell off in stock markets world wide, and concerns about renewed currency wars. By week's end, markets had calmed--and the S&P rose on the week. The initial market reaction and the somewhat desperate rhetoric accompanying it seem quite overdone, in that China has maintained a managed peg to the dollar over recent years, so that, as the dollar has

strengthened, China's currency has as well. China's has been one of the very, very few currencies in the world that has not dropped significantly against the dollar in the last year and, because it is a major exporter, its rising currency has been a drag on its economy and exports. Consider that since the end of 2010, the renminbi has appreciated against the dollar by 3.1%, even after the devaluation this week. Over the same time, the Japanese yen has declined by a whopping 52.8% against the dollar and the euro by 19.8%. As was remarked by James Macintosh in the *Financial Times*, if this is its approach to the 'currency wars,' China brings a knife to a gun fight.

The US stock market is shown below, the S&P 500 with dividends reinvested. As can be seen, the bull market that began in March 2009 has run for a long time. Stocks are not cheap by any means, and, with interest rates likely to rise over the next couple of years from rock-bottom levels, caution is warranted.

In the developed countries. So far, this has been an usually quiet year for American stock and bond markets, despite the always-present knowledge that Fed policies are changing. The S&P 500 is up all of 2.8% for the year with dividends included, and the broadest measure of tradable American bonds is up by 0.3%, interest payments included. Nor have there been any significant price swings along the way. The S&P has varied by less than 4% from its opening level in 2015; bonds by a mere 2%. Things have been less placid and more productive in Europe and Japan, whose stock markets have been stronger, particularly when the currency translation effects are hedged away. (The strong dollar and the still-loose policies of European and Japanese central banks have driven down the exchange rates of the Euro and the Yen this year.)

Core has had currency-hedged investments in Europe and Japan all year. As a result, and despite the drag from weak bonds, clients' equity-oriented portfolios have achieved gains in excess of US stocks and US bonds. (Please remember that there are variations in returns among clients' accounts, arising from considerations of willingness to accept investment risk, individual circumstances and predilections, and a host of other reasons.)



Economies and Central Banks in the Developed Countries. The key elements to the markets lie in the small differences among economies of the developed countries and the larger differences in the responses by their respective central banks. (We will certainly look back on these years during and after the acute financial crisis and note the exceptional actions by central banks in response. It is too soon to write with any confidence about the long-term effects of the radical policies; suffice it to say that central banks have loomed large--very large, especially in financial markets, since 2008.) At present, the US looks back on moderate growth since 2009 and looks forward to the continuation of modest economic growth.

By contrast, Europe and especially the countries using the euro (the 'Eurozone countries') endured several rounds of follow-on recessions and crises occasioned in large part by the politics of the euro. In 2010 came a large stock market retreat; in 2011 and 2012 came a more severe one. Mario Draghi stabilized matters and ignited a large recovery in financial markets with his undertaking in the summer of 2012 'to do whatever it takes...and it will be enough' to preserve the euro and Europe in the acute phase of the Eurozone crisis. Things in Europe improved after Draghi's promise, only to be dragged down again to a smaller degree in the

last year in the context of the latest round of the crisis with Greece. Since Draghi's undertaking, Europe's stock markets have kept pace with America's.

Japan's central bank and its markets have provided even a stronger contrast to the US. Japan's real estate and stock market bubble burst in 1989. In the decades since, Japan has suffered long bouts of deflation--falling prices--and periodic recessions. Under the government of Shinzo Abe, Japan's central bank has pushed down the value of the yen from 80 yen to the dollar in late 2011 to 125 now. Concurrently, with spending and tax policies, Japan seeks to stimulate Japan's economy and inflation. Whatever has been the effect on Japan's real economy, the combined monetary and fiscal actions have caused its stock market to rally to levels not seen in years.

