CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

December 26, 2011

As the Year Winds Down

The European Central Bank has commenced a massive program to provide capital to banks. This mitigates the risk of a banking crisis over the next few months, and provides some support for new European government debt in this period.

Because we have pulled back from the abyss once again, because the risk of crisis has diminished, Core has made modest new investments.

By

Jack Mayberry

A note of thanks. Before writing the next round of musings on the state of things political and economic, let me express the deep gratitude that we at Core feel for the opportunity you have given us to work for you. We thank you sincerely for the privilege of investing your capital on your behalf. The intellectual challenge offered by this remarkable and extended economic and financial crisis, now entering its fifth year, is stimulating and exciting. For better or for worse, 2012 promises more of this kind of challenge to investors: Euro-zone problems are still unfolding and the fraught election in the United States will provide more grist for our mill.

We enjoy greatly our work with you individually on specific personal financial matters and the exchanges we have with you over the course of the year. We hope that you are savoring the joys of life and family and friends at the year-end holidays. We wish you and your family a new year full of stimulation, good health, and good fun.

* * *

And now, to matters European. In my gloomy letter of a few weeks ago, I wrote of the risks to investment assets from the Euro-zone crisis. Since then, short-term risks have receded because of actions of the European Central Bank (the ECB). As mentioned in that letter, leading central banks, the Federal Reserve, the ECB, and the central banks of the UK, Switzerland, Canada, and Japan, in early December announced a co-ordinated program by which the Fed would make unlimited amounts of dollars available in swap transactions with the ECB.

The next step in the process became known at the December 9 European summit meeting, when the ECB announced that it would extend the term of its lending to European banks in a program called the Long Term Refinancing Operation (LTRO), by which it would lend to banks at 1% for terms up to three years. On Wednesday the 21st, the ECB announced that it was lending €489 billion to 523 European banks in 17 countries. This massive bank funding effort will accomplish two things: (1) provide needed capital to banks at this time when their access to funding in private markets (e.g., US money market funds) has all but dried up, and (2) permit the banks to earn profits by investing this new, very inexpensive capital in sovereign debt issued by European countries. This in turn provides Italy, Spain, Belgium, France, Portugal and others potential buyers for the issuance of new debt in coming months on reasonably favorable terms. It is, in effect, a back-door way for the ECB to support the sovereign debt markets. Recall that the more direct approaches for the ECB to meet the liquidity needs of governments have been effectively vetoed by Germany.

From the Fed's playbook. This massive LTRO program recalls actions by the Fed in the aftermath of the Lehman bankruptcy in September 2008, when, through a series of radical new programs, the Fed and the US Treasury recapitalized US banks and restored the functioning of various credit markets. My expectation is that the ECB will continue the LTRO program and will introduce other new operations in coming months to maintain the functioning of the European banking system and the government bond markets.

While this operation does not end the Euro-zone crisis by any means, it does provide more time for the resolution of this complex matter. It lessens substantially the risk of a bank failure or similar event that could plunge the world back into financial crisis. For the time being, the LTRO provides needed liquidity for undercapitalized European banks and it lowers the cost of shorter-term European government borrowing. In the days following the ECB announcement, a series of auctions of sovereign debt with maturities up to a year or two were successfully concluded at low interest rates. Because the imminent danger has receded, Core has taken some modest steps to invest again in a more 'normal' way. We have used some of our large cash position to invest in an exchange traded fund that replicates an index of all tradable American bonds, treasuries, agencies, and corporates. We also added modestly to our US dollar position. If and as the situation in Europe stabilizes, we expect to make further investments.

LTRO does not solve the Euro-zone problems. While the ECB program may be an effective medium-term solution to bank capitalization and, perhaps, to government refinancing needs in coming months in Italy, Spain and other countries, it does nothing to restore the solvency of the indebted countries in Europe. Short-term *liquidity* is not the same as long-term *solvency*. The long-term solutions announced at the December 9 summit involve extraordinary fiscal austerity and, by my thinking, will necessarily depress economic activity. The troubled European countries desperately need economic growth; the German approach does not foster growth. The ECB action buys time for the complex fiscal and inter-governmental measures to be enacted. The essential problems of competitive imbalances between Germany and the rest and of the absence of economic growth remain unsolved. We will certainly be writing much more about all this for many months.

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CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

December 2, 2011

The Eurozone is at the brink of collapse

The sovereign debt crisis in Europe has worsened markedly in recent weeks. The opportunity to resolve matters before real chaos unfolds is narrow. Germany and the European Central Bank can resolve the crisis in the short run, but they continue to refuse to countenance the needed action.

The risk of a European event leading to another financial crisis has become uncomfortably large. We are engaged in a series of trades to remove risk from portfolios.

By

Jack Mayberry

You will have noticed a large number of buys and sells in your accounts with Core in recent days. Here is the explanation: In the last week, I have concluded that the risk of disorder in Europe has risen markedly. The chances of the collapse of the Euro, of bank failures, of defaults in government debt have reached levels far above the trivial. Any of these events could lead to chaotic market conditions and to sharp declines in many assets, akin to what we experienced after the bankruptcy of Lehman in the autumn of 2008. Officials in Europe, at the IMF, and in the central banks are intent on solving these problems, and they are working mightily to restore calm, liquidity and solvency. It is also clear, however, that the insistence by Angela Merkel, the German chancellor, on narrow remedies raises the alarming possibility that markets and banking conditions will unravel before the German approach can become effective.

After an exceptionally grim period of weeks, the markets relaxed and a rally unfolded in this week just past. Major central banks have entered into a new program to extend lower interest rates on US dollar interbank loans for a longer period; three auctions of government debt (in Belgium, France and Spain) have 'gone well'. (In this case, a 'good' auction means at much higher rates than similar ones a month ago, but with enough demand at the high rates to sell the bonds on offer. In normal times, no one would call these 'good' auctions.)

A new plan is afoot, to be announced on December 9, which might, just might save the Euro. The outlines are being discussed in the press. If one had not been reading similar reports of solutions over the last year and more, one might be inclined to optimism. Recall that, on October 26, and with some fanfare, European leaders announced a "comprehensive solution" in three parts "to overcome the present difficulties". The three legs of this involved a "voluntary" write down of Greek government debt by some private holders, a beefing up of the EFSF (European Financial Stability Facility) to enable it to provide a backstop of sorts to prevent Greece's default from imperiling other heavily indebted but still solvent debtors, including Italy and Spain, and recapitalization of European banks, weakened by ownership of imperiled European government bonds.

Without detailing the weaknesses of each of the three provisions, suffice it to say that within days, the weaknesses were exposed in the markets. Interest rates on government bonds of Italy, Spain, and Belgium rose steadily. More disconcertingly, the yields on the bonds of the strongest countries, those with AAA credit ratings, Finland, the Netherlands, France and Austria also climbed. Note that the Greek and Italian governments fell last month, replaced by so-called technocratic governments. Despite the new and well respected Italian prime minister, Mario Monti, Italy's borrowing costs have reached unsustainable levels, threatening its solvency. The "firewall" to prevent the Greece's problems from damaging the solvent countries like Italy and Spain involved bringing lots more capital into the ESFS. Unfortunately, its first auction after October 26, of a mere €4 billion to continue funding an existing activity, failed. Bringing the ESFS to the planned €1 trillion seems like the remotest of possibilities. There is no firewall.

Most ominously, on November 23, a regular auction of ten-year German government bonds--the bund--failed, in that only about 60 percent of the €6 billion issue was sold at auction. The Bundesbank had to take the rest. Thus, the credit-worthiness of Europe's strongest country, the very core of Europe and the Eurozone, is now in question, as investors contemplate (a) the collapse of the Euro or (b) Germany's taking on (all unwillingly) the debts of its weaker Eurozone member states.

In this week, the news became positive and the market reaction nothing less than ebullient. Concerted action by the major central banks, a suggestive speech by Mario Draghi, the new head of the European Central Bank (the ECB) about what it *may* do after governments take more concerted fiscal action, and renewed hopes for another plan, have lifted the gloom. For now.

The existential crisis for Europe is at hand. Events have moved with alarming speed in recent weeks. The failure of the Euro, should it happen, would not be a small event; its consequences would not stay in Europe. The slowness of decision making within a large group of different countries certainly heightens risk. Worse than that, however, is the misguided brinkmanship played by Germany. Germany does not wish to pick up the tab for the failures of the last decade, despite its reaping the fruits of the easy borrowing and lending. Nor does it wish to create the 'moral hazard' of stepping into the breach to stop the downward spiral. It insists that the problems be handled by austerity at the level of the individual countries.

The failure of the ECB and Germany to act raises, day by day, the risk of real peril. Without something along the lines of an ECB program of unlimited sovereign debt purchases or the issuance of so-called euro-bonds (bonds to raise money for Eurozone governments with the joint and several guarantees of all Eurozone countries), the Euro will fail. The failure would give rise to a serious global recession, widespread bank failures and a financial crisis of a scale greater than that experienced when Lehman failed. From these events would flow serious social unrest; the rioting and falls of governments in Europe so far witnessed offer a prelude. Will Germany and the ECB act? Time will tell.

Core's actions. It is impossible to know the likelihood that a decisive response by the governments of Europe will be launched before the markets riot and descend into chaos. My assessment is that the risk of chaos has risen markedly in recent weeks; Core has decided to concentrate the portfolios for which we have responsibility in the safest securities, those investments that passed through the post-Lehman crisis without failing. These are few: the US dollar, the Japanese yen, and US government bonds. We have been selling securities, including high-grade US corporate bonds and the government debt of financially strong countries, which, in 'normal' markets, would be quite safe, but which would be at risk in a full-on financial panic.

It is our hope that the exceptional actions we now take prove unnecessary. We hope that we will soon reinvest in these normally safe investments with good returns. Given the adverse developments, given the record of European policy makers delivering far less than promised, given the risk of government bond defaults, and given the risk of the failure of the Euro, we feel that we must take these measures to protect your capital.

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CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

October 31, 2011

The Latest "Comprehensive Solution"

With considerable fanfare and some self-congratulation, European leaders announced a complex set of agreements (and hoped-for agreements) last week. In anticipation and at the announcement, stock markets rallied very strongly.

As further negotiations and more sober examinations of proposed arrangements unfold, we will realize that the Grand Bargain does not resolve matters. Instead, the slow process of widening Eurozone problems will continue, threatening government bond markets and banks.

