

# CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

December 9, 2012

## Recent Investments

During this week just past, Core has undertaken trading in most client accounts as outlined prospectively in the letter we sent on December 3. You will have seen a blizzard of trading confirmations in the last several days and it seems useful to explain. Some trades were for the purpose of realizing capital gains on profitable positions so as to take advantage of the now low tax rates on capital gains. As mentioned in last week's letter, the 'fiscal cliff' negotiations are likely to make changes to the tax code. There is certainly a fair chance that taxes on capital gains will rise in 2013, so realizing gains this year is probably advantageous. The second set of trades we made last week involved changes in investment allocations, motivated by investment considerations, not taxes. First, the tax-driven changes:

In most client accounts with more than \$50,000, we made swaps for tax purposes, selling positions with unrealized gains and buying securities with very similar investment characteristics. In these trades, we accomplished our tax job without changing the investment characteristics of portfolios. We sold US high-grade corporate bonds (symbol LQD), US high-yield corporate bonds (HYG), and a REIT holding mortgages (STWD). We replaced these with a Vanguard exchange-traded fund holding high-grade US corporate bonds (VCLT), an iShares ETF for high-yield bonds (JNK), and an ETF holding mortgage-backed securities (REM). The investment holdings and characteristics of our replacement funds are quite similar to those we have held, so these trades merely push forward the realization of the capital gain to this year.

We made these same trades in IRAs and other types of accounts that are not taxed. Of course, there is no tax reason to make swaps in these accounts, but we made the trades in those for what we consider good administrative purposes. Having a similarity in holdings in accounts with similar investment goals and risk characteristics lessens the chance that we will make mistakes in the administration of the accounts we supervise.

[ Our other investment activity changed our allocations to different assets and reflect purely investment considerations. We have sold two positions--in both of which there were meaningful profits--in order to make investments in European equity markets. Earlier this year, we made investments in German stocks and Swedish stocks, but had the largest portion of our equity investment in US markets. The crisis in the Eurozone, of which we have written extensively, caused European stocks to underperform US stocks by a long shot. Although the crisis is far from resolved, the risk of serious banking and financial system problems is far lower than last spring and last year, before the commitment by ECB president Mario Draghi, of which we wrote in our letters in July, Septem-

*By*

*Jack Mayberry*

ber and October. Although Europe's economy is likely to be weaker throughout the year ahead than America's, the very low prices of European stocks, when compared to American, make European stocks quite attractive here. To fund these investments, we sold the S&P 500 ETF (SPY) and the ETF for gold bullion (GLD). We think it likely that European stocks will do better than gold and better than the US stock market in the year ahead. Accordingly, for our equity-oriented portfolios, we add to German and Swedish positions with investments in France and the Netherlands.

The matters discussed in the paragraph above do not apply to the accounts that we manage in our Capital Preservation portfolio, which generally avoids equities and invests mostly in bonds. We have retained our gold position for those accounts. Of course, we did not own US stocks in these portfolios, nor did we buy European stocks.

If you have questions about this set of trades, please do not hesitate to get in touch with us. Remember, also, that we can readily prepare reports showing our purchases and sales and the realized capital gains. These will be quite useful in the preparation of tax returns. If you need reports like this, please contact us or have your tax preparer do so.

### **A word of thanks**

As the year draws to an end, we wish you and your families the best for the upcoming holidays and the new year. We are grateful for the opportunity to work on your behalf with your investment capital. The investment work itself endlessly interesting to us, and our work individually with you is rewarding and fascinating. Best wishes to all.

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# CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

December 3, 2012

## The Election, 'Fiscal Cliff,' Taxes... ... more Wall Street Corruption

*The drama surrounding 'fiscal cliff' negotiations is a bit overdone. A deal of some sort will be made, either before or after January 1.*

*One likely outcome of these negotiations and of the election is higher tax rates on investment income. We are making a few sales of positions in which portfolios have unrealized gains, so as to realize those gains in this low tax year.*

*We are also shifting portfolios for equity-oriented investors, by cutting investment in US stocks and adding to European stock investments. The Euro crisis has resulted in considerable weakness in European stocks as compared to American stocks. This has created value in Europe, particularly with the far lower risk of catastrophe in Europe.*

*We will write more fully about these trades after completing them.*

**By**

**Jack Mayberry**

The election seems decisive in some respects and inconclusive in others. It is inconclusive in that the same divisions in our government will prevail next year. The president will continue for a second term; the Democrats still hold a slim, but somewhat larger majority in the Senate; the Republicans still hold a substantial, if slightly smaller majority in the House. It may be decisive in that some hard-fought fiscal issues appear to have been resolved by voters. The composition of the federal courts will not shift further to the right; the health care law--Obamacare--will be implemented; taxes on the rich will rise; taxes on investment income may rise.

The immediate post-election issue concerns the so-called 'fiscal cliff', a set of already-enacted tax increases and spending cuts that will become effective as of January 1, unless Congress and the Obama administration can agree on changes to them. The term 'cliff' is not terribly apt. The effects of the tax increases and the spending cuts, while substantial, will be felt only over a period of many months after January 1. Hence, it is misleading to suggest, as the term 'fiscal cliff' does, that our economy will tumble into the drink on the stroke of the New Year, unless the government acts in the final weeks of the year.