After the Fed begins to raise rates. The strong dollar has already reduced foreign earnings of the many American companies that do business abroad. This explains some of the weakness in US stocks this year. The anticipated rise in interest rates comes after six years of rising stock prices. (The chart on the preceding page show the extent and duration.) US stocks are not cheap. Many sectors of the US bond market have been weak in anticipation of rising interest rates. The bonds of developed countries trade at historically high prices; much government debt in Eurozone countries provides negative yields. That is to say, one pays Germany for the privilege of lending to it for a five-year period.

The Fed's intends to raise rates in the context of generally weak global economic activity, very low and still falling commodity prices, and now, China's possible currency devaluation. With economies in such febrile condition, a Fed campaign to raise rates, however slowly, may exacerbate economic weakness and deflationary forces. The action of long-term treasury bond yields, which have been falling again, suggests that bond investors fear deflation and even slower growth. Consider as well the reasonable likelihood of some market chaos created by the shift in Fed policy. It is not hard to imagine that market turmoil in the context of weakening global economies may well give rise to a bear market in bonds and in stocks.

Core's investments. We have been reducing stock investments in stages since May. We have altered the mix of our fixed-income investments and sold outright a position in high-yield bonds. The effect has been to raise cash in client accounts. Given that money market funds still yield nothing, the cash does not provide investment income for us. It does, however, provide safety. Capital preservation is again important.

Greece and Germany; the IMF's dilemma.

Early this week, Greece and its creditors reached agreement on the plan put forward in mid-July for further loans to and further fiscal restrictions upon Greece. On Thursday, Greece's parliament passed the plan. On Friday, the finance ministers of the Eurozone countries approved the plan. Hence, €86 billion will be loaned to Greece, some of it quite soon. The initial tranches of the new money will be used by Greece to repay its creditors amounts from the two earlier rounds of lending to Greece.

The whole enterprise has been extremely dispiriting in so many ways that it is

hard to unpack the ways in this brief note. Over the weekend of July 17, the framework for a deal to lend the new €86 billion to Greece was hammered out. Greece capitulated utterly to the demands of its stern creditors, led by Germany. I wrote a long letter about this shortly after the weekend, but on re-reading it before sending it out, I realized that I had expressed my anger about Germany's actions in rather strong terms. I consigned the screed to deep storage.

The northern creditor nations, including Germany, Finland, the Netherlands, Austria and others, insisted upon further extreme fiscal austerity conditions and an exceptionally intrusive oversight regime. Given the 25% contraction of Greece's economy over recent years, worsened substantially by onerous fiscal conditions imposed in the first two loans, it is essentially impossible for Greece to repay the previous loans. The International Monetary Fund ('IMF'), one of the lenders to Greece in the 2010 and 2012 rounds, recognizes that the debt cannot be repaid and has argued forcefully for substantial debt forgiveness in this 2015 round. Indeed, IMF rules for lending forbid IMF loans unless repayment is feasible. The Germans and their allies have been adamant that no discussion of rescheduling the existing debt can occur until after Greece's implementation of the new demands placed upon it. (Will Germany agree to write off some Greek debt? Don't bet on it.)

The matter of IMF participation is up in the air. Without it, the Eurozone countries and the European Central Bank will find it politically difficult to win approval in various parliaments. This gives the IMF leverage to win meaningful debt reduction. (The United States, although not a participant in the Greek lending, except as the IMF's largest shareholder, argues strongly in favor of writing off a good deal of Greece's debt.) It is a tautology that debt that cannot be repaid will not be repaid. But the benighted proponents of cutting government spending in order to stimulate economic growth--the Germans and their allies--still do not recognize that their rules constrain economic growth, despite years of evidence to the contrary across many European countries. Politics and ideological obtuseness consign Greece and its people, who have suffered through six years of economic depression and high unemployment, to more of the same.