By

Jack Mayberry

Another pair of European summits on the October 22nd weekend and on Wednesday of last week has reached another complex deal, characterized by the leaders as a "comprehensive set of additional measures...to overcome the present difficulties." This is the third such "comprehensive solution" this year. Like its predecessors, this one may buy some time, but it will be tested by reality in coming weeks. It will be found wanting.

At best, the agreements leave for another day (and later summit meetings) agreement upon key details. The 'Grand Bargain,' as it has been called, has three components: The first is a negotiated restructuring of Greek debt, by which banks and other private holders of Greek debt agree to exchange their Greek holdings for new (still undefined) securities with half the face value of the Greek bonds to be retired. Second is recapitalization of the weakened banks, the capital of which is impaired by the declines in values of Greek and other government debt. The third is an increase in the capital of the EFSF (European Financial Stability Facility) to enable it to provide a backstop of sorts to prevent Greece's default from imperiling other heavily indebted but still solvent debtors, including Italy and Spain.

In the three weeks since the markets were in their greatest turmoil, there has been a growing sense that the key parties to the European dilemma were acting with serious concentration to craft solutions to these issues. Markets have rallied strongly in these weeks and celebrated last week's announcements with robust rallies. But, as negotiations to implement the agreements unfold, their shortcomings will be revealed. The mood is likely to sour once again; Italian, Spanish and perhaps French government bond yields will rise further, and the banks' capital and funding problems will reassert themselves.

The bank recapitalization agreement has modest targets for increasing banks' core capital. The assumptions about capital required do not take into account the ever-growing likelihood of a slowdown in European economies, perhaps a recession. Moreover, banks have until the middle of 2012 to meet the new capital requirements. As the Grand Bargain announcements were being made, one bank after another declared that it would not raise new private capital nor accept capital infusions from governments in order to meet the new capital requirements. Thus, banks have determined to shrink their assets, including their loan books: Europe's economy will be deprived of bank credit precisely when growth is needed to restore the finances of governments, banks, and people.

EFSF. The schemes to increase the capital of the EFSE involve its insuring the first 20 percent of losses on government debt and raising capital from Japan, China, Brazil, the IMF and others. Without offering an explanation, allow me to assert that the losses from insuring the first 20 percent of losses are likely to exceed what would be lost if the EFSF purchased Italian and Spanish debt directly. And, unfortunately for the plan to raise money from other countries, Germany's Bundestag (like the parliaments of its creditor northern neighbors, the Netherlands, Austria and Finland) voted on the day before the Wednesday summit to put no more German money into the EFSF. On what terms will China and Japan wish to risk their capital when the Germans will risk no more of theirs?

The write down of Greek debt is the most promising aspect of the three agreements. In a sense, this is merely to recognize what has been painfully obvious for some time, that Greece has no hope of repaying its accumulated debt in full. But this 50% write off does give Greece some hope for a return to growth in the future.

Like the earlier 'comprehensive solutions,' this one is not likely to resolve Europe's sovereign liquidity and solvency crises. None of the previous agreements has calmed markets for long; none has contained the spread of the crisis, which is now near to engulfing Italy. These half-solutions and ill-structured arrangements with their unintended consequences do not even buy time. As previous agreements have demonstrated their failings, the crisis has continued to widen and the costs to resolve it have risen. In my view, this process is continuing.

Meanwhile, in the United States, economic reports over the last month have been more encouraging than feared just a few weeks ago and recently-announced corporate earnings reports have been generally favorable. In speeches by Fed Chairman Ben Bernanke and other Fed officials, there have been strong indications of further Federal Reserve actions to stimulate the economy should they be needed. The combination of better news from Europe with these positive American signs has produced strong rallies in stocks and other assets that had fallen so sharply from July and into the beginning of October. Risks loom in the United States, however: the summertime negotiations in Washington about the federal government's spending and taxing ended only with an agreement to appoint a super committee of Representatives and Senators to seek a deal. That deadline looms in late November. It seems a certainty that the negotiations will continue without resolution until the last possible moment; it is naïve to expect constructive and thoughtful solutions to emerge. Poisonous political posturing seems far more likely.

Core's outlook and investments. Our view is that, in light of the problems discussed above, investment risk remains high. The swings in asset prices from day to day are quite remarkable. We have retained large investments in high-grade US corporate bonds, in US treasury bonds, and in the Japanese yen as havens. As fear has diminished, as Europeans have worked in concerted fashion, and as the Fed has made its plans clear, we have begun to invest again in currencies that rise with a decline in the US dollar. We have added to small positions in high-yield US corporate bonds and in global infrastructure. We seek to invest in assets with high and safe dividends and interest, in the expectation that waves of market volatility will be muted by the stable income streams Core's portfolios produce.

As we all have been realizing this year, the biggest risks to economies and to financial markets comes from policy makers in Europe and America. Good decisions may be made by public officials, but so far poor ones are more in evidence.

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

September 27, 2011

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. Alarmingly, 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

Jack Mayberry

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

September 12, 2011

The European Crisis Worsens

The crisis in Europe has deteriorated further since our last report. It appears that we have reached a crucial stage. Default on its bonds by Greece seems increasingly likely. This will impair the capital of important French and German banks and may have adverse repercussions on the banking system in the US, as well.

This is my fifth draft of a letter attempting to describe and assess convulsions in Europe and their effects on our investments. I have not yet been able to finish a letter before its having been overtaken by new events. I re-read my letter from mid August and see that I was not far off the mark, but not quite pessimistic enough about the speed with which the problems would develop. We are, it appears, peering again into the abyss of a banking crisis.

Euro-zone bonds. Last week, the German constitutional court ruled in litigation brought by opponents to German efforts to aid Greece and other euro-zone 'peripheral' countries. The first news reports made the point that the direct challenge failed: the challenge to Germany's participation in the EFSF ("European Financial Stability Facility") mechanism set up in May 2010 to provide support to the indebted governments. A fuller analysis, which I read yesterday, makes the point that the EFSF facility passes muster because of its temporary nature, but that next steps in a process that might resolve the crisis, namely participation by Germany in the issuance of so-called 'euro-zone' bonds, would offend Germany's constitution.

I have no German; if I did, I would still be unqualified to render a view on German constitutional law. I can only report that Germany is now preparing for a default by Greece on its bonds. German banks have large holdings in these bonds. If Greece defaults, the capital of these banks (and major banks in France) will be gravely impaired. If the German banks are undercapitalized, US banks are at risk. US banks directly hold very little debt of the benighted 'peripheral' countries, but major US banks are connected to the major German and French banks through opaque derivative contracts. We cannot assume that problems in German banks will stay at home.

Euro-zone bonds have seemed a promising way for the creditworthy European companies to assist the uncreditworthy ones and to preserve the decades-long project of European integration. These now seem to be off the table. What remains?

By

Jack Mayberry

Monetization by the ECB. The euro-zone does not have a joint fiscal authority to issue bonds, collect taxes and the like. It does have a joint monetary authority, the European Central Bank, which has taken an active role in this whole farrago of indecision that has characterized Europe's handling of the crisis. As I described in my last letter, the ECB has been a purchaser of bonds of the countries facing crisis. In the summer, Italy and Spain became flashpoints; the ECB stepped in to purchase their debt, suddenly being shunned by private investors. Like other central banks, the ECB possesses a

Our foreign currency and precious metal hedges have produced positive returns, as have our large investments in bonds.

'printing press.' That is, the ECB may issue euros in what quantities it will; it may use these euros for its purposes, including to buy government debt of the countries in distress. Thus, it may 'monetize' that debt and resolve the immediate crisis. The ECB is utterly unwilling to undertake that. Its outgoing head, Jean-Claude Trichet, has staunchly and recently defended its decision not to take such action. Indeed, last week, Jürgen Stark, the German member of the ECB executive board, resigned without comment, but with the clear implication that even the modest buying of Italian and Spanish debt was too much. Monetization of Greek debt seems out of the question. What remains?

Default by Greece looks like the next step in this misadventure, although a report this afternoon in the *Financial Times* encouraged the hopeful: Italy has called upon China for help. China may (or may not) find advantage in helping here; at the least the news may forestall panic. It may give Germany and others time to prepare the way to re-capitalize their banks for losses likely to be realized soon.

Investing in this. The report on Chinese interest might lead, in the normal course, to speculation about the likelihood of Chinese help. But this makes clear the problem with investing now: how is it possible to know what decisions may be made by various policy makers about these matters? Never in my memory--with the ugly exception of the autumn of 2008--has the environment been one in which investment outcomes will be determined so much by policy makers, by heads of central banks, by finance ministers, by inscrutable leaders of China's sovereign investment fund, by Tea Party rabble-rousers, by the indecisive president of the United States, by hitherto unknown members of executive boards of the ECB, by minority members of Angela Merkel's coalition, by Christine Lagarde, the new IMF president?

In September 2008, when Lehman collapsed, the principal central banks and fiscal authorities of major countries acted in unison, quickly and decisively in response to the existential crisis facing the global financial system. The situation in 2008 appears in retrospect far more grave than that facing us now, but….wait until next week. Now, three years after Lehman's collapse, resources are far more limited and political will for co-ordinated action seems to be on another planet. Late last week was a meeting of G7 finance ministers. The euro-zone crisis was on the boil, but silence reigned. Not reassuring.

Where does this leave private investors? Core has had very small equity positions for the last several months, and we have attempted to use respites from selling as opportunities to reduce exposure to stock markets. Germany's stock market has fallen by an astounding 41% since May, while the more 'robust' US stock market is down by a mere 15% over the same period. Despite major losses in stock markets, Core's accounts in the aggregate show positive returns for the year to date, because of our large investments in bonds, currencies and gold.

The US economy is either growing very slightly or contracting very slightly. Weak economic growth is a perfectly fine backdrop for our bond investments and we may expect bonds to continue to thrive, even if the deliberations in Washington result in further fiscal restraint.

In sum, the very worrisome conditions in Europe and the absence of growth in America argue for even fewer equities and more bonds. The euro-zone crisis may not ultimately manifest itself; the single currency and it weak governments may yet muddle through. In case they don't, we have very cautious investments.