Nevertheless, it is probably useful to employ somewhat apocalyptic terms to describe the situation, because without a sense of imminent danger it is unlikely that our government will rouse itself to act in a constructive fashion. It is widely believed that, without changes to the present tax and spending laws, our slowly-growing economy would slide back into recession. In the days just after the election, House Speaker John Boehner and President Obama both addressed the issue. Before Thanksgiving, Congressional leaders came to the White House to meet with the president. After the meeting, the participants spoke of the constructive tone and looked toward an agreement. With Congress back in session after Thanksgiving, a good deal of noise emanates from Washington, mostly rancorous, some soothing.

Because an agreement to resolve the fiscal issues seems reasonably likely and because the December 31 deadline is not all that significant, we continue to invest on the view that the American economy will grow modestly. Although the countries using the Euro continue to suffer from terribly weak economies worsened by policies of fiscal austerity, the resolve of Europe's leaders and its central bank appear likely to keep the calamity at bay. Moreover, because selling in European markets in the last two years has been extreme, many European stock markets offer unusual value. In short, the investment environment

is acceptable. Recent selling in stock markets does not seem like the beginning of large decline, but a respite after the rally of the summer and early autumn.

*The insider trading investigations by the US Attorney for the Southern District of New York over the last three years have revealed far more corruption in the highest levels of Wall Street than had been known. The latest round involves the very large and successful hedge fund group, SAC, and appears to be targeting its principal, Steven Cohen.*

*Why do high level and very successful participants in the securities businesses feel compelled to commit crimes or to push to the edge of criminal behavior in the quest for more money? Is it not abundantly clear that, when financial markets and securities companies are well-regulated and supervised by government agencies, the public will have confidence in the fairness and integrity of the markets, to the benefit of all its participants?*

*Unfortunately, the seemingly unending line of high-level miscreants undermines this confidence. Perhaps the diligent work of the US Attorney's office will give the public reason to believe again that the government is acting to protect the public interest.*

Tax changes appear inevitable. It seems a fair bet that the income tax rate on high-income individuals and on capital gains will rise. During December, we plan to sell some positions in which we have unrealized capital gains and to replace these with similar securities so as to maintain investments in the asset classes we want. The result of this 'tax selling' will be to take some of our unrealized gains at the present low rate, against the possibility that capital gains will be taxed at a higher rate after the new year. For reasons mentioned in preceding paragraphs, we will add to positions in European stocks for Core clients that invest in equities. We will write of these explicitly after we complete the project.

**Corruption.** Another dispiriting tale is unfolding in the securities business. In the last few years, we have come to hear of 'expert networks', employed by hedge funds and other institutional investors, in which insiders in various industries are employed to ferret out information useful to these investors. Recently the US Attorney for the Southern District of New York, the key federal prosecutor for financial markets who has successfully prosecuted high-profile insider trading crimes in the last three years, arrested a portfolio manager for SAC Capital Advisors, a very prominent hedge fund, and brought a criminal action against him and the firm, a subsidiary of SAC, in which he worked. The complaint asserts that the SAC manager, Mathew Martoma, received information from Dr. Sidney Gilman, a neurology professor at Michigan Medical School, about clinical trials at the FDA for Alzheimer's drugs developed by Elan and Wyeth, which pharmaceutical companies had hired Gilman to oversee aspects of the trials. The US Attorney alleges that the SAC company had paid Gilman \$108,000 for consultations with Martoma.

SAC funds had large long positions in Elan and Pfizer (of which Wyeth is a subsidiary). It appears that Dr. Gilman informed Mr. Martoma of adverse results in clinical trials of the drug. SAC funds sold its holdings in Elan and Pfizer and took short positions instead, thereby, according to the complaint, avoiding losses on the long positions and gaining on the shorts in the amount of \$276 million. The principal of SAC, Steven Cohen, is not named in the complaint, but reference is made to 'Portfolio Manager A', apparently Mr. Cohen. Cohen and his funds have been enormously successful and he has been very highly regarded. In earlier insider trading cases investigated by the US Attorney, six former or current employees of SAC have been tied to insider trading; three have pleaded guilty. Last week the SEC announced its own investigation; it appears that Steven Cohen is the ultimate target of the SEC and the US Attorney. Mr. Cohen has not been charged and asserts his innocence.

How pervasive is insider trading at the highest levels of Wall Street? Far more so than we had imagined. The investigations and prosecutions in insider trading cases brought by Preet Bharara, the US Attorney for the Southern District, have brought convictions against another prominent hedge fund manager, Raj Rajaratnam, and Rajat Gupta, the former head of McKinsey and a board member of Goldman Sachs. Insider trading and corruption by small scale Wall Streeters is regrettable but not so disturbing as that by Steven Cohen or Rajat Gupta. Those at the top of the profession should be well aware that a robust regulatory system and integrity by key figures on Wall Street gives the public confidence in the fairness of the system and its participants. Corruption destroys that confidence and undercuts the businesses from which they earn their handsome livelihoods.

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# CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

October 21, 2012

## Central Banks Confound the Cautious

As we move into the year's last quarter, the overall situation looks more robust and healthy than only a few months ago. The painfully slow economy in the US is improving. Jobs are more plentiful; people are spending more and have more confidence in the economy. The housing market is improving modestly, with higher home prices and more building. In Europe, the overall economy is in recession and is unlikely to grow in 2013 by more than a nominal amount. But the dangers presented by the sovereign debt crisis in the 'peripheral' Euro-zone countries have lessened: The extraordinary (if contingent) commitment by the European Central Bank (ECB) to assist Spain, Italy and others coupled with the apparent resolve by Germany and other leading actors to prevent a break-up or collapse of the Euro have restored calm and taken the edge off the still-unresolved crisis.