The European project that gave rise to the European Union and the euro, begun after the World War II, has had two principal goals, firstly to end the terrible cycle of disastrous wars that crippled Europe and much of the world, and secondly to improve living standards for Europeans. This latter goal was stopped by the financial crisis of 2007 to 2009, the debt crises among the 'peripheral' countries, and the accompanying recessions. One unfortunate feature of the various crises arising among the peripheral countries is the undemocratic nature of the process. Germany and its allies have sought to change governments in indebted southern nations--consider the virtual expulsion in 2011 of (the unlamented) Silvio Berlusconi in favor of Mario Monti in Italy. The decision-making process in the European Union must seem quite remote from the people affected by the decisions. To the extent that the process seems undemocratic, to the extent that the economic effects constrain the economic well-being of Europeans, to the extent that Germany is seen to impose its rules-based approach on Greeks and others, the entire decades-long European project is threatened. Alas.

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May 17, 2015

A Return to Normal?

How much does a ten-year bond pay one who buys it when it yields 0.05%, as the German bund did last month?

Assume that one invests €100,000 in such a bond. The interest one receives is €50 per year, or a whopping total of €500 over the ten years.

Those who bought the bund at yields like those presumably expected that the bund's price would keep rising (and its yield keep falling). The expectation was that the bund would soon be trading with a negative yield, because of the ECB's buying.

And that may still happen.

By

Jack Mayberry

The past several weeks have witnessed remarkably swift reversals in government bond markets, most notably in German government bonds, the *bund*. All bonds, including US treasuries, have been touched. To quantify the changes in prices and yields, note that at the time of the last *Core Comments* of April 19, 2015, the bund had risen in price to such a degree that its yield, which moves inversely to price, had touched 0.05%. This is, of course, an astonishingly low yield, never before seen. Since then, the bund's price has fallen and its yield recently touched 0.80%. This is still an extremely low yield, but it represents an exceptionally fast change in price and yield, especially since it appeared in April that the bund's yield would turn negative, a situation that obtained last month with Swiss government bonds, among others.

The ten-year US treasury yielded about 1.80% at the time the bund changed hands at 0.05%. In the intervening weeks, its price has also fallen and its yield moved up, but less remarkably, to around 2.37%. (As of this writing, the bund yields 0.62% and the treasury 2.14%.) The historically low yields and high prices for these and almost all bonds have arisen in the aftermath of the financial crisis and great recession. Economic growth has been far lower that in typical recoveries and economic expansions, for the many reasons discussed in these letters over the years: Major central banks, the Federal Reserve Board, the European Central Bank (the ECB), the Bank of England and the Bank of Japan, have engaged in a series of hitherto untried monetary policies, notably massive asset purchases (referred to as "quantitative easing"). Governments, especially but not only in Europe, have restricted government spending; these fiscal policies have further depressed economic activity. It is beyond the scope of this letter to explain how these various actions have wrought their changes on economies and bond markets; it must suffice here just to list some factors. The very recent increase in rates may be a sign that fixed-income markets now anticipate the ending of extraordinary monetary policies and the return to more 'normal' levels of economic growth and inflation. At Core, we have doubts about this thesis.

As 2015 began, the ECB was about to commence--at long last--its asset purchase program, by which it is purchasing about €60 billion of bonds of European Union governments each month. The ECB plans to continue these purchases until it has purchased more than €1 trillion of such bonds or until deflation risk has abated. This €60 billion per month is a rate roughly equal to the total issuance of such bonds. Meanwhile, the Fed ended its latest--and probably last--asset purchase program last autumn, after having increased assets on its balance sheet from the pre-crisis level of about $800 billion to $4 trillion in bonds and other securities. US job creation especially but economic growth generally appeared to have reached decent levels in the second half of 2014. The expectation, encouraged by the Fed itself, was that the Fed would begin to raise short-term interest

rates, which have been essentially zero in the seven years since the crisis. As the year began, the contrast between still-weak economic growth in Europe and relatively strong US growth, and between the ever-loosening monetary policy of the ECB and the Fed's incipient monetary tightening produced the following effects in bond, currency and stock markets: The dollar rose against most currencies, but especially against the euro. European stock markets rose in anticipation of economic stimulus from the ECB's program, and European bonds rose in price as the ECB bought every bond in sight.