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

August 14, 2011

European Crisis Worsens…
…Odds of Recession Increase

Europe is convulsed by the ever-widening problems with government bonds of member countries. As economies weaken in Europe and America, and political opposition to government efforts to stimulate economic growth grows, the Fed and the European Central Bank are left alone to alleviate panic. Markets have reached levels of volatility and intense selling seen at the worst of the 2008-2009 crisis.

Large bond investments and hedges in Swiss franc and gold are helping Core's portfolios in the chaos.

By

Jack Mayberry

The European Central Bank (ECB) and the Federal Reserve both took new and dramatic actions last week, as financial markets rioted and economic reports showed marked deterioration, raising fears that European and American economies were slipping into a new recession. Investor panic, akin to the worst of the 2008 and 2009 crisis, produced startling market moves.

As yields on Spanish and Italian government bonds rose above 6% and threatened to bring Europe's sovereign debt crisis to these large economies, the ECB announced an expansion of its bond-buying program. This was immediately effective: Spanish and Italian bond yields fell and prices rose. But, within days, rumors of problems at major French banks began to swirl, and the locus of the crisis shifted to France.

German unwillingness to act decisively to resolve the broadening European crisis increases the chances of a widespread banking problems. Major French and German banks hold a great deal of the debt of the weak 'peripheral' countries. If these holdings are valued at now-prevailing market prices, then the capital of these banks is impaired. In addition, many other banks in Europe (and perhaps in America) are exposed to counterparty risk with banks that are direct holders of such bonds, providing an avenue for further banking havoc. As the crisis grinds on without resolution, it becomes clearer that the principal source of funds to recapitalize the banks is Germany. Thus, however unwillingly, Germany's public funds must be used to resolve the problems emanating from Greece, Portugal, Italy, Ireland, Spain, and (heaven forfend) France. (An investment colleague of mine recently made the astute and alarming point that it is in Germany's short-term interest to keep the problems unresolved. Irresolution depresses the value of the Euro and its relatively low value is important to Germany's powerful export industries. A resolution that removed the uncertainties might well cause the Euro to rise sharply in value….)

On its own, the European crisis is sufficiently serious to cause major financial market disruptions. Add to it the evidence of America's utterly dysfunctional political system as America's economy weakens, political opposition to fiscal support for lagging economies, and markets around the globe resorted to panic selling in stocks and other 'risk assets'.

The Fed's action Tuesday was an undertaking to keep the Fed funds rate at 0% to 0.25% until mid 2013. It came on the heels of the downgrade of US government debt by Standard & Poor's and a week of concerted selling of

Like the Swiss franc, gold has attracted funds seeking a haven from the selling in stocks and the concerns about the viability of the Euro. Core continues to maintain hedges in gold, the Swiss franc and in other foreign currencies.

stocks. In the few days since the announcement, stocks, bonds, currencies, and commodities (especially gold and oil) around the world have continued to trade with enormous swings in prices. Unanswered questions that seem to be driving the wild price swings include these: Is the United States headed toward another recession? Will the Federal Reserve undertake new initiatives to help the economy? Will the European sovereign-debt problems impair the capital of major French and German banks and lead to another massive international banking crisis? Are the resources of the United States, the major European countries, the Federal Reserve and the ECB sufficient to handle another financial crisis? Is there the political will and political wisdom to forge effective responses to what lies ahead?

Core's investment approach. Our view is that the odds of a US recession are higher now than they were only a few months ago. At best, it seems to us that economic growth in Europe and America will be quite weak in the coming year. In a 'normal' recession or an extended period of weak growth, high-grade bonds will continue to perform well, as they have since the spring of 2009. And if the long process of 'deleveraging'--whereby individuals, corporations, and now major Western governments act to reduce indebtedness--continues for the next several years, as seems likely, these same bonds will provide relatively safe returns. In such an environment, high-yield bonds (those issued by companies of lower credit worthiness) and stocks of well-capitalized companies with secure dividends will also provide good returns and with only a small amount of additional risk. (In the last couple of weeks of panic conditions, high-grade bonds gave up virtually no ground and US treasuries soared in price. By contrast, high-yield bonds and stocks fell in price.) Core will continue to focus portfolios it manages in these securities.

Our hedging investments, especially gold and the Swiss franc, provided positive returns for our portfolios through the relentless selling of stocks, precisely as expected. We wrote about the Swiss franc in our letter two weeks ago; it rose further since then, to the consternation of the Swiss. For Switzerland, the enormous increase in the value of the franc against the Euro is a disaster for its economy. The Swiss National Bank, its central bank, is intervening to hold down its value and speculating openly about temporarily 'pegging' its exchange rate to the Euro. Apart from the complexity of effecting a temporary peg, the move runs counter to Switzerland's fundamental and longstanding independence from the rest of Europe. We do not expect the SNB to be successful in its effort to keep down the Swiss franc's value while the crisis in Euro-land remains at the boil. We hold our hedges in the Swiss franc gold.

There is not too much useful information to be drawn from investment returns over very short periods, but Core's investment approach has been quite effective in the last two weeks, two months, and in this year in mitigating losses in this havoc and earning returns in excess of the stock market and of the standard benchmark including stocks and bonds. The SEC is rightfully concerned about how investment managers discuss returns publicly, so I will leave it at that. If you wish to discuss returns in your own portfolios and any other matters, please do not hesitate to contact me by phone or email.

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CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

July 31, 2011

Self-Inflicted Wounds

Policy makers have failed in their duties, in Europe by allowing the sovereign debt problems of Greece to linger without resolution, in the United States, by the ideological intransigence of Congressional Republicans and the Obama administration's supine negotiating strategy. These are unnecessary problems with grave consequences.

Financial markets have responded with growing alarm to these spectacles, featuring increased volatility and selling in stock markets.

An array of hedging investments have enabled Core's portfolios to continue to grow. We hold the Swiss franc and other currencies and gold, along with large helpings of US corporate bonds and government debt of developing economies.

By

Jack Mayberry

In a world with enough problems, a visitor from Mars might view debt-ceiling discussions in Washington and the sovereign-debt drama in Europe as self-destructive acts by short-sighted, dim-witted politicians. Given the serious economic problems in Europe and the United States, it passes believe that the policy makers should be focused on actions that will restrain growth. But here we are.

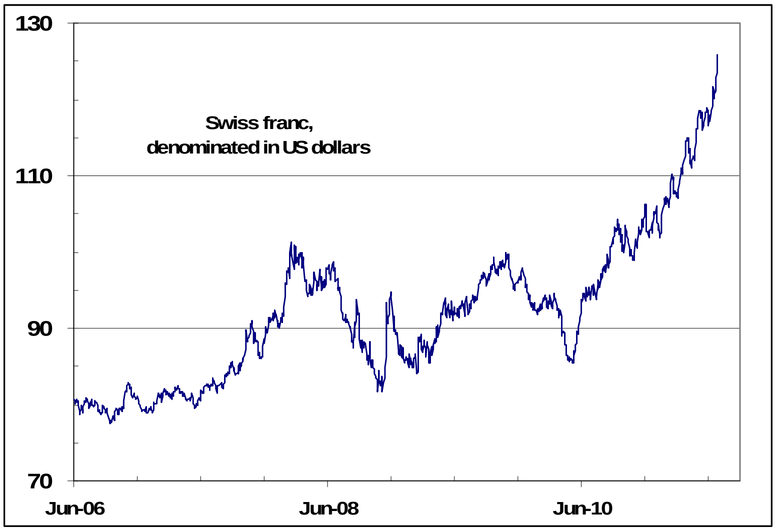
As our political leaders in Washington spend their energies blaming others, financial markets, acting entirely rationally, have become increasingly volatile and risk averse. We have maintained portfolios that are long on hedges against this turbulence and rather short on stocks. As a result, the aggregate of all the accounts we manage rose by more than one percent in the turbulent month of July while stocks posted losses. A discussion of some specific investments will show how this unfolded.

For a long period, we have observed the decline in the value of US dollar and have invested in foreign currencies we thought we rise in value against the dollar. We invested in gold a few years ago partly to reflect the dollar's decline. In this year, as the Euro crisis deepened, there has been a growing view that so-called *fiat* currencies all depend on the strengths and weaknesses of the issuing countries. The defects in the US and European political processes have made the attraction of gold more apparent. A year ago, we made a successful investment in silver, the last part of which we closed out this month. In early January, we made an initial investment in the Swiss franc, seeing it as a haven for investors fleeing the Euro for the sanity of Switzerland. (See the chart on the next page.) We added to our Swiss franc position a few weeks ago. Amazingly enough and despite the strong gains in gold this year, gold has weakened in Swiss franc terms. That is to say, the value of the Swiss franc in US dollar terms has appreciated more this year (by about 17 percent) than gold in US dollar terms (about 14 percent). Our large investments in the bonds of developing countries, our Asian local currency fund, and our US corporate bonds have performed well in July and all year. (Another investment, essentially unchanged in July but strongly positive in the months since we bought it, is Brookfield Infrastructure Partners, a fund holding utilities and various infrastructure projects around the world, mostly in developing countries, where the building activity is growing and strong. Unlike others discussed here, the Brookfield investment is not a hedge against Euro and dollar problems, but a growth-oriented investment.)

Of course, some of the hedges that have performed so well during this anxiety about the discussions in Washington may well pull back when there is a resolution about the debt ceiling. When this happens, we can expect that the equity positions we hold will rebound from the nervous selling of recent weeks.

The Swiss franc has proved the most effective hedge against the policy crisis. Unfortunately, it is now vastly overpriced and damages Switzerland's economy.

To punctuate the absurd debate in Washington came Friday's announcement of economic growth in the United States. After a 'normal' recession, economic growth during the recovery is swift and robust, with Gross Domestic Product growing at about 6 percent per year after inflation. After and during the 2008 to 2009 recession brought on by the credit crisis, the private sector--consumers and businesses--acted to repair balance sheets. Consumer spending and business investment languished, restraining GDP growth. It had been estimated that annualized real (after-inflation) growth was 1.9% in the first quarter of 2011, far below a more normal 5% or 6% rate. Friday's report revised that already anemic rate down to 0.4%; and made a preliminary estimate of a mere 1.3% growth rate for the second quarter. Revisions also showed the recession to have been deeper than previously reported. This report shows how perilously weak is the US economy; such rates of growth will do next to nothing to create jobs for the millions now unemployed or under-employed. Deep cuts in federal spending, should they be a part of the debt ceiling package, threaten to cut already anemic growth even further.