To be sure, problems are readily apparent. The so-called 'fiscal cliff' looms in the US. Without a deal among the houses of Congress and the administration in the lame-duck session, income and payroll taxes will rise as of January 1 and sharp cuts federal spending will unfold. Should there be no deal, the US economy would almost certainly contract because of the far tighter fiscal backdrop. Financial markets would be shaken. At present, the expectation is that some sort of deal will be achieved. Because of the completely unresolved problems in Europe, a crisis there may arise in any number of ways. China, the world's second largest economy, has been weakened by economic contraction in Europe and slow growth elsewhere. If Chinese economic growth continues to weaken, social unrest in China, where millions have lost jobs, may become a problem. The usual geopolitical risks from Iran, Syria, and elsewhere remain.

Considering these risks against the relatively positive backdrop, one has to put a couple of extra weights on the positive side of the scale to give effect to the role of the central banks. The Federal Reserve has been forthright in its determination to counter the contractionary aftermath of the financial crisis. Last month, it announced a new phase of its so-called quantitative easing, whereby it will buy large amounts of mortgage-related securities. The Fed specifically cited the weak jobs market and its mandate to promote full employment as the basis for this action. Significantly, it did not set a termination date for the buying program. Perhaps more important now even than the Fed is the ECB. Its announcement of unlimited buying of bonds of governments that seek and accept support of the European Union reduced borrowing rates of Spanish and Italian bonds dramatically and reduced fears of chaos. The proposed bond buying is specifically contingent upon a nation's request for funds from the European Union and compliance with the conditions imposed by the EU on government spending and tax policy. Spain is likely to be the first to seek this

*By*

*Jack Mayberry*

aid. So far, Spain has not made its formal request, presumably hopeful that it can avoid the certain fiscal strictures that will accompany further funds.

The astonishing thing is that the ECB has not yet taken any action, but only promised contingent bond buying. Yet that contingent promise has been sufficient to defuse the crisis that seemed in June to be on the point of exploding. Shortly after Mario Draghi, the ECB president, began his public discussion of the policy in July, Chairman Bernanke and other Fed members began to discuss the Fed's next round of quantitative easing, which was formally announced and begun in September. The influence of these two central banks is extraordinarily potent, especially in financial markets. Bernanke has made the point more than once that the Fed's monetary policies support asset prices--stocks and bonds--arguing that higher asset prices increase the wealth and the spending of members of the public. This increased spending supports and enhances economic growth, as the argument goes, to the benefit of the job market.

Particularly in the case of the Fed, it is important to distinguish between the possible economic outcome of its radical monetary policy and the effects of that policy on asset markets. The Fed asserts that its monetary policy during and since the financial crisis has directly enhanced economic growth. That is probably true, but it is not at all certain that the current round of buying mortgage-backed securities and keeping short-term rates at essentially zero will cause the economy to grow from this point. Be that as it may, it seems more certain that the Fed's actions will continue to support stock and bond markets, as they have done since the crisis.

It is harder to know whether the ECB's actions--or, more precisely, its promised actions--will continue to have such a soothing effect on the Euro crisis. The markets have given the ECB the benefit of the doubt, encouraged also by the apparent commitment to the preservation of the Euro by the important political leaders in Europe. But the situation in Spain is fraught with terrible problems: overall unemployment is 25% and far higher among the young; Catalonia holds a vote shortly bearing upon its secession from Spain. Despite its best efforts, Spain's debt level will fall far short of the existing targets set by the EU; further fiscal austerity may make things worse. The International Monetary Fund, a lender in the European bailouts, warns ever more forcefully of the dangers of the imposition of such austere fiscal policy. The overwhelming complexity of the Eurozone crisis makes the political, fiscal and economic issues faced by the United States seem almost trivial. (They are not trivial.)

The calm that prevails now has come about because the key central banks have taken exceptional actions and made exceptional promises. (Mario Draghi said in July that "the ECB will do whatever it takes to preserve the euro. And believe me, it will be enough.") The central banks have been the bulwarks in these crises. But what if more is needed from the Fed and the ECB? Central banks can print money, as the saying goes, in unlimited amounts. How much more unlimited buying of various securities is feasible in the face of strong objection by important political forces in Europe and America? In America, the underlying economy is improving; more novel Fed support may not be needed. In Europe, the economy is weak, but political movement is positive. For now, Core's portfolios tilt toward opportunity, but we are well aware that serious problems remain. We will remain alert.

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# CORE *Comments*

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

September 11, 2012

## Don't Underestimate Mario Draghi

In the previous *Core Comments*, I quoted the comment of Mario Draghi, president of the European Central Bank (ECB), from late July that “the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough.” In the analysis presented in that letter, I argued that German opposition and the terribly difficult economic and fiscal problems facing many European countries would overwhelm the then-unexplained actions that Draghi was contemplating. As an investment matter, my skepticism about the European Central Bank’s capacity to deliver a meaningful solution to the Eurozone problems led me to maintain the hedging positions in Core’s clients’ portfolios and to keep investment risk in portfolios low.

In the short run at least, I underestimated the power of Mr. Draghi’s ECB. Mr. Draghi discussed his plans over the last several weeks and appeared to reach an agreement with German Chancellor Angela Merkel and others with a program that was announced formally on Thursday of last week. By this, the ECB will buy in the markets short-term (up to about 3 years in maturity) government debt of Spain, Italy, and other indebted countries. This buying is to be contingent upon agreements by the debtor countries to fiscal solvency conditions imposed by the European Union the International Monetary Fund (IMF) and the ECB, the so-called ‘Troika.’ This is a key provision, giving assurance to creditor countries like Germany that ECB support will only flow if and as the debtor countries submit to the austerity demands of the creditors. Moreover the bond purchases will be ‘sterilized’, i.e., the ECB will sell securities it now holds in amounts equal to those it buys in the markets, so as not to be ‘printing money’. (The ECB’s assets will not grow in amount, but they will deteriorate in credit quality, because it will be selling German bonds and other high-credit quality holdings as it buys Spanish and other low-quality bonds.)