And so things proceeded during the first few months of the year. Core's portfolios were structured to take advantage of these market movements and we enjoyed strong returns. As the first quarter progressed, various economic reports began to show that US growth was slowing during the winter, until finally the March jobs report showed the lowest level of job creation in a year. Meanwhile, similar reports from Europe indicated faster growth there. The settled view of economic weakness in Europe and strength in the US was not being borne out by the facts.

Thereafter came rapid adjustments in currency and bond markets: the euro, having fallen from $1.40 to $1.05 in a year, stopped its seemingly inexorable move toward parity with the dollar, and began to march higher--to $1.14 at present. Yields of the bund, the treasury and other bonds changed as noted. As it happens, stocks have not been much changed. There have been sharp moves of a few days duration, first downward, then upward, but the results have been modest. The S&P 500 made a nominal new high on Friday; European stocks are only a tad lower.

A return to normal? Does the sudden and sharp change in direction in currency and bond markets in recent weeks mark a turning point in the long path to recovery after the financial crisis? Have we finally seen the lowest bond yields in human history? Is this the first step away from the era in which extraordinary monetary policies by the central banks so affected prices of stocks, bonds and other assets? I think not. Firstly, from times long before the financial crisis, Fed policies have driven asset prices. This will not change and the only new thing in recent years is that the Fed employed monetary policy tools it had never before used. (Well done, Mr. Bernanke and Ms. Yellen!) Secondly, the ECB is still in early stages of its massive quantitative easing program. The economic effects in Europe are still unclear; early reports are favorable but not conclusive. It remains likely, in Core's view, that the ECB's asset purchases will push stock and bond prices in Europe higher and its currency lower. Quite independent of the ECB's policies has been the slowdown in US growth in the beginning of this year, a phenomenon we have seen in recent years; another severe winter in the Northeast and the ports strikes in California explain some of the weakness. Thirdly, market dynamics themselves may explain much: There was little doubt, as the year opened and the ECB began its project, that the euro would fall, while the dollar and European stocks and bonds would rise. That did happen…until it didn't. It was what is called a one-direction trade and everyone piled in. In recent weeks, the direction changed. Swiftly.

Core's view is that the recent shift augurs nothing. It is simply one more example of a 'crowded trade' reversing suddenly. Volatility--large price swings--is simply a characteristic of modern financial markets. Let us not accord too much significance to short-term price movements; instead we must assess larger underlying economic movements and the monetary and fiscal policies of the major countries. We consider this to be our assignment. Our conclusion now--always subject to change--is that the shifts in asset prices in the last few weeks mean very little.

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

April 19, 2015

What will be the outcome of negative interest rates?

Stock markets in Eurozone countries have been flying this year. Bond prices are soaring and their yields are falling, in many cases to negative territory. Even economies in these countries are coming to life in the context of a set of favorable conditions.

Although Japan's economy is far from vibrant, its stock market is reaching heights last seen at the turn of the century. The Quantitative Easing programs in Europe and Japan are a tonic for investment markets, whatever is their effect on real economies.

By

Jack Mayberry

European stock markets have continued to be strong and it now appears that economies in most of Europe are beginning to improve, as well. As I have written, the enormous asset purchase program by European Central Bank (ECB) has caused the value of the euro to drop in relation to the dollar and has caused asset prices, including stocks and bonds, to rise. At the ECB's recent press conference, its president, Mario Draghi, commented that the asset purchase program is only one kilometer into its marathon. This suggests that the recent trends--falling euro and rising stocks and bonds--will continue.

Growth in the Eurozone countries. Moreover, after several years of wavering between recession and anemic growth, economies of Eurozone countries are improving and might just grow faster in 2015 than the US economy. Four things appear to be helping these countries, First, sharply lower oil prices help consumers and businesses. Second, the decline in the euro's value makes exported goods cheaper in dollar terms. Third, after years of fiscal austerity, government spending is growing a bit. Finally, the pressure to reduce debt is easing and credit is expanding. All this may be temporary, but it is quite welcome; there are positive signs of economic growth throughout the region. This provides a contrast to the American economy, which faltered in the first quarter, presumably as a result of the strikes in California ports and the quite severe winter weather in the Northeast. Given the strength in US stocks markets in 2014 and the weakness in the Eurozone, it is unsurprising that European stocks have raced ahead in 2015, while US stocks have barely budged. Our substantial investments in European stocks have done very well.