It seems highly likely that growth in the United States will continue to be weak, even if a slide back into recession is avoided. In Europe, the troubled 'peripheral' countries are doomed to deep recessions by the policies imposed by the International Monetary Fund, the European Central Bank, and Germany and France. Those larger European countries have growth modestly, but are hardly robust. Developing countries in Asia and Latin America enjoy much stronger growth, but are plagued by growing inflation. Fiscal and monetary authorities in those countries are imposing various policies to deal with their local problems, some of which have adverse effects on their local economies and/or their stock markets. The outlook for the world's economic growth over the next twelve months is somewhat troubled, to put it mildly

Investment implications. Slow growth--even recession--favors bond investments. US corporations have shown very convincingly that they can operate at low costs and strengthen their balance sheets. This makes their bonds less risky for investors. Government bonds of developing countries, in which we have major investments, have very favorable credit characteristics and yield a good deal more than the (weaker-credit) government bonds of the developed countries. The problems in the US and Europe, exemplified by the current crises, will not be resolved in a short time, even if a US deal temporarily deals with the immediate crisis. Thus, our foreign currency investments in Switzerland, Australia, Canada, and in Asian currencies (not including Japan) should continue to gain in US dollar terms. Likewise gold, will continue to receive investment support as a hedge against the ineffectual governments of the issuers of the US dollar and the Euro. Once the immediate debt-ceiling fiasco is resolved, US stocks in various sectors should resume their growth.

The investment environment is tricky--when is it not? But the scope of investment assets available to us makes it feasible to build productive portfolios even in these unsettling times. Core has accomplished this and we continue to work away at it.

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

July 7, 2011

A Shift in the Balance…
...For the Better

In light of some positive developments over the last week, we take a more positive view of the economy and the stock market over the next six months.

In light of these constructive developments, we have added some equity positions and increased our high-yield bond holdings.

By

Jack Mayberry

In recent letters, I have argued that risks to the economy, financial system, and financial markets outweighed opportunities, and from the beginning of May until quite recently, Core had been cutting our more risky investments in accord with this view. My view now is that the balance of risks is shifting.

Greece. More favorable recent developments include the complicated moves in Europe to deal with Greece, especially the "French option", whereby major French banks have agreed to exchange maturing Greek government bonds for long-term bonds at fairly low interest rates. Presumably German banks, also large holders of Greek debt, will also agree, however reluctantly, to this exchange. In response to this and to the enactment in the Greek parliament of new austerity measures, the IMF is set release more funds to Greece. This buys more time and postpones chaos. It is not a final solution, but it reinforces the notion that policy makers in Europe and at the IMF in Washington will work hard and with imagination to avert the looming crisis.

Oil. Global oil prices have fallen, and the release of a modest amount of crude oil from reserves of major Western countries has pushed oil prices down a bit more. In the US, gasoline prices have fallen in recent weeks and appear likely (as the futures markets suggest) to fall further. This is a modest boost to the US economy.

China and Japan. Chinese Premier Wen Jiabao wrote a piece in the Financial Times last week saying that the cycle of tightening monetary conditions in China is near its end, reducing the risk of a 'hard landing' in China. Global manufacturing disruptions caused by the Japanese earthquake and tsunami are abating, suggesting that industrial production will improve in coming months in the US and elsewhere.

As always, risks remain. There is still no deal in Washington to raise the debt ceiling. Although it seems likely that the impasse will be resolved and that the United States will not default, it is not too easy to be sanguine as one listens to the expressions of intransigence from both sides. And, of course, it is hard to imagine really strong economic growth in the US and Europe for the rest of the year. Modest growth seems likely, with the continuation of weak job markets.

Although the economy may be lackluster, financial markets may be healthy. Relatively weak growth is perfectly fine for bond markets, and many corporations have learned well how to earn ample profits in the environment that has prevailed since the recession ended. Core's portfolios earned decent returns in the first half of the year, when external conditions were uninspiring, at best. We can expect fair returns in the coming months in similar conditions.

Consistent with the view that the balance is beginning to tip toward opportunity and away from risk, Core has made some additional purchases of high-yield US bonds and equities. Our portfolios are still decidedly on the conservative side, but we are willing to add some risk and buy some assets that appear attractively priced.

Please note that the comments about our investments do not apply to the fixed-income portfolios that we manage for some clients. In these, we do not hold any equity positions. If you have questions about your individual portfolios, please do not hesitate to contact us.

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CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

June 17, 2011

Policy Dilemmas

Dauntingly complex problems confront policy makers in the United States, Europe, the developing countries, and the central banks. Given fragile economic conditions in the developed world, inflation problems in developing economies, sovereign debt problems with many developed countries, mistakes in policy decisions can derail economic growth and create turmoil in markets.

In this risky period, Core has cut equity investments sharply.

By

Jack Mayberry

Stocks markets have faltered as economic reports show that US growth is slowing. Markets are increasingly concerned that private economic activity is not sufficiently strong to sustain growth during the period ahead when US government support for the economy is being withdrawn. Since early in 2008, the Federal Reserve has undertaken a series of actions to ease monetary policy, spur growth and prevent deflation. Short-term interest rates have been essentially zero for a long time; there is (obviously) no scope for lowering rates further. The second round of unconventional 'quantitative easing' policies comes to an end this month; in a recent speech, Chairman Bernanke suggested that 'QE3' is not in the works.

On the fiscal side, involving taxation and spending policies, there appears to be very little political likelihood that Congress and the Administration will agree on policies to stimulate the economy further. By contrast, political winds seem to favor fiscal austerity, with Republicans bargaining for large cuts in federal spending. Moreover, the fraught negotiations to raise the ceiling on Federal government borrowing give rise to the growing possibility that the United States could default on its debt, creating untold havoc in markets and the financial system, and probable negative shocks to the economy.

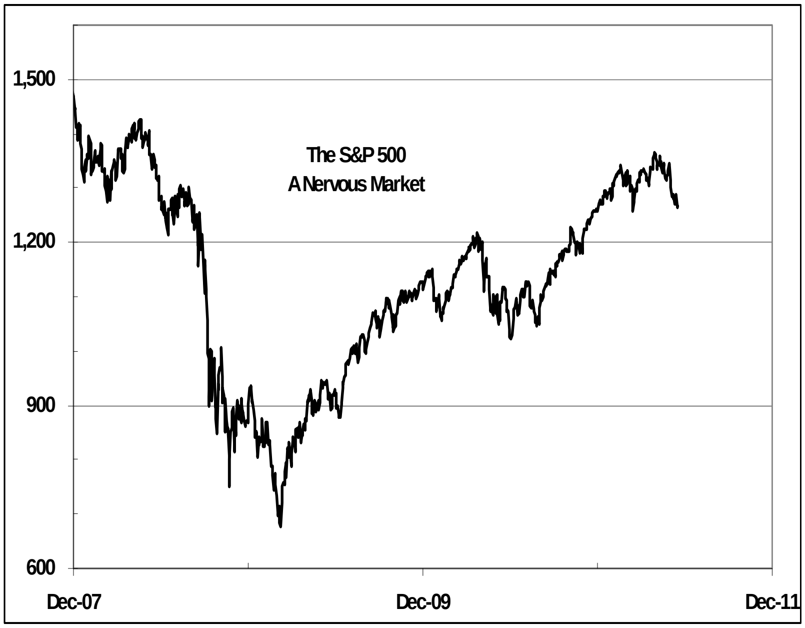
Nor is it the case that the United States is the weak reed in an otherwise sturdy global economy. Witness Europe, where the unfolding drama with the sovereign debt of Greece careers toward crisis at increasing speed.

Given the political conditions during this period characterized by a remarkably poor employment report and other indications of a weak economy, it is little wonder that the US stock market has fallen for six weeks. Some major stocks indices are now negative for the year.

Core's actions. Since the beginning of May, we have made a series of sales of equities and commodities, to reduce risk in the portfolios we manage, and have increased our bond investments. In the aggregate of all the portfolios we manage, equities and commodities now comprise 39 percent of assets, down from 53 percent when May began. Bonds and cash account now for 61 percent of our holdings, up from 47 percent. As a result, while the US stock market shows a loss for the year, as measured by the S&P 500 and other major indices, Core's accounts are ahead, in the aggregate, by more than 2.3 percent.

The risk of policy mistakes. More so than at any time in my memory, the greatest risk to financial markets and to the world's economies comes from policy makers in governments, in central banks, and international organizations like the IMF. The problems faced by policy makers are enormously complex and short-term competing interests impinge on the process of finding good solutions.

Consider the situation in Greece: the level of its indebtedness would be unsustainable in a country with robust growth and efficient tax-gathering. Greece has neither --and the policies imposed on it as a condition of the lending by the IMF and the European Central Bank ("ECB") weaken its economy, cut living standards, and raise unemployment. Much of its debt is held by German and French banks, so that a default or negotiated restructuring of the debt will create large losses for those banks, requiring the German and French public to put up funds to recapitalize their banks. Political feeling in Germany is hostile in the extreme either to 'bailing out' the profligate Greeks or to shoring up their own improvident banks. Because Greece no longer has the drachma, which could otherwise be devalued to reduce the burden of the debt, it can only become a competitive economy by lowering its wages. And so the messy situation lurches toward a very serious crisis, threatening much larger and consequential countries like Spain., while policy makers face the difficult task of balancing short-term competing interests.



In America, the painfully slow recovery from the financial crisis is threatened by the political impasse in Washington. The irresponsible brinkmanship engaged in by both parties over the need to raise the limit on federal government borrowing puts at risk the long-standing, very advantageous conditions created by America's unassailably strong credit position. Despite evident weakness in the economy and the disastrous social situation created by long-term unemployment and very weak job markets, the strongly-held view by conservatives is that government should pursue austerity policies and cut federal spending sharply. This conflicts with the view put forward by the Obama administration. The negotiations to resolve the differing points of view seem to focus on short-term political advantage, rather than the long-term good for America.

It is easy to criticize policy makers and the lobbyists who advocate the narrow interests of their paymasters, but rather unfair, as well. The problems are complex in the extreme and not amenable to easy resolution in democracies. However, the consequences of mistakes in judgment are enormous. Japan's 'lost decades' of the 1990s and 2000s that followed the collapse of its real estate markets and the damage to its banks loom large as an example of the failures by policy makers.