Jens Weidman, president of Germany’s Bundesbank and a member of the ECB’s governing council, has been adamantly opposed--as have many Germans--to the buying of debtor countries bonds. He denounced the plan forcefully and repeatedly in recent weeks and cast the sole vote against it. Financial markets have seen it differently. Since Mr. Draghi’s late July announcement and during his elaboration of plans in recent weeks, yields on two to three year Spanish and Italian bonds have fallen markedly, from above 6% in Spain’s case to around 3% now. At the same time, stock markets generally have risen.

*By*

*Jack Mayberry*

Many impediments to European growth remain. The ECB’s action will keep at relatively low levels the cost the ‘peripheral’ countries must pay to borrow in the short term. Lower borrowing costs lessen the impact of the austerity measures--higher taxes and lower government spending--that these weak countries

***Soros' suggestion to Germany:  
'Lead or Leave'***

*A point Soros makes is that the European Union is dividing into creditor and debtor countries, with somewhat punitive strictures being imposed on the latter by the former. This contrasts with the aspirational goals that informed the creation and development of the European Union, beginning with the European Coal and Steel Community through the launch of the Euro. The current situation compares, Soros reminds us, with the imposition of reparations on Germany after the First World War. The political unpopularity of the economic burden under which Germany suffered led, in a straight line to the rise of the Nazis and Hitler.*

*Soros suggests that Germany should be a 'benevolent hegemon' in the EU, or leave the Eurozone itself, perhaps with other creditor countries like the Netherlands and Finland.*

must endure. But, because the ECB will only undertake the bond buying program for countries that accept the austerity strictures, Spain and Italy face the unpleasant task of consigning their people to a weaker economy, rising unemployment and less support for social services provided by the government. Tomorrow the German constitutional court is expected to rule on the constitutionality of the key pan-European rescue institution, the European Stability Mechanism. Imminent elections in the Netherlands and strident opposition in Finland to further support for the periphery threaten the complex process. The Troika's fraught decision to provide further funds to Greece lies ahead.

I am now persuaded that the ECB has the tools and the will to reduce risk of a systemic problem from the Eurozone problems, thus the title to this letter. An important effect of ECB bond buying in the secondary market will be improvement in the balance sheets of European banks. They will be able to sell their short-term bonds of Italy, Spain and others to the ECB at relatively favorable prices. This will reduce risk of major bank failures in Europe, decreasing risk to the global financial system. This appears to be a helpful plan; it demonstrates Mr. Draghi's political sophistication and abundant skills.

In this country, our central bank appears poised to commence its next round of monetary policy easing. Chairman Bernanke's speech last week in Jackson Hole and the weak employment report released on Friday point toward imminent action. Many doubt the effectiveness of the Fed's earlier rounds of monetary easing despite Mr. Bernanke's arguments. Most agree, however, that the actions support the financial markets and asset prices. We are in the process of lifting a portion of our hedging positions and investing somewhat more forcefully.

In this extended aftermath of the financial meltdown in 2008, the Great Recession, continuing economic weakness, and fiscal policies tilted toward austerity in Europe and the United States, the role of the central banks is of paramount importance. Under Mario Draghi, the ECB has joined the Federal Reserve and the central banks of Japan and the UK in actions to sustain economies and the financial system. Given the extended periods in which short-term interest have been near zero, monetary policy has generally focused on support of longer-term bonds with the result that most 'risk' assets, including stocks, are indirectly but powerfully supported by the central banks. The dramatic approach of the ECB leads us to reduce our hedging position and add to our equity holdings, now in Germany's stock market. In the last year, our equity investments have been tilted toward US stocks and infrastructure development, while European stocks have, quite reasonably, been notably weak. The startling underperformance of European stocks make Germany attractive, despite the ongoing and still unresolved problems in Europe.

A rather long but extremely interesting analysis of the European crisis by George Soros appears in the current issue of the New York Review of Books. I attach the piece as a pdf; this is the link to it: <http://www.nybooks.com/articles/archives/2012/sep/27/tragedy-european-union-and-how-resolve-it/?pagination=false&printpage=true>. The web version has a brief preface discussing last week's ECB announcement, which came after the main article was published.

For the time being, Mr. Draghi has calmed the markets with another forceful move. Now attention shifts the United States and the 'fiscal cliff' that lies before us. The world's economy and its financial markets are hostages of the policy makers, themselves with differing goals, ideologies, and capacity to understand.

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# CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

July 31, 2012

## Mario Draghi Ups the Ante

Eurozone problems grind on in their cyclical pattern with periods of calm and hope lasting days or weeks, succeeded by periods of anxiety and despair. June's summit meeting initiated a hopeful period, with the understanding that the €100 billion for Spanish banks would be loaned directly to the banks, without becoming an additional obligation of Spain. More recently, however, Germany declared that the lending would have to be Spain's obligation and the downward cycle of anxiety began again. Anxiety increased markedly and yields on quite short-term Spanish government notes reached impossibly high levels, suggesting that Spain could not raise money from private lenders even on a short-term basis. Into the breach last Thursday stepped Mario Draghi, the president of the European Central Bank. He told an audience in London that "[w]ithin our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough."