Greece and other risks. Several weeks ago, as the new left-wing Greek government was beginning negotiations with the European Union (EU), the International Monetary Fund (IMF) and the ECB to alter the terms of bailouts of Greece by these three entities, there appeared to be a clear path to a new agreement. In the weeks since, positions have hardened, but Greece's funds available to meet its obligations over the next two or three months seem insufficient. A Greek debt default and the possibility of its exit from the Eurozone ('Grexit' is the infelicitous term that denotes it) seem to be distinct possibilities. Although Grexit might be accomplished without too much collateral damage to the European banking system and to other countries in the Eurozone, there is, of course, no precedent for this. The sanguine predictions might prove to be so much wishful thinking. More generally, the various issues that have kept the Eurozone economies weak--including an aging population, an ineffective currency union, and damaging fiscal austerity--are likely to restrain growth in coming years. For now, however, our European investments should prosper.

One unforeseen consequence of all the radical monetary projects since the financial crisis is a new era of negative interest rates on many European bonds.

This phenomenon is essentially a new one and distortions it may cause in economies and financial systems are yet unknown.

Japan, a somewhat similar story. Japan began its massive asset purchase program well before Europe's. Since Japan's quantitative easing (QE) program began, the yen has fallen sharply against the dollar and Japanese stocks have soared in price. However, the deflationary pressures in Japan and its economic contraction have hardly abated. These were the reasons to engage in QE in the first place. Thus, there is a good chance that the asset purchases and other unconventional monetary practices will be increased in coming months. Whatever is the effect on Japan's economy, further appreciation in Japanese stocks is likely.

The worrisome aspect of the ECB's bond purchases. I have written often in these letters how the QE programs of the Federal Reserve (which has come to an end), the Japanese Central Bank and the ECB are so beneficial for the investment markets in which we invest. The ECB's new and huge program may come to reveal how it can damage markets. The ECB is buying €60 billion per month of bonds and plans to continue for an extended period. (A 'marathon,' Mr. Draghi calls it.) The problem is that there are not really enough bonds being issued by Eurozone countries or readily available in the secondary market to support buying of such magnitude. As a result, interest rates for European bonds are plunging (and their prices rising) to hitherto unimaginable levels. The German 10-year government bond, the *bund*, which yielded a very spare 0.5% *per annum* as QE got under way, has seen its price rise and yield fall. On Friday, the yield fell to 0.05% and is moving inexorably to negative territory. The Swiss government recently issued a new ten-year bond at a negative yield. Something more than half of all European government bonds and notes now have negative yields. If one buys a newly-issued bond with a negative yield, one pays the issuer for the privilege of lending. Why would one pay 10,500 Swiss francs to the Swiss government for the promise by Switzerland to repay 10,000 francs in ten years? What are mattresses for anyway?

At the request of a number of clients, we have sent our quarterly reports by email in .pdf files to most clients. If you wish to receive these by email, please let us know. We will continue to send regular paper reports to all who wish to receive them. And, we are happy to send these reports in both formats to you. Let us know your preference, please.

In the past, there have been occasional, brief, and infrequent episodes of negative interest rates--paying to lend. (These have generally involved Switzerland, always a haven for nervous owners of capital.) There has never been a situation in which hundreds of billions of government bonds and notes have yielded less than nothing. What will be the outcome, particularly as the ECB's marathon buying spree is only beginning? Insurers sell annuities with promises to pay sums certain over a period of years; they sell promises to pay sums upon the deaths of insureds. To honor these promises, insurers need to earn positive returns on the premium income they collect.