Markets are responding to the enormity of these problems and the likelihood of policy mistakes by selling. In the context of weak economies, the margin for error in policy making is narrow. As a result, we are at risk of another bout of panic selling across financial markets. We have reduced investment in assets vulnerable to a 'market riot'; we are watching carefully to decide upon our next steps.

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CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

May 16, 2011

A Weakening Economy and Strengthening Dollar?

In April, stock and commodities markets were very strong. In the new month, oil and precious metals fell while the dollar rallied. Does this presage a weak economy and the beginning of an extended period of strength in the US dollar?

Strong employment growth augurs well for 'self-sustaining' economic expansion.

The Fed is determined to maintain very 'easy' monetary conditions, despite political opposition. This will support the economy indirectly and investment asset prices directly.

The dollar will likely continue its stately and long-term decline.

By

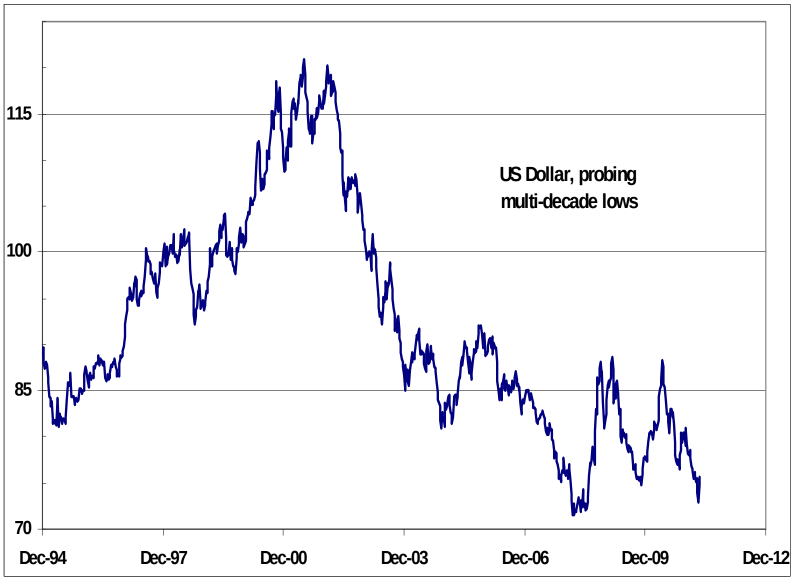
Jack Mayberry

With the beginning of May came sharp changes across many markets: Commodities fell with a thud, the dollar has rallied, and stocks have declined modestly. The weakness in oil, other industrial commodities and precious metals follows speculative advances in many commodities, so the selling may represent nothing more than profit taking that invariably follows bouts of speculation. But selling in industrial commodities must raise the question whether global economic activity is slowing, and with it the demand for oil and other commodities. Quite separate are issues raised by the dollar's rise after many months of persistent declines. Commodities are priced in dollars, hence a decline in the dollar's value will, all other things being equal, cause an increase in the prices of commodities. Does the recent rally in the dollar mark the end of its long decline and the beginning of period of a stronger dollar? First, a look at the economy, then some comments on the dollar.

Self-Sustaining Growth. In the midst of days of intense selling in commodities came the monthly report about the US job market, a very strong one indeed, showing unexpectedly high levels of private job formation in April and upward revisions to already-strong estimates for February and March. The employment report lends support to the argument that economic growth is real and encourages the hope that growth in America is now 'self-sustaining'. As the term is used these days, 'self-sustaining' growth is sufficiently strong growth in the private sector as to be able to withstand the withdrawal of government support. Given the solid Republican rejection of federal government 'stimulus' spending and its determination to cut federal spending generally, it is quite likely that federal government fiscal policy will tend to slow economic activity. Will withdrawal of federal support turn economic growth into contraction? Not if economic growth is now 'self-sustaining'.

In addition to the likely diminution of fiscal support, what of the end of the Federal Reserve Board's policy of quantitative easing, by which, since November, it has been purchasing $600 billion of treasury bonds in its so-called QE2 program? Come June, this buying stops. Although the Fed is independent, it will be hard pressed to engage in a significant new round of monetary easing in light of Republican opposition. Fed Chairman Ben Bernanke has been forthright in his discussions of upcoming Fed actions. The Fed's Open Market Committee, its policy-making arm, confirmed at its last meeting that, apart from the scheduled end of the treasury buying program, the other aspects of the extremely accommodative monetary policy will remain in effect for 'an extended period'. By this we can be sure that, as it receives interest and principal payments from its huge portfolio (now exceeding $2 trillion), the Fed will reinvest these in more treasuries and that its very low short-term interest rates will continue.

The dollar. From an investment point of view, this has important implications. All the other major central banks in the world have 'tighter' monetary policies than does the Fed. The European Central Bank, for example, has begun to raise short-term rates and emphasizes inflation risks. The Fed's policies give a high probability to continuing depreciation in the value of the US dollar. Moreover, it is quite clear that the Fed--and the Treasury, as well--prefer a weak dollar, because it supports the export of US manufactured goods, making them cheaper for foreign buyers. As consumers spend less and save more, the direct and probably long-lasting result of the financial crisis, the US economy will depend more on manufacturing and less on consumer spending to maintain growth. Although Treasury Secretary Geithner and Bernanke utter the 'strong dollar' mantra, they really want the dollar slowly to weaken further.



Before the early May bounce in the dollar, its value against a basket of currencies of its main trading partners, shown in the adjacent chart, had been declining steadily since last summer. By the end of April, it was trading near its lows since the 1970s. The imminent end of the Fed's QE2 program, coupled with these very low levels, may be reason enough for the dollar to strengthen. In Core's view, the dollar's young rally does not presage the end of this long decline--about 40% since 2002. For most of this last decade, Core has held and continues to hold investments that benefit from the dollar's decline, either directly, in the case of foreign currencies, or indirectly, as with commodities. Our most recent is an exchange-traded fund that holds Asian short-term fixed-income investments (excluding the yen), denominated in local currencies. For a longer period, we have held positions in Australian and Canadian dollars and the Swiss franc. Additionally, our investments in agricultural commodities, gold and silver are fairly direct plays on US dollar weakness, since these commodities are priced in US dollars. (As the dollar weakens, one needs more dollars to buy an ounce of gold, for example.) Many of our equity investments benefit from a decline in the dollar in relation to other currencies, including those US companies involved in exporting manufactured goods, the oil companies, and the non-US companies in our portfolios, whose stock prices in US dollar terms rise as the dollar falls.

The late 1990s extended rally in the dollar, shown in the graph above, came during the second term of Clinton's administration during the period of higher tax rates than now prevail, controls on Federal spending and a very vibrant economy. The Federal deficit fell sharply, then turned into a surplus during that period. Financial markets and job growth were very strong. Is it too much to hope that a similar period may begin soon?

The dynamics that support the dollar's weakness will persist, especially if the jobs market remains weak. In this present political environment with its hostility to fiscal policies to encourage growth, the Fed must assume the burden on its own. The tools of monetary policy are not terribly well-designed to create jobs--the Fed cannot engage in road repair or the building of high-speed rail lines, for example--so its policies have an indirect way of helping the economy. The Fed's policies push investors into risky assets, among other things by cutting rates so low that holding money market funds is a losing proposition. The theory is that higher asset prices will lead to economic activity. Well, maybe so. But at all events, the investing business is about buying assets that increase in price, so Fed policies have a direct benefit for investors alert to the consequences of the Fed's work.

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April 5, 2011

The Triumph of Wishful Thinking

The resilience of the world's stock markets to the possible melt down at Fukushima and to the widening and violent revolts in North Africa and the Middle East is remarkable. But it is sensible?

The assumption seems to be that not much worse will come of the earthquake, tsunami and Fukushima reactors, and that the revolts and warfare will not cause more serious problems than already manifest.

This is a dubious assumption.

By

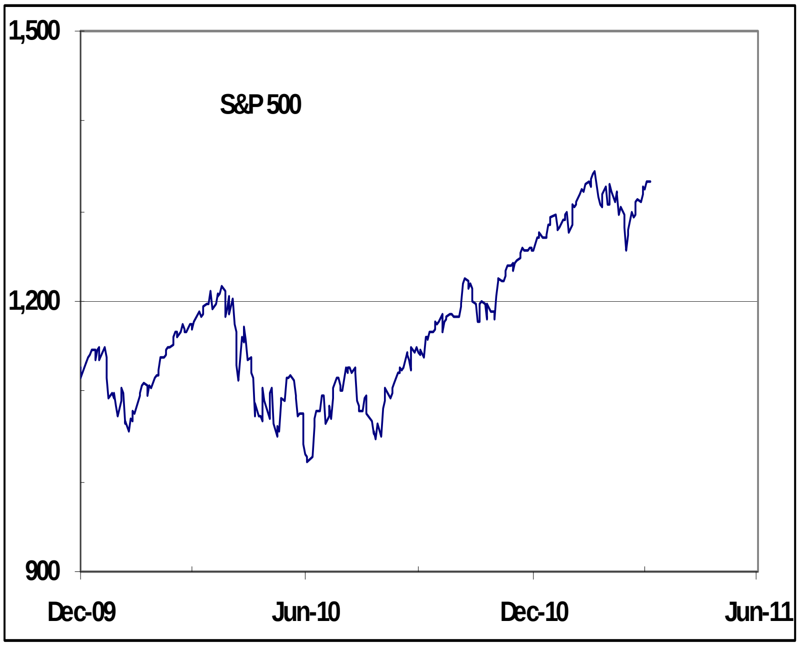
Jack Mayberry

In the first three months of this new year, the world delivered about as much in the way of the unexpected and the unnerving as might be thought possible. The market's response? A brief--very brief--shudder, then a return to the drinks table. Is this the triumph of wishful thinking over common sense, or a sober assessment of risks presented by revolutions in North Africa and the Middle East and by the still-possible melt-down of nuclear reactors in Japan?

There is much in this economic and monetary environment to like and much to support strong stock markets. The recovery in the United States from the acute financial crisis and profound economic recession is still routinely described as 'fragile', but it appears increasingly robust. Last week's employment report provided modest upward revisions to the (already decent) January and February employment gains and reported a satisfactory increase in jobs in March. The Federal Reserve maintains its exceptionally accommodative monetary policy and continues its large Treasury bond purchase program, referred to as QE2. Despite the ever-present risks that Congress and the Obama administration will make a hash of fiscal policy in their fraught negotiations over budget matters, there is ever more reason to be confident that economic expansion will continue.

