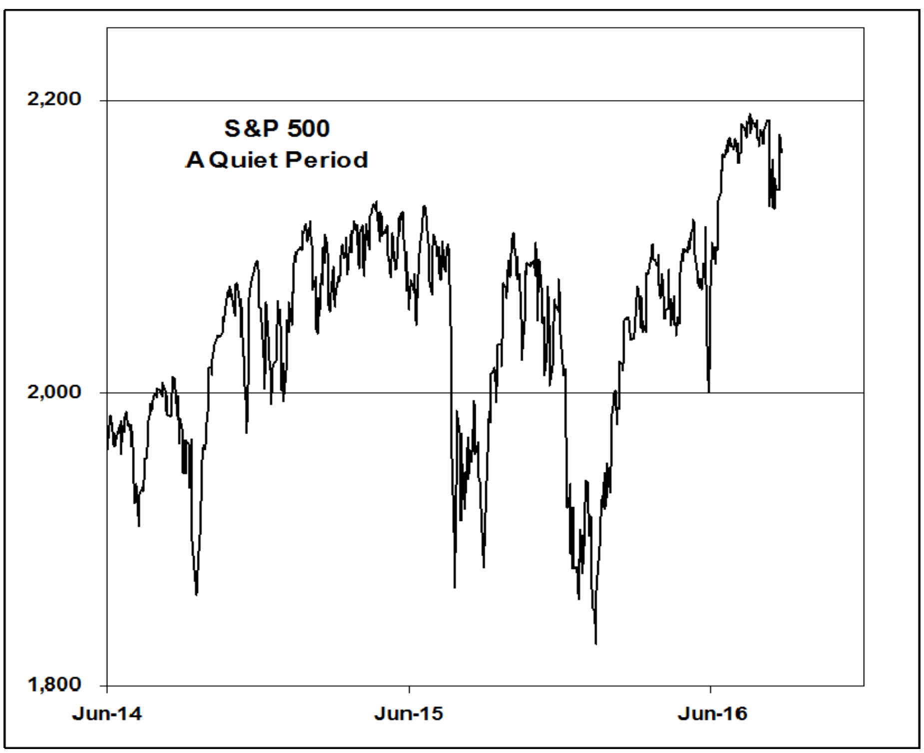
CORE Comments
ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

September 24, 2016

Slow and Steady

The graph below of US stocks, shows a rather quiet market, with small price swings and a modest increase in the last two years.

The year grinds on with little disturbance in financial markets. After the June Brexit vote and the intense selling that followed, the US stock market and Treasury bonds moved to new highs. Treasury yields, which move inversely to price, fell to historic lows. (A note on <u>very</u> long-term yields is at the end of this letter.) Thereafter, for several weeks, prices of stocks and bonds were very stable, with virtually no change day to day. Always simmering below the surface are questions about upcoming central bank actions and the efficacy of these central banks in supporting economic growth and the asset markets. A recent speech by the head of the Boston Fed suddenly reintroduced volatility, first a sharp and deep fall prices, then a sharp rebound, then more up and down. What can we conclude from the extended stability and the sudden price swings that followed?



In the last couple of years, investment capital has moved relentlessly to traditionally safe investments, to government bonds, US stocks and high-grade US corporate bonds. These have performed very well, while related assets have fallen. For example, while the S&P 500, the primary benchmark for US stocks is up by 8% in the last two years, stock markets in the Eurozone countries are down by 14% and in developing countries by 15%.

What to make of these anomalies? Certainly the US economy has been stronger than Europe's and the US is surely far more credit worthy and sound that China and other developing economies. But, why have US stocks so far outperformed others? What are we to make of negative yields on most government bonds issued by Germany, Switzerland, Japan, Sweden and others? Fourteen <u>trillion</u> dollars worth of sovereign debt of such countries trades at negative yields. A couple of weeks ago, two European companies--not giants like Nestle's or Unilever--issued notes with negative yields. This means that, if you were to lend 10,300 euros to such a company, you would receive, in return, a promise to pay you 10,000 euros in two years. (What happened to mattresses?) These make corresponding yields in America--1.6% for 10 year Treasuries and 3.2% for the most creditworthy of US corporations--seem inexplicably generous.