Although much is being written about benign or dire effects of negative interest rates, in truth, no one knows how this will play out. Our letters have noted in recent months that volatility (price fluctuation) is becoming more pronounced in various markets. These wide swings in asset prices reflect the risk <u>and</u> the uncertainties created by these bond market developments. We at Core are mindful of risks exemplified by this price volatility. Although markets have favored our investments, particularly currency-hedged equity investments in Japan and Europe, we will not get carried away by the exuberance on display in some markets.

Energy in the future: oil and solar. For another letter is a discussion I had planned for this one about oil-related investments after the tremendous decline since last summer. In short, it appears that the Saudis and OPEC no longer control oil prices; instead these are set by the costs of production. Ever-improving oil and gas extraction technology will keep oil prices low--or so I think. I also plan to discuss solar power, where technology has driven costs ever lower and permitted the doubling of installed photovoltaic generation capacity every two years. It will not take too many more doublings to supply all we need. More to follow.

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ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

March 5, 2015

A Strong Start to the Young Year

Strong stock markets in Europe and Japan and the weakening euro and yen flow in large part from the massive European and Japanese central bank asset purchase plans.

The European Central Bank will begin its asset purchases next week, but its January announcement of the program's dimension galvanized stock and currency markets.

The combination of liquidity provided by central bank programs and modest improvement in economic growth have been the forces behind this year's healthy stock market gains.

The new year has begun very well for our investments, particularly in foreign stocks. This somewhat reverses the results from 2014, when US stocks were quite strong and European stocks rather weak. As discussed in our last letter, the European Central Bank (the ECB) finally announced its plans for a very large and open-ended program of asset purchases, referred to as 'quantitative easing' or 'QE.' This plan, involving the purchase (mostly of bonds issued by European governments) of €60 billion per month for eighteen months, was announced in January and will commence next Monday. The planned purchases are designed to enhance economic growth in the Euro-zone countries and to counteract deflationary forces in Europe. Whether these results are achieved by the ECB's program is by no means certain. However, it is quite likely that the asset purchases will cause prices of various European (and other) assets--including bonds and stocks--to rise in price. The outperformance by European stocks this year may be attributed in part to the ECB's announcement of its QE intentions.

The decline of the euro. Additionally, it is reasonable to expect that QE will cause the exchange value of the euro to continue its decline against the US dollar. The euro has already fallen by about 20 percent against the dollar since May. It may fall further because the US economy is stronger than Europe's and because the Federal Reserve has finished its asset purchases and will probably begin to raise interest rates later this year, while the ECB just begins its own quantitative easing now. The differences in rates of growth and in monetary policies are likely to cause the euro to decline further against the US dollar. (Note that for Core's investments in European stocks, we use a fund that hedges away the euro currency effect, thus the decline in the euro does not cut into the returns earned by appreciation of European stocks.)

The tone improves in Europe. Despite slower growth in Europe, things European are decidedly less gloomy than they have been in recent years. The interim deal made last week between Greece and the parties involved in 'assisting' Greece with its large debt burden--the European Union, the ECB, and the International Monetary Fund (the IMF)--suggests strongly that an arrangement will be made with Greece that will keep Greece within the Eurozone and will not disturb financial markets unduly. (Whether it lessens the severe pain that Greeks have suffered in recent years from the economic depression into which the country has fallen is quite another matter. Let us hope so.) And, after a rather grim 2014, when most European economies were teetering at the edge of recession and deflation, the prospects for 2015 are more positive. Economic growth is hardly robust, but estimates are being raised, not lowered.

By

Jack Mayberry

Japan and other equity markets. Similarly, Japanese stocks have been quite strong so far this year. The massive quantitative easing program by Japan's central bank has been under way for over a year. Its effect has been to increase the prices of Japanese stocks and to bring down the exchange value of the yen. (Precisely as we expect, *mutatis mutandis,* from the ECB's QE program.) As with our European stock investments, so our Japanese investments have been hedged against the yen's decline. Early this year, we added an unhedged Japanese stock investment, alongside our hedged one, on the notion that the yen's decline may largely be over. The US stock market has lagged Japan and Europe a bit this year, but it made another new high at the beginning of this week. Although the Fed will begin 'normalizing' interest rates later this year, its policy is still very accommodative; it provides a good tail wind for US stocks and helps the US economy.