One must draw the careful distinction, in discussing the present environment, between its effect on people and its effect on capital. Despite the ostensibly improving job situation in America, it is obvious--and tragic--that there remain vast numbers of unemployed, under-employed and under-paid people in America. Moreover, prospects are poor for the creation of good, well-paying jobs in numbers sufficient to satisfy the demand for employment. The uncomfortable irony is that the very weakness of labor in this economy redounds to the benefit of capital. Those of us with money to invest are being well taken care of in the present economic environment.

The Problems. But even granting that the flow of economic reports and the Fed's monetary policy in the United States is favorable to capital, how are we to evaluate the insouciance of the financial markets to events unfolding in Japan and the Arab countries? Western powers have poured Tomahawk missiles onto Libya. Saudi Arabia sent troops to Bahrain to smother a Shia uprising there; the Assad family's four-decade Alawite regime in Syria now visits awful attacks on protestors; Yemen's president has said he would leave, but he has not; violence continues. In the countries in which revolutions have succeeded--Tunisia and Egypt--an uncertain path lies ahead. Will the secular and democratic forces carry the day? Will sectarian Islamist parties, having suffered grievously for decades, join secular forces in forming new governments and new societies? Probably--and then, what will emerge? Of course, all of this is unknowable, certainly to us in the United States. Libya had been a meaningful exporter of oil, but Saudi Arabia increased its production to make up cessations in oil exports caused by the civil war. there. What happens when Algeria goes 'offline'? When the Strait of Hormuz is mined to prevent shipment of oil from Iran and Iraq? Looking a little further afield, how brittle is Russia, now the world's biggest producer of oil? Well, it is brittle; and it is utterly dependent on its own oil and mineral export revenues; and it possesses an uneasy structure at the head of its government. Did the Russian people like the re-trial of Mikhail Khodkorvsky and his sentence to another long span of years? How did the governmental echelons right below Putin and Medvedev enjoy that spectacle? What lessons did business folks--Russian and foreign--take from that trial, conviction, and harsh sentence?



On the right side of the graph above, is the sharp, shallow and brief sell off that began in mid February and the swift recovery from it.

We shall see how all this unfolds.

The Market Response. One conclusion to be drawn is that the financial market response to all of this is strictly limited to the present. There is enough spare capacity in Saudi Arabia to make up for lost production in war-torn Libya; Bahrain is quiet now that the Pearl Roundabout has been cleared, however violently; riots in Syria are being met by stern resistance by Bashar al-Assad, but…. And, certainly, no one has yet dared to raise his or her head in Russia. Radioactive water is now being poured into the Pacific from Fukushima, but this is only a 'small' meltdown.

The financial markets, as shown by the sharp rebound in prices since March 16, the nadir of fears about all this, have voted to ignore the manifest problems and to look instead to the favorable economic and monetary conditions to support their expressions of the values of companies, commodities, and other assets. What might go wrong in this analysis may be ignored--until it does go wrong. In the last few months, as all this has unfolded, Core has moved some of your capital toward investments that stand to do well if things get worse in the Middle East, North Africa, and beyond. We have made new investments in oil-related securities, to benefit from already higher oil prices and against the possibility that oil could rise much higher in the next round of the unfolding dramas. We have cut investments in places and things we think likely to suffer from higher oil and agricultural prices. We have shifted toward export-oriented US companies, and away from the developing economies where higher prices for foods and oil loom much larger and more destructively than here.

Over my years working in financial markets, I have observed the proclivity of markets to ignore risks standing quite clearly before us and to focus instead on the similarly evident opportunities. At the risk of fighting the last war, one remembers that, in the autumn of 2007, when, despite the summer-time failure of two prominent Bear Stearns hedge funds deeply involved with mortgage-backed securities, the stock market rose to new highs even as the country entered its recession. It appears that we are in a sustainable economic expansion (and not about to slip into recession) and that a number of powerful companies will benefit handsomely. The prices to buy ownership interests in them is not terribly high, so it is reasonable to expect profits if we own them now. But, there is a widening set of revolutions in the Islamic world, where much oil lies. Thus the conundrum. Thus our caution.

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

March 6, 2011

The Spread of the Jasmine Revolts…
...and Risks from Rising Oil Prices

Revolution and civil war in North Africa and the nascent revolts on the Arabian peninsula have introduced a new force into world economies and financial markets. The Libyan war has cut its oil production already.
What cannot be known is whether these revolts will spread and cause still more havoc.

This letter outlines Core's investment approach to these problems. To date, war and rising oil prices have not hurt financial markets gravely. It is not sensible, however, to assume that the relaxed atmosphere in financial markets will continue.

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By

Jack Mayberry

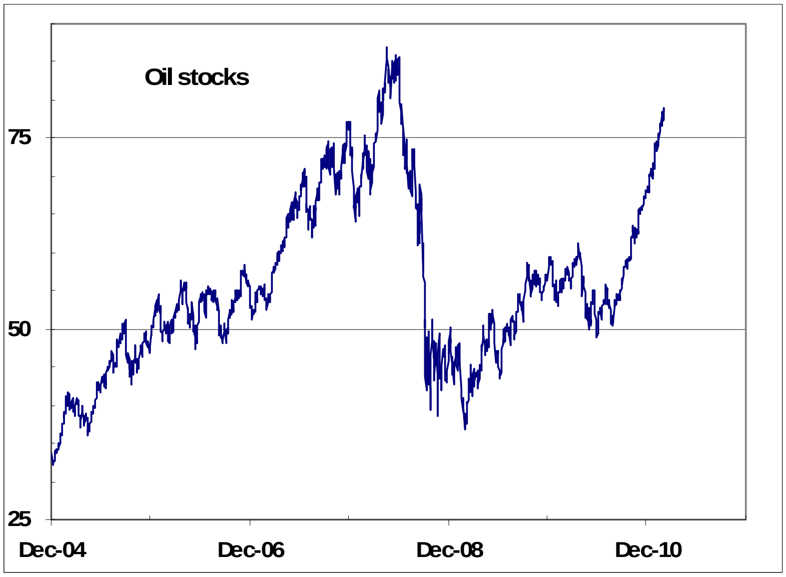
For the first time in nearly a decade, the geopolitical situation has an enormous influence on investment markets. The uprisings across northern Africa and the Arabian peninsula, focused now on the savage fighting in Libya, have roiled global oil markets. It is impossible to know what comes next and what will be the shape of things in the region in a year. Because the region provides 40 percent of the world's oil production and 57 percent of its reserves, the spreading of these 'Jasmine' revolts to other countries may disrupt oil production and cause further sharp price increases. It goes without saying that higher oil prices and disruptions in supply can be very damaging for the world's economy and for financial markets. Already, since uprisings began in Tunisia in January, crude oil prices have risen by about 20 percent.

Analyses of potential problems arising from damage to oil fields in Libya or their shut down are somewhat encouraging. It appears that there is sufficient excess capacity to make up for lost Libyan oil and that the Saudis are willing to pump more and supply the needed oil. Well and good. However, what we do not know and what we cannot know is whether other oil production, in Algeria or Saudi Arabia, for example, may be cut as and if the uprisings continue to spread. We cannot know whether oil shipments from the Persian Gulf through the Strait of Hormuz, through which 20 percent of the world's oil shipments flow, may be blocked.

We can be quite sure, however, that if oil production and/or oil shipments are cut in a meaningful way, oil prices will rise sharply. How to protect investment capital in this situation is a question Core faces. Here is our approach: If oil prices rise sharply--and it is worth thinking about oil prices above $150 per barrel, from the present $104--some investments assets will probably rise in price, others will fall. Our approach is to reduce the vulnerable positions and to increase investment the others.

Since the Tunisian revolt began, we have cut our investments in equity markets of various emerging economies (e.g., Malaysia, Indonesia and Brazil) and in some sectors of the US and European stock markets, while adding to investments in oil-related, infrastructure and industrial equities. Our investments in gold, silver, agricultural commodities and the Swiss franc all have appreciated, some dramatically, so far this year. We expect that these investments will rise further if the revolts become more intense in the Arabian peninsula and elsewhere in North Africa.

The investment environment now may be seen as one supported by very favorable economic and monetary policy influences, but under the dark cloud of revolution and civil war in a terribly important part of the world. About 20 percent of Core's portfolios are comprised of investments that are fairly direct hedges against a sharp rise in oil prices. These positions should strengthen with oil prices at these levels and go higher still if oil rises further. In addition, we hold large bond investments, largely immune to these Middle Eastern disturbances. We maintain investments in assets that should continue to appreciate in this favorable monetary and economic environment. On Friday, we had a more favorable report on US employment, especially welcome after the months of very week job reports. The report does not prove that strong hiring and wage growth are now underway in the United States, but it is consistent with the other moderately strong economic reports.



The chart above shows the prices of our investment in oil-related stocks. Recall that crude oil ran all the way up to $140 per barrel in 2008, even as the recession was beginning and the financial crisis was exploding. Demand for oil, its price, and the prices of oil stocks then collapsed--as did almost everything. As economies have recovered and oil demand from the developing Asian economies soared, oil prices and oil company stocks have risen. Add war and fear to this rising demand, and we have a volatile situation.

* * *

Tax reports. Remember that we can provide useful information to you and your tax preparer about capital gains, dividends and interest income. Get in touch with us and we will send relevant information to you promptly. As you know, Schwab, as custodian for your investment accounts, is required to provide to you and to the IRS the various reports relating to investment income. Among these this year is a form K-1 for our investment in the exchange-traded fund ("ETF") through which we invest in agricultural commodities, the PowerShares DB Agriculture fund, symbol dba. This ETF is taxed as a partnership; hence, we shareholders of DBA receive a K-1 from the fund. The K-1 includes instructions about how to report this information on a federal tax return. (Of course, all the tax reports, including this one, are irrelevant to IRAs, 401Ks and other qualified retirement plans.) Your tax preparer is likely to be quite familiar with K-1s, although our investment activity is rarely in funds that are formed as partnerships. Contact us, if you have questions.

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

February 11, 2011

Gingerly into 2011...

The resignation of President Mubarak is a welcome development; the people's revolts in Tunisia and Egypt are hopeful and exhilarating.