This was a very bold statement and it looks forward to central bank meetings later this week and to Mr. Draghi's meeting with Jens Weidmann, the president of Germany's Bundesbank. The Bundesbank staunchly opposes outright purchases of government bonds by the ECB as forbidden direct financing of national governments. On Friday, the Bundesbank asserted that there "had been no changes" in its position on this question. The Bundesbank also opposes an alternative means of financing Spain and Greece and the others, namely by the application of the (forthcoming) European Stability Mechanism (ESM) for a banking license, so that it may leverage its €500 billion fund to lend onwards to governments and banks. Over the weekend, German Chancellor Angela Merkel and Finance Minister Wolfgang Schäuble gave support to Mr. Draghi's mooted actions, but without being specific as to actions.

One recalls the tonic--but short-term--effect of the ECB's dramatic and enormous lending program, the LTRO, in December and February, by which it loaned a total of €1 trillion to hundreds of European banks. Like the second bailout for Greece and the announcement in June of the rescue package for Spanish banks, this action lifted moods and markets and engendered optimism about the Euro. Note, however, that the none of these actions has 'solved' the problem; none has given more than temporary respite from the worsening of the crisis. Moreover, there cannot be another LTRO of the same scope. The ECB loaned its €1 trillion against security offered by the many banks. It is widely acknowledged that these banks have very little in the way of adequate collateral to offer in exchange for further dollops of ECB cash. The cupboard of ECB tricks may be somewhat bare.

*By*

*Jack Mayberry*

The markets responded very dramatically and positively to Mr. Draghi's Thursday announcement. In two days global stock markets rose by more than three percent and Spain's borrowing costs fell by a full percentage point. Expectations are sky high for a large round of buying of Spanish and other peripheral country governments bonds, or for even more radical actions, despite the fierce opposition of the Bundesbank. If Mr. Draghi can bring the Bundesbank round his way of thinking this week, the ECB will have shown itself again as an effective (short-term) manager in the crisis. If the Bundesbank does not budge, the ECB will have failed and will have damaged its credibility in a meaningful way. Markets will respond swiftly and negatively. This will be a dramatic week; August vacation plans for European bureaucrats, central bankers, finance ministers, and heads of government may be upset.

**The bigger problem** is that the European situation is unsustainable, no matter what the ECB's action or inaction this week. The ECB's decision will have a powerful impact on financial markets this week, but still the outcome must be collapse of the Euro system as it has existed and the continued and worsening recession in the 'peripheral' Eurozone countries. Greece and Spain and Portugal are doomed to shrinking economies. It is hard to imagine that social unrest (so far limited to occasional violent protests in Athens and Madrid) will not become endemic with overall unemployment levels exceeding 20 percent and with unemployment for young people exceeding 50 percent. The regime of ever more sovereign borrowing from the ECB, the IMF and European Union entities, largely in order to roll over existing debt owed to these same entities, while economies are squeezed by austerity measures that serve only to shrink economic activity will almost certainly lead to the collapse of the whole edifice of borrowings. As time passes, the borrowings become ever more onerous; consider that the €1 trillion in loans by the ECB to hundreds of European banks all come due between December 2014 and March 2015. Consider that Spain needs to borrow more than €300 billion over the next year and Italy a greater amount. The short-term solutions that the ECB and others consider simply amount to piling on more debt, but pushing off the repayment crisis for a time. An enormous house of cards has been erected; it becomes less stable as its height increases.

**Core's investments.** We reduced our hedging positions modestly in the last weeks, but still hold meaningful hedges. Our several large high-yielding investments have been very strong in recent weeks, including high yield bonds (symbol HYG), emerging market debt (EMD), global infrastructure (BIP), mortgage REIT (STWD) and speciality finance (KFN). In the context of the European turmoil and the upcoming tension within the US government over taxes and budgets (referred to in the press as the 'fiscal cliff'), these high yielding investments provide solid dividend income, even though their share prices are sensitive to chaos in the markets. Our holdings of somewhat lower yielding bonds (LQD and DBLTX) are much less volatile in price and have produced solid total returns.

We will continue to invest cautiously in this troubled period. The principal characteristic of these years of ongoing financial crisis is the degree to which policy makers and public institutions impinge upon private economic activity. The decision making process in Europe is complicated by the existence of seventeen sovereign nations within the Eurozone (and several more in the European Union), each with its own fiscal and monetary authorities. The partisan gridlock in the US creates its own obstacles to simple, direct action. Policy makers have differing interests, some quite in opposition to good sense.

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# CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

June 25, 2012

## Europe

*Economies in Spain, Italy, Greece and Portugal are contracting a rates of 2% to 5% per year. Unemployment is rising, having exceeded 20% in Spain and Greece already. It is notable that at the level of 20% unemployment in Germany in the 1930s, the National Socialist party (unfondly remembered as the Nazis of the Third Reich) began to take seats in the Reichstag from liberal democratic parties. In dire economic environments, people attend to the voices of angry totalitarians. There are lessons for Germans here--and for Americans.*

The situation in Europe is too complex to attempt to summarize in these occasional letters to summarize the situation. At best, we can offer suggestions about what may lie ahead. First, however, a reminder of the bigger picture: Since the Second World War, western European countries have engaged in the project that has become the European Union and its common currency zone, in part to put an end to the cycle of war that had plagued Europe in previous generations. To date the European enterprise has achieved that goal, and, in the process, peacefully integrated the Soviet-bloc central European countries--notably including East Germany--into the European Union.