By

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The general explanations for all this revolve around the matters of the extraordinary monetary policies of the central banks against the backdrop of constrictive fiscal policies of developed countries. (Fiscal policies refer to the spending and taxing policies of governments.) 'Fiscal austerity' is the term of art to describe the unwillingness of governments to spend money--whether on education, roads and bridges, basic research and the like--while pursuing the presumed greater good of balanced government budgets. (I do not agree with fiscal austerity, in case the reader is in doubt.) The Federal Reserve had the scope to initiate heretofore unused--one might say unimagined--tools to attempt to resuscitate the economy after the 2007 to 2009 financial crisis and recession. The Fed had held some $800 billion of US Treasuries when the crisis began; it bought more of these and other fixed-income securities in its programs of 'quantitative easing.' It now holds more than $4 trillion of such securities. It pushed short-term interest rates, which it controls directly, essentially to zero. Last December, it raised the Fed funds rate by 0.25%. Thus, we now have short-term rates at that level. (We remember with fondness and longing the days when our money market funds yielded 4% or 5%. Will you see such levels again in your lifetime? Only if you are young enough.)

The presidential election looms. Its outcome may move markets. If Trump were to be elected, financial markets could be shaken mightily. If Clinton wins, there will be a sigh of relief and a likely further rally.

Meanwhile, seven years after the US economy began to recover from recession and the stock market began its new bull market, the result is uninspired. In the US, economic growth as has been steady but subdued. In Europe and Japan, economies have teetered into and out of new recessions. Inflation, which the Fed wishes were at 2% or so, has been too low for comfort and too close to drifting into deflation--falling prices. We will save a discussion of the problems with deflation for another day.

A colleague of mine remarked at lunch the other day, 'low inflation, modest economic growth, low interest rates, what's the problem?' His point was that, for an investment manager, the environment is fine. The investments he holds will continue to do reasonably well while this environment persists. What will disturb it? Nothing in the US economy seems terribly out of balance; we learned recently from the Census Bureau that median income for households rose at a remarkably good rate in 2015. Slow and steady seems to be working.

External events. John Lennon told us that 'life is what happens while you're busy making other plans.' The placid state of affairs in the US economy and financial markets faces a presidential election in fewer than seven weeks in which we have an utterly unpredictable Republican nominee putting forward views the likes of which we have not seen in living memory from a serious politician. He seemed to be a bad joke until he won his party's nomination in a campaign characterized by bigotry, ignorance, vulgarity, lies and insults. With new advisors, he restrains himself from uttering so frequently his unfiltered views and, for now, seems to be winning support from likely voters.

Government bond yields over the last 700 years? Now that is a long-term perspective.

The prospect that he might become the president is deeply unsettling to financial markets. (We will leave unstated reactions of actual American people to that prospect.) What else might disturb things? A bomb exploded in the Chelsea part of Manhattan; in a Minnesota shopping mall; a fellow stabbed ten people; more black men have been killed by police. Although the economic impact of these incidents hardly registers on the scale, the political impact may play in the election and in the markets we invest. The election or some other external event may disturb the market's placidity. We are alert.

A Post Script: Lowest yields on government bonds since 1300? A respected research firm, to which Core has subscribed for years, formerly called the Bank Credit Analyst, now BCA Research, published a report on Monday purporting to show yields on government bonds since 1300. Of course, there were no US Treasuries, no UK gilts, no German *bunds* then. The yield data begins with bonds issued by Venice and Genoa, Dutch bond yields are added a few centuries later, then the data broadens to the United Kingdom, France and the United States as these countries began to issue bonds. It shows that sovereign debt has never been lower in yield and higher in price than it was in July. (Yields are higher by a tiny amount since then.) It makes the interesting point that in truly severe financial crises, like the world-wide depression of the 1930s and other alarming predecessors, yields were then higher than now. This is an exceptional time!

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