Financial markets have generally observed these events in a placid manner, perhaps underestimating the complications and difficulties that lie ahead. However, for now, celebration is the order of the day.

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By

Jack Mayberry

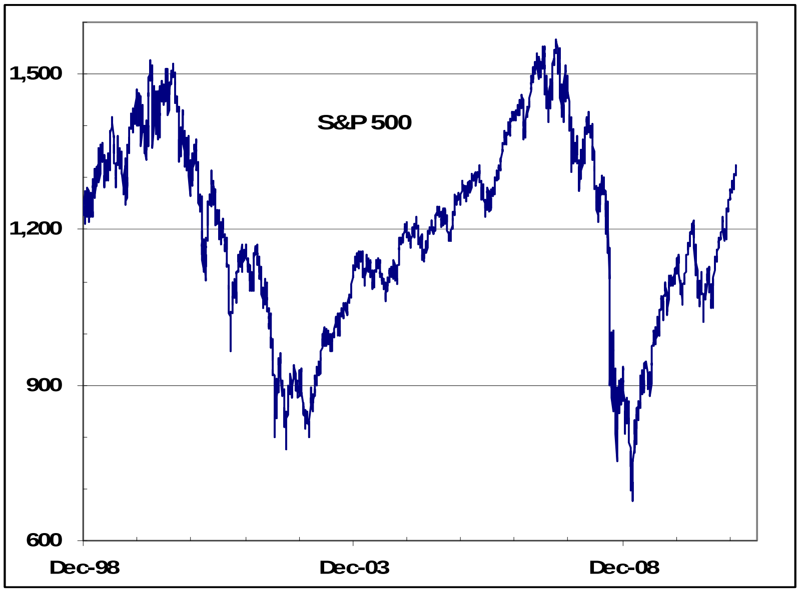
The still-young year has been characterized--at least as it relates to our investing--by several strands: the exceptional political uprisings by the people of North Africa against entrenched, corrupt, and autocratic regimes; steadily advancing stock markets, especially in the United States; increasing evidence of strengthening in the US economy; and apparent movements within Europe to resolve the sovereign debt crisis in a way that preserves the decades-long goal of closer integration of the countries of western Europe. Lurking just ahead of us are decisive battles in Washington between newly-empowered, radical Republicans on the one side and Federal Reserve Board and the Obama administration on the other.

The Mahgreb, Egypt, the Levant and Arabia. The uprising that began in Tunisia has electrified the peoples of North Africa, the Arabian peninsula and the Middle East. It is impossible to offer a meaningful discussion in this short (investment-oriented) letter. But we can offer our opinions that this event has just begun, that the resignation of Mubarak does not end the uprising, and that change to political alignments around the globe is now underway. Israel excepted, none of the countries of these regions is a democracy. This popular uprising may be the first phase that lifts the lid from decades-old autocratic teapots. The consequences may only be imagined, but, as your investment manager, we must imagine. The insouciance so far demonstrated by financial markets is probably more a proof of short-term thinking that drives markets rather than a reasoned judgment that these consequences will not disrupt the stately advance of prices of securities. Core expects uncertainty and difficulties flowing from this in the months and years ahead; these will find periodic expression in financial markets by crisis-driven selling. This set of events will have the importance to financial markets at least as great as that posed by the European sovereign debt problems.

The US economy and politics. Despite the persistent--let us call it 'agonizing'--weakness in the labor market, data showing economic growth in America are encouraging. It seems likely that US growth will be strong, at least in the first half of this year. The significant and unresolved question is whether this economic growth in the private sector is 'self-sustaining.' In the lame-duck session of Congress, the Obama administration negotiated an arrangement with incoming Republicans for significant fiscal support (lower FICA withholding and extension of unemployment benefits) in exchange for an extension of the Bush-era tax cuts for those with high incomes. Coupled with exceptionally accommodative policies of the Federal Reserve, the US economy enjoys meaningful support from the government. This support will fall away in time. When that time comes, will the private sector exhibit suffi-

Darrell Issa's article may be found at http://www.ft.com/cms/s/0/d949c6c8-32fc-11e0-9a61-00144feabdc0.html#axzz1DVgjBjc4. It is not terribly persuasive.

cient vigor to keep the economy growing? This is an open question. The tart exchange on Wednesday of this week between Paul Ryan, the new chair of the House Budget Committee, and Ben Bernanke, chair of the Federal Reserve Bank, gave a fair outlook of the disputed ground: Is the Fed's QE2 policy inflationary? Will present federal deficits lead to debasement of the dollar and future inflation? Is rising inflation in emerging economies a result of Fed policy or of droughts in Russia and the like?



There is a settled view on the right that the federal government policies--of the Fed and of the Bush and Obama administrations as the crisis unfolded--were unneeded, ineffective, and destructive of economic growth. This view is driven more by ideology than evidence, but we shall be hearing lots about this. No less an economic thinker than Darrell Issa, the new chair of the House committee on oversight and reform, opines in the Financial Times on the subject (reference in our side bar). His view is a good synopsis of the argument from the right, a rather weak argument as Core sees it.

Inflation. Increases in prices for food and fuel may have engendered some of the problems behind the North African uprisings. We shoppers in America see them here; politicians raise voices about inflation and point to higher yields on US treasuries as proof that rising inflation lies ahead. Yields on government bonds have risen, but the inflation portion of these increased rates (as measured by the market for inflation-adjusted securities) is far smaller than is the increase in 'real rates', which have risen on expectations of faster and stronger economic growth. In effect, increases in Treasury bond yields represent a return to more normal, but still very low levels, after the scare last year of deflation and 'double-dip' recession.

The US stock market has been strong, in absolute and relative terms, since the early autumn. The strengthening economy offers hope that real job growth lies ahead.

Investments. We have expressed our views about the world and the markets in your investment portfolios by selling equity positions in Brazil and Malaysia in favor of US industrial and energy-related investments. (Better prospects for the US export-intensive companies and for oil energy companies, when weighed against the tightening monetary policies in Brazil and China, informed these changes.) We did a swap (after the calendar turned over--no taxes on the gains payable until April 2012) into a very inexpensive Vanguard emerging market ETF from an somewhat more expensive iShares ETF, to save us all some underlying fee expenses. We took a small position in the Swiss franc against the risk of further confusion and distress in the European sovereign debt conundrum. As mentioned at the top of this letter, although we think that the political support for the Euro and for the general European integration project of the last forty years will produce a favorable resolution to European sovereign debt problems, we can buy some very inexpensive insurance by investing in Swiss francs. We have reduced your investment in utilities and in preferred stocks of large US banks to fund these investments. These high-yielding and quite safe investments are still attractive and we retain investments in them for most client accounts, but we think we can earn somewhat more than offered by these securities, without taking on much more risk. We contemplate shifting some of your bond investments from the highest-grade corporate debt to somewhat lower grade debt. We will continue to watch the political, economic and financial market developments to keep your investments on a safe and production path.

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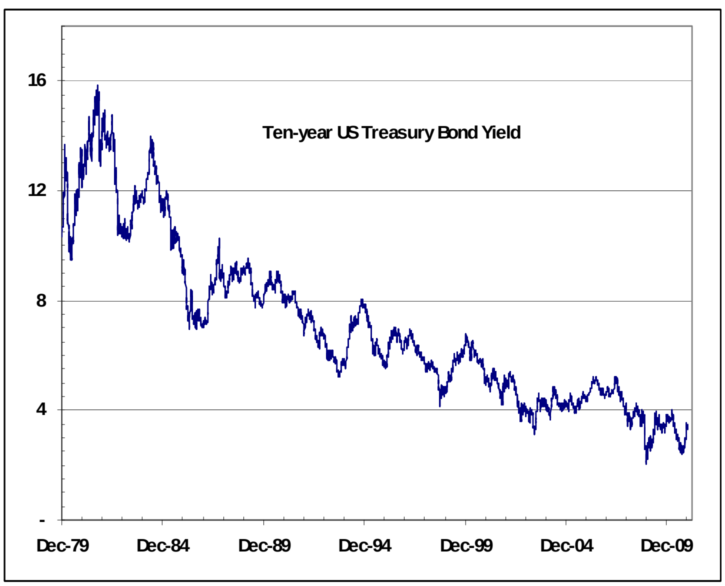
CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

January 7, 2011

A New Year Begins…
…A Look Back and Forward

For thirty years, the yield on the benchmark 10-year US treasury bond has fallen. During the worst of the financial crisis at the beginning of 2009, and again last autumn, yields fell to extremely low levels, reflecting fears of deflation. The very recent rise in yields (and fall in prices) is quite modest in this context.



By

Jack Mayberry

The US economy ended 2010 similarly to the way it began, with signs of increasing strength. Much of the year, however, was characterized by palpable concern that the tottering economy was poised to sink into recession once again. The labor market was distressingly weak and house prices began to fall again in the second half of the year. Recovery from the severe recession began in the middle of 2009 and, a year ago, things seemed to be proceeding with some vigor. But late winter brought the beginning of the still-unresolved problems with sovereign debt in European countries. At the same time, growth faltered in the United States. By August, the Federal Reserve, which had been hinting in the spring that it would begin to 'normalize' monetary policy, announced that it was planning a second round of so-called 'quantitative easing' in order to ease fears of that the economy would contract again and that price deflation was at hand.

Within the last month, and despite a very poor employment report for November, it appears that the 'soft patch' of the summer months has given way to more vigorous economic growth. Thus, we enter the new year with the economic winds blowing more favorably. The big question, discussed below, is whether economic growth in the United States has become 'self sustaining', that is, whether the economy can continue to grow without the stimulation provided by high levels of government spending and by the Fed's exceptionally easy monetary conditions. This question looms especially large because of the hostility expressed by Tea-Party Republicans to the Fed's policies and to deficit spending by the Federal government.

The mid-year economic weakness and the troublesome euro-land crisis had their impact on financial markets: The dollar rallied against most currencies and especially the euro as the near-insoluble problems of Greece and other 'peripheral' European countries became apparent. Stocks and commodities, sensitive to global economic growth and reflation, fell as fears grew in the spring and early summer. Bonds, especially long-term US treasuries, rose sharply in price and their yields fell. Gold, which had been rising steadily for some time, took further support from the euro-currency crisis, and continued its ascent.