These titanic accomplishments are now at risk from stresses of the Eurozone crisis, including anti-democratic decision making processes and extreme political passions unleashed in the straitened economic conditions. I had lunch on Saturday with a Dutch friend, a sophisticated and astute man in his mid fifties, who tells me that, for the first time in his life, he can now envisage war in Europe. In many countries, including his own rich, formerly staunchly liberal Holland, as well as in the economically depressed countries along the Mediterranean, extreme right- and left-wing political parties gather strength. These parties nurture crazily incendiary passions against Germany, against political 'elites' in Brussels, against immigrants, against putatively feckless Greeks... the list could be lengthened. Thus, apart from purely economic travails, apart from the possibility of vast banking crises and financial market chaos is the risk of the unraveling of the social and political fabric in Europe with consequences uncomfortably frightening to consider. (See comments in the adjacent side bar.)

As written in these letters in recent months, there exist approaches to put an end, virtually at a single stroke, to the cycle of ever-weakening governments and their ever-weakening banks. These involve Europe-wide deposit insurance for banks, Eurozone-wide mutualization of at least a portion of the debts of individual countries, and/or a program by the European Central Bank of buying unlimited amounts of government debt of the weak countries. (As to this last point, recall that the Federal Reserve, the Bank of England, the Bank of Japan and the Swiss National Bank all stand unreservedly behind the debt issued by their countries. There is no risk of default of debt of these countries.)

**By**

**Jack Mayberry**

Germany has staunchly rejected all of these measures until a framework of treaties, constitutional changes, and national laws transfers away from the individual countries to real European institutions the power to regulate banks and control taxing and spending decisions in individual countries. Germany's position is reasonable on every point. Except one: As Angela Merkel points out, Germany's resources are not infinite; if Germany lends directly to Spanish

*Unfortunately, 'bailouts' by the EU are not always what they seem. JP Morgan Securities estimates that of the €410 billion of total 'rescue packages' for Greece in the last two years, only €15 billion--not a misprint, just fifteen billion euros--has entered the 'real economy' in Greece. The rest has been to bail out and protect creditors, including a very substantial sum for German and French banks. (Might we have called these improvident lenders? These were big buyers of US subprime debt, as well.)*

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*Two statistics about Europe's role in the world's economy. 36% of global software sales are in Europe. 15% of S&P 500 revenues come from Europe. Taken as a whole, Europe's economy is larger than America's, and far larger than China's.*

banks, it has no control over the activities of those banks; Germany's constitution forbids certain measures it is asked to take; et cetera, et cetera. One point tells against Germany's utterly reasonable strictures, namely that time has run out. The collapse of the Eurozone, a staggering banking crisis, and political upheaval across Europe are in plain view. Prompt decisive action is needed to prevent this outcome.

The situation with Spanish banks and Spain's debt is dire. Directly behind Spain and its banks lurk similar problems with Italy and France, problems that will almost surely arise unless a scheme to handle Spain is effected in short order. The ill-defined agreement of two weeks ago to lend €100 billion to Spain to recapitalize its banks only increases Spain's debt to such a degree as to render virtually meaningless Spain's deposit guarantees and to worsen its ability to service its debt. The slow-moving bank runs in Spain, Italy and elsewhere are ruinous. Belated half measures from the endless string of summits of heads of governments and finance ministers have, as is said, 'bought time'. Unfortunately, the time purchased has been spent unwisely; problems that were eminently soluble at relatively low cost eighteen months ago have now gotten very costly indeed.

**Core's investments.** In recent weeks while market conditions have proved reasonably favorable, Core has built meaningful hedging positions in the 'volatility' instrument of which we have written. In our judgment, there is nontrivial risk that either inaction or policy misjudgments will lead to sharp declines in stock markets and related financial markets. Our hedges offer protection from this eventuality. (Note that some of our large bond investments, like emerging market debt and US high-yield corporate bonds, have a fairly high correlation with equities, so we seek to hedge our exposure to these, as well.) Because possible losses in equities (and related bond investments) will be offset by gains in the hedging positions, we are able to maintain these investments we favor. This is all to the good, but a note of caution is in order: although it appears that we have built our hedging position at reasonably favorable prices, the ultimate benefit to be realized from these hedges will only come about if we manage the whole process effectively. The level of uncertainty in markets is exceptionally high, because so much depends upon the judgments and actions of many officials in many countries, in central banks, and in international agencies like the IMF. Decision-making authority is dispersed among officials and governments with interests that are inconsistent with each other and, in some cases, contrary to the greater good.

**The global economy.** Apart from the political, banking, and financial market stresses discussed above, we have the state of the world's economy to consider. Of course, it is intimately tied up with Europe's problems: A very substantial part of the business of American and Chinese companies is European. (See side note.) The long deleveraging process, begun when the housing bubble burst in the last decade, will inform--and constrain--economic activity for some time to come. Whether or not an aggressive Keynesian approach could have restored a higher level of economic activity is now a moot point. The developed world is stuck in a the realm of slow growth, always threatening to tip back into recession. One can invest productively in a such an environment, but the world's economies remain constrained by the policy uncertainties in Europe and the US. News today from Europe is a little more hopeful. We observe and we take action that should redound to the benefit of the portfolios we supervise.

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# CORE *Comments*

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

May 21, 2012

## The End Game for Greece Approaches

The inability of Greece to form a government in the two weeks after its recent election has caused another to be scheduled. The parties winning the most votes two weeks ago opposed the painstakingly negotiated agreement that Greece had made with the so-called 'troika', the European Union, the International Monetary Fund and the European Central Bank. With each passing day, the odds of Greece's exit from the Eurozone seemed to increase. With this has come the realization that chaos across Europe and throughout the banking system would follow. Stock markets around the globe have fallen almost daily and selling has begun to arise even among assets that seem rather remote from these problems. What are the risks now?