Two factors have helped the world's stock markets recently: the liquidity provided by the world's major central banks and the modest but real economic growth in most regions. Central banks increase funds available for investment through their asset purchase programs, while, at the same time, their purchases withdraw significant amounts of government bonds from the markets. The Federal Reserve now holds $4 trillion of securities; Japan and Europe are engaged in multi-trillion dollar purchase programs. The effect is to drive up prices of bonds and push investors into other assets, like stocks and real estate. Central bank liquidity will remain a formidable factor in financial markets all this year and perhaps some time beyond.

Russia. After writing this rather cheerful account of central bank actions, financial markets, and growing economies, it is depressing to turn again to Russia. In the last month came another cease fire agreement settled in Minsk among Putin, Merkel, Hollande and Poroshenko. Before the ink was dry, the Russian-backed forces in the eastern part of Ukraine declared that the agreement did not apply to the railroad junction they were attacking, so the fighting continued there. Then came last Friday's murder on a Moscow bridge in the shadow of St Basil Cathedral of Boris Nemtsov, the able Russian opposition leader. It is plausible to consider this an assassination approved, if not ordered, by Putin. Or, in the climate fostered by Putin's characterizations of political opponents as 'traitors' or members of 'fifth columns,' it might be that a radical group sympathetic to Putin murdered the 'traitor.' It is quite possible that we will never know what happened, but this act shows us once again that Putin is prepared to go to extremes to maintain his power.

Dreadful as Mr. Putin's Russia has become, we should not overestimate the impact of these Russian and Ukrainian matters on investment markets. Geopolitical events, however nasty, rarely have a meaningful impact on financial markets. The Arab oil embargo in the mid-seventies is an event that did bear heavily on markets for a long time, but all the wars and terrorist attacks since have had little more than fleeting impact. To put this another way, Janet Yellen is far more important to investment markets than Vladimir Putin.

Mr. Putin, with his vast arsenal of nuclear weapons and, apparently, some very able special forces units, could rival Ms. Yellen in importance if he should escalate things enormously, by invasion of Estonia and the other Baltic states, or otherwise. Until then, we can consider these unhappy events in Russia and Ukraine without worrying unduly about their impact on our portfolios.

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CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

January 24, 2015

The European Central Bank Lays out its Plan

The European Central Bank has announced its Quantitative Easing program, after many months of hints, speculation, and behind-the-scene negotiations with the Germans and others who have opposed the plan.

It is a massive program, under which €60 billion will be purchased each month for at least 18 months. Will it reverse deflationary expectations? Will it stimulate demand and rouse the eurozone economies from slumber? Time will tell.

It is quite likely that the ECB's QE program will cause stock and bond prices to rise and the value of the euro to fall.

By

Jack Mayberry

The new year has begun with financial markets and the global economy roiled by uncertainty and unexpected events. The European Central Bank has been the source of major uncertainties: firstly, what action it would take to attempt to revive growth in Europe, and, secondly, what effects will its actions have. The relentless decline in the price for crude oil has unsettled markets, economies, and geo-political calculations. The startling and utterly unforeseen action by Switzerland's central bank to end its 'peg' to the euro focused investors' fears that central banks had so manipulated normal prices for credit, currencies, and other assets as to render these prices and their underlying relationships unpredictable and vulnerable. This list could readily be lengthened.

These events, these uncertainties occur at a time of difficult economic conditions. Pervasive weakness in global economic demand has caused prices for goods and services in many countries to stagnate. Median inflation in developed economies is now below 1 percent. Deflation--i.e., falling prices--is at hand in many countries; the 50 percent decline in oil prices in six months pushes prices even lower. While the United States had reasonably strong growth in last nine months of 2014, Europe, Japan, and other developed economies have been barely positive. China's growth, still strong by standards of mature economies, has slowed considerably.