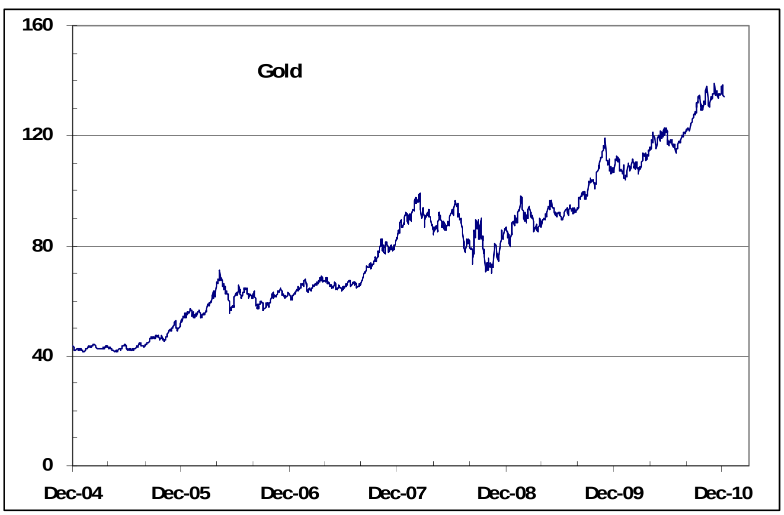
As Federal Reserve officials gave speeches through the late summer and early autumn about its planned quantitative easing actions, the markets responded. Stock prices and commodities made lows in the summer and began to rise anew. Treasury bond prices rose further on expectations that the Fed would be a big buyer of these securities. The yield on the benchmark ten-year treasury, which stood at 4% in early April, fell below 2.4% in October, an astonishingly low level, suggesting real fears of recession and deflation. But then, as the economy steadied and grew more vigorous, the yield on the ten-year rose sharply in the last weeks of the year to about 3.5%. Surely, this suggests a return to more normal price and yield levels and presages, we can hope, more 'normal' economic growth.

The chart below shows the rising price of gold over the last several years. (It is a chart of the price of the exchange-traded fund that tracks the gold price.) Does the rising price of gold reflect fears of future inflation? Does is reflect disenchantment with paper currencies? (Note that this graph shows gold in US dollar terms. The slope is the pretty similar when gold prices are measured in Japanese yen or the euro or other currencies.)

In addition to our gold investment, most Core portfolios have investments in silver and in agricultural commodities.

Into 2011. And so we begin the new year. In the developed countries--Japan, the United States and Europe--it is reasonable to expect modest economic growth, the most in the US. In the developing countries, most of which rebounded very quickly from the banking crisis and recession in the developed countries, we can expect a continuation of a high rate of growth. Inflation is very low--worryingly so--in developed countries, but higher and beginning to rise in developing countries. Monetary conditions throughout the world are extremely loose; interest rates on short-term debt are near zero in most developed countries; in developing countries, short term rates are rising. (But rising rates in the developing world are offset by near-zero rates in US, whose dollar is the world's reserve currency and whose monetary policy has effects far beyond its borders.)

In the United States, households and private businesses continue the process of reducing debt and improving their balance sheets. This phenomenon shows up in the personal savings-to-income ratio among households, which turned slightly negative in the middle of the decade just past, but has, since the financial crisis, hovered around 6%. In the traumatic period of the crisis and its immediate aftermath, the move to cut spending and to save restrained economic activity in the private sector. Now, with the savings rate stable at this higher level, consumer spending is growing again with income growth. The business sector is strong; manufacturing activity is growing; capital spending and, we can hope, hiring of new staff will probably continue to improve.



The combination of moderate economic growth in the US and very favorable monetary conditions suggest that the US stock market will be reasonably healthy in 2011. But, apart from problems that may arise outside the United States, discussed below, there is the real possibility that changing government policies may upset the applecart. When the private sector--households and businesses--tightened belts suddenly and extremely in the financial crisis, it was only the federal government that could take up the slack and make up for some lost spending. Of course, tax revenues fell sharply in the recession, with the result that increased federal spending gave rise to enormous federal deficits. For all the political reasons with which we are familiar, the November elections brought to office Tea-Party enthusiasts who campaigned on cutting government spending at all levels. Another feature of many of the new folks is their abhorrence of the Federal Reserve Bank in general and of the Fed's very easy monetary policy, especially QE2, as the newly-

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The bitter partisan feuding in Washington presents a threat to the continuation of the still-fragile economic recovery. Apart from Republican opposition to the federal spending to support the weak economy and those suffering its worst consequences, there is full-throated opposition to the actions of the Federal Reserve Bank. The upcoming fights are almost certain to rattle markets, even if the economy does grow reasonably well.

Perhaps more serious is the worsening condition of state and local government finances. 2011 will present us with further evidence that a recession brought on by a credit crisis takes a very long time to play out.

The sovereign debt crisis afflicting the 'peripheral' European countries and threatening the Euro itself will continue this year.

Solutions are not hard to picture, but the political obstacles they present stand in the way of their timely adoption. A renewed market crisis may unfold before these problems are solved.

commenced round of treasury bond purchases is called. If it should develop in coming months that these new officeholders succeed in cutting spending sharply and in forcing the Fed to tighten monetary policy, we might discover that private economic growth will falter. There is a serious question whether the economic recovery is 'self sustaining', or if it continues to need the federal government and Federal Reserve fiscal and monetary support. At present, this is unknowable. A cautious policy approach is warranted.

Turning away from Washington for a moment, consider the problems with state and municipal finances. A very large part of the 2009 Federal stimulus funds went to state and municipalities to help make up for declining tax revenue and increased demand for services during the recession. As we all know, financially healthy states are few and far between; their numbers do not include the big states. Unless tax revenues rise much faster than now seems likely, many state and local governments will face enormous deficits this year. The problems are substantial; the solutions unknown. Severe cuts in public spending at the state and local level are already underway; they are a tangible depressant of economic activity. More cuts will mean more economic weakness.

From outside the United States. Risks to the US economy and to financial markets come from outside the United States, as well. It is almost certain that there will be another round of distress involving the government debt of Greece, Ireland, Portugal, Spain and/or Italy ("PIIGS" in the unfortunate acronym), because there was no resolution of the underlying problems in the two episodes in the last twelve months. The European Central Bank ("ECB"), the International Monetary Fund ("IMF"), the European Union ("EU") and its strong members, especially Germany, bought time for this crisis and provided sufficient funds to provide for the borrowing needs of these countries in the short term, but they have not dealt with the solvency problems these countries face. That is, will the governments of these highly-indebted countries be able to generate sufficient tax revenue to pay interest and principal of their sovereign debt and meet their other obligations? No. It is hard to find a credible argument or to lay out a plausible scenario by which Greece and Ireland can be considered solvent. Because these countries are within the euro-zone, they cannot depreciate their currencies; they are stuck with the euro. Thus, they must lower their cost structures--especially wages--to become competitive. The austerity measures imposed by the IMF and the ECB are causing and will continue to cause shrinking domestic economies. This lowers tax revenue, which weakens their debt service capabilities. This in turn causes the interest they must pay on new debt to rise, making their indebtedness worse. A vicious cycle is underway.

The ECB or EU members individually could buy Greek and Irish debt and remove the problem; the holders of the debt, which include German and French banks, could be forced to take less than 100 cents on the euro for this debt. Debt restructuring in sovereign debt crisis is extremely common and quite fair. Both these solutions are entirely workable, but both are fraught with political difficulty. There is intense political opposition in Germany to 'bailing out' the profligate PIIGS. Forcing the banks to take a 'haircut' on their holdings of this debt would lead to undercapitalization of many of those banks, requiring one more round of public support (by German taxpayers) for private banks. To say the least, there is little appetite so far for these solutions.

Therefore, it is likely that we will lurch into another round of crisis and another round of riot in financial markets, before the ECB, the EU, and Germany are forced to take the steps they abhor. Disruption in financial markets arising from the failure of European authorities to resolve the crisis can lead to the realization that the different, but related sovereign debt problems for the UK, the United States and Japan would dwarf the problems with Greek and Irish debt.

The contrast between the problems and risks presented by United States and Europe and the opportunities of the developing countries is striking. Economic growth is strong, government finances are generally strong, and capital seeking investment in Asia and Latin America is abundant.

US multinational companies are beneficiaries of this growth, many commodities, and the local bond and stocks markets themselves all present fine prospects.

The Developing Countries. The developing countries of Asia and Latin America present a much more pleasant aspect. Their economies continued to grow throughout the Great Recession, in 2009; for example, at 2.5% while developed economies contracted by 3.2%. In the year just ended, the emerging countries grew around 7%, as against about 2.7% for the developed economies. The IMF forecasts growth rates of 2.2% (developed) and 6.4% (emerging) for 2011. As we mentioned in previous letters while discussing the attractions of emerging market debt, the problems that plague the PIIGS are absent: Developing economies are growing fast, demographic characteristics are favorable (lots of workers per retiree), and their governments have relatively little debt. In short, the financial condition of most developing countries is quite strong. One feature of the financial strength and robust growth in these countries is that foreign capital, a good portion of which has been set loose by our Federal Reserve Bank, finds its way into these countries and their asset markets. This in-flow of foreign capital is not an unalloyed blessing for these countries; it sets inflation in motion and presents difficult policy choices to their officials.

For us investors, however, the local problems are overshadowed by the investment and business opportunities. Foreign companies, including US multinationals, generate enormous profits in the developing world. Investors like ourselves benefit from the robust growth and in-flow of capital, which lift prices of our investments in commodities, in emerging market bonds and stocks, and in US multinationals.

Conclusions. My sense is that the principal risks to the continuation of economic growth in the US and the developed world arise from the possibility of policy mistakes, in Washington and Germany primarily. I also sense that the policy makers will, unwillingly and belatedly, make the 'right' decisions. Markets will be shaken as the euro-land sovereign debt crisis and the partisan bickering in Washington about the scope and activities of the federal government play out. But, at the same time, the markets will be supported by the backdrop of continued growth, low inflation, and very favorable monetary conditions.

We at Core will continue to be cautious in our investing, mindful that our favorable expectations may not be borne out. At present, it appears that our mix of investments is suitable, including high-quality bond investments, equity investments focused on the areas and companies with the greatest exposure to global growth, precious metals and agricultural commodities, and commercial real estate. We look forward to investing in 2011.

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