In the last week, it appears that Greek banks are losing their deposits. Their depositors are reckoning by day the odds that their deposits in Greek banks, now denominated in euros, may be forcibly converted to new drachma, most assuredly worth far less than euros. The rational action for Greek individuals and businesses is to open new accounts in Germany, Switzerland, London, or elsewhere, and transfer one's euros from one's Greek bank account to one's new account at, for example, Credit Suisse in Zurich. Thus begin bank runs.

Greece is well and truly insolvent; it cannot repay its debts. Spain is not insolvent; it faces a liquidity crisis, in that it cannot borrow from private markets at rates low enough to permit Spain to service its debt. The severe fiscal contraction in which Spain finds itself causes its economy to shrink, unemployment--already at an astonishing 24%--to rise. This terrible situation also causes Spanish banks to lose deposits, not yet at the Greek rate, but .... And, if a disorderly exit of Greece from the Eurozone will cause widespread losses--and it will--then a run on Spanish banks would cause extreme chaos. Unless the troika quickly finds a resolution to the Greek problem, bank runs will begin in Portugal, Spain, Italy, and perhaps in France with catastrophic consequences.

Germany, often cast as the villain of the piece, is, in very important ways, operating effectively and in the interests of preserving the grand European project. It has rejected solutions that could support government borrowing by the weaker countries without the imposition of strict conditions to improve those governments' financial condition. But, recall that in December, when a banking crisis loomed urgently, Germany did not prevent the European Central Bank from undertaking its massive one trillion euro loan program to recapitalize European banks. In my judgment, Germany will again take actions--or refrain from forestalling actions by the ECB--that will prevent the crisis in Greece from causing a European-wide or world-wide financial crisis.

*By*

*Jack Mayberry*

One solution that is often mooted--and most assuredly being considered by the major actors--would involve the use of the European Stability Mechanism (ESM) to lend directly to governments, using funds loaned to it by the ECB. This is complicated for various reasons, including that the ESM has not yet come into existence! It will succeed the European Financial Stability Facility (EFSF) shortly as a 'permanent' rescue funding mechanism for governments. If it were to obtain a banking license, the ECB could lend to it and the ESM could directly lend to Italy, Spain and others. The ECB and Germany have already rejected this idea out of hand, but when comes the moment that unlimited funds are required to prevent the collapse of everything European, this approach may be the one employed.

France's new president, Francois Hollande, last week said "either the European Central Bank should lend directly to states, which it refuses to do for the time being, or there is another option...rather than lending to banks, the ECB could lend directly to the ESM." Given that the ECB can create and lend onwards an unlimited amount of euros, this scheme could end in an instant the liquidity problems facing Italy, Spain, and others.

This is not the only scheme to halt the crisis. Eurozone-wide deposit insurance, akin the FDIC insurance in the US, would be fully effective to prevent bank runs. Other approaches are also possible. All have so far been opposed by Germany.

Over the weekend, heads of state and of governments of the G8 met at Camp David. No announcement was made of a new accord to settle the Eurozone crisis, and experience teaches us not to expect decisive action until the last possible moment before disaster is at hand. Experience also teaches us that, at that last possible moment, Germany, the ECB and the IMF will take action. As a result, we can hold investment positions that offer good value, even if their prices are temporarily depressed by anxieties arising from matters European. We intend to continue our use of the volatility index, discussed in our last letter, as a hedge during the bouts of market anxiety.

By 'decisive action', I do not suggest that European leaders will agree to a comprehensive plan to solve the inherent problems with a currency union that lacks a central government for taxation, bank guarantees and the like. Unless and until the Eurozone is bound more coherently in a political way, the crisis in Europe will continue this experience of bouts of crisis, followed by periods of relief and calm. For now, we are in another bout of crisis.

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# CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

May 3, 2012

## Contraction in Europe... ...Modest Growth in the US

*The ongoing crisis in Europe is keeping most countries there mired in recession or growing very slowly. This contrasts with the situation in America, in which the economy continues to grow, even if rather slowly.*

*In our view, the poor situation in Europe is not likely to lead to another systemic crisis, at least in the foreseeable future. We hold 'normal' levels of equities in our portfolios, with a small hedging position*

The Eurozone crisis still presents the biggest risks for global economies, despite the massive bank lending program (LTRO) of the European Central Bank (the ECB), commenced in December and concluded in February. Indeed, the effects of the LTRO, which pulled the banking system and financial markets back from calamity that threatened in autumn, are wearing off and stark problems remain unresolved. The essential issue is that the European fiscal pact requires that member nations of the Eurozone (with some exceptions) cut government deficits to three percent of GDP in 2013. With economies of the heavily indebted countries, including Spain and Italy, already weak, with individuals and businesses cutting their own indebtedness, sharp cuts by governments to attain these goals only constrict economies more tightly. As governments cut spending in an environment marked by private sector deleveraging, economic activity necessarily slows. Slowing economic activity reduces governments' tax revenues, thus increasing the deficit, which is, after all, nothing other than the difference between a government's revenues and its spending.