The European Central Bank settled one open question on Thursday with its announcement of its plan to buy a huge quantity of bonds issued by the various eurozone member governments. The scale of purchases is larger than expected; it is comparable in size (€60 billion per month) to the recently-ended Federal Reserve's asset purchase program; it is potentially open ended insofar as the ECB promises to continue the asset purchases until inflation returns toward the ECB's target level. The planned purchases are very great, €1.1 trillion or more, and the concessions to Germany's opposition are modest. Thus, at long last, the ECB begins its quantitative easing program (QE).

The ECB's announcement and the market's favorable initial reaction begs the question: Will it succeed? This is unknowable. QE programs initiated by the Federal Reserve and the Bank of England have been followed by higher economic growth in the United States and the United Kingdom, but those programs began several years ago. Has the ECB come too late to the party? Japan's central bank is in the midst of an enormous asset purchase program, but its was also begun rather late in the game. So far the result in Japan has been to weaken the yen and to bolster the stock and bond markets. These results were intended and expected, but the bigger targets, the revival of Japan's growth and the escape from deflation, have not been hit. It is simply impossible to know if the ECB

can halt the deflationary spiral in Europe and stimulate economic demand. Europe, like much of the developed world, suffers from too little demand. As a result, it is awash with savings not put to productive use, while it has terribly high and very long-term unemployment, particularly afflicting younger people.

Investment implications. Three points to consider: First, European stocks will probably rise with the ECB's QE program, while the euro declines in value. Second, US stocks and the US dollar are the favored investments by most investors around the globe. Finally, volatility--wide and sharp swings in asset prices that have characterized the last six months--is likely to continue.

Whether the ECB's asset purchase scheme will raise inflation toward ECB's close-to-but-less-than 2% target is an open question, about which skepticism is well warranted. Whether the program will stimulate much-needed economic growth is similarly unknown. What seems quite likely, however, is that the ECB's program will stimulate the prices of investment assets in Europe and around the world, just as has been the result of the QE programs of the Fed, the Bank of England, and the Japan's central bank. Stock prices in eurozone countries will rise. Equally likely is that the euro will continue to decline against the US dollar. Since the middle of 2014, the euro has fallen from about $1.40 to $1.12 today. Although the euro may not continue its straight-line descent, over the next 18 months of the QE program, it is likely to fall further. Accordingly, we will continue our investments in European stocks and we will maintain our currency hedge, so that the decline in the euro does not offset the gains in the stock prices.

The US stocks dollar was as strong as new rope in 2014 and US stocks provided better returns than did most other equity markets. Surveys show that many investors expect similar results for 2015. This remains to be seen; rational expectations are often dashed by reality. We maintain a balanced approach and hold European, American, and Japanese stocks. The continuation of Japan's very large scale QE program and the initiation of the ECB's will support their stock markets and others around the world. The Fed promises to take great care in raising interest rates. The result is likely to be decent, if unspectacular, economic growth in the US, giving rise to improved corporate profits and supporting stocks valuations.

Finally, we have seen an increase in the frequency of sharp falls and rises in the prices of various assets and currencies. Expect this to continue. The unsettled nature of economies and the divergence in monetary policies between Japan and Europe on the one hand and the US on the other will probably disturb markets. The very sharp decline in oil in since last summer is also a cause of increased volatility, in part because of stresses it creates in Russia and the Middle East. (Witness the violent upsurge in fighting in recent days in eastern Ukraine, again at the apparent instance of Russia and with another large influx of Russian arms and personnel. This appears to be Mr. Putin's response to the economic distress in Russia caused by the collapse in the rouble and oil prices.) Geo-political concerns, also including ISIL, the Iranian nuclear threat, the Sunni-Shia violence throughout much of the Muslim world, and Ebola, are likely to unsettle markets more than once this year.

Core seeks to strike a balance between opportunities and risk, by maintaining a goodly set of investments that stand to gain in coming years, while taking measures to mitigate the risk of deep declines in portfolios. Increased volatility certainly heightens risk, but it also gives alert investors opportunity to buy at temporarily low prices. Onwards into 2015!

CORE Comments

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