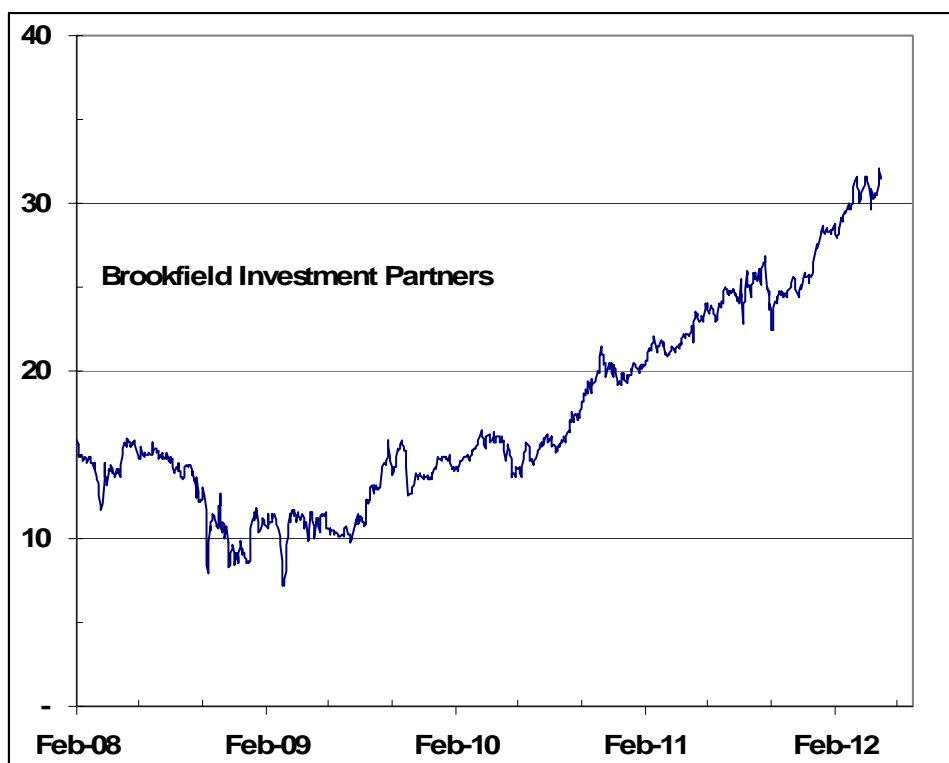
Economic activity slows throughout Europe, tipping some countries back into recessions, precisely at the time when economic growth is needed to supply the tax revenues to pay back government debt. Recently came the report that the United Kingdom has slipped back into recession, having suffered economic contraction in the last two quarters. For Britain, with its own currency, a very supportive central bank and an open economy, to fall into recession again is likely a result of the government's austerity policies. It is a sad spectacle, watching all these governments, led by Germany but supported widely throughout the continent, insist that self-constricting fiscal austerity will somehow enable the indebted peripheral countries to restore their finances. Meanwhile, unemployment rises and hope for a good future within a wider Europe vanishes, replaced, one fears, by despair, suffering, and civil disturbance.

Government borrowing rates in Spain and Italy declined after the LTRO loans enabled banks to buy more of their governments' bonds. But in recent weeks, borrowing rates have risen again toward the unsustainable levels that preceded the ECB's announcement. The new conservative Spanish government, firmly in the austerity camp, has pleaded with European Union officials to relent a little on the unachievable deficit target given its terribly high unemployment--24%-- and recession, but the compromise agreed to scarcely gives Spain breathing room. The draconian austerity imposed on Spain is self-defeating and unattainable without impossible sacrifice by Spaniards.

**By**

**Jack Mayberry**

*The graph below shows the total return of an investment we hold in most accounts. Brookfield is develops, operates, and owns power generation facilities and other utilities in various countries around the world. It is a good way to invest in infrastructure in developing countries. We made the investment a year ago; its prospects look very good.*



Ten days ago came the news that the government of the Netherlands has fallen, as the far-right politician Geert Wilders pulled out of the governing coalition as it prepared to imposed new cuts in government services. This is richly ironic, given that Holland, one of only four AAA-rated countries in the Eurozone, has been an ardent supporter of austerity and harshly critical of the profligate southern European debtor countries. It should also be a clear warning to the benighted ‘austerians’ that their strictures worsen the crisis.

**Crisis, solutions?** Does this situation lead to collapse of financial systems and markets? I think not. The ECB showed the world in December--when banks teetered on collapse and the financial system was poised again at the edge of that abyss--that it would take radical action to prevent things from spinning out of control. Proposed solutions are fully discussed in countless journals and newspapers. Political leaders, including Angela Merkel, have made clear their awareness

of the gravity of the situation in Europe and their duty to find its resolution. For now at least, it appears that Europe’s economic weakness is unlikely to cause another Lehman-like collapse of markets and banking systems.

**Investments and Hedges.** As a result, our portfolios are positioned for the modest economic growth that we now experience and foresee continuing in the US. Our investments, in bonds, currencies, and stocks, are heavily weighted to American investments.

We have also been building a hedging position in many accounts we manage. Despite our view that things are reasonably healthy in America and that we will not be pushed into the abyss by inaction in Europe, we fully expect anxieties to rise again. A list of

what might go wrong in Europe and elsewhere is a good indication that market anxiety lies ahead: Spain and Portugal may well need bailouts; France is likely to have a new Socialist president who may be in the vanguard of opposition to austerity; unrest and riots will likely emerge in various cities and countries in Europe; more countries may tip back into recession; political opponents in the US will become more boisterous as the election approaches.

For our hedge, we use an exchange traded note that correlates highly with a widely-used measure of market volatility, the so-called VIX or volatility index.. Volatility is inversely related to stock prices, that is, it increases as stock indices fall. When anxiety rises and stocks fall, volatility increases and our hedging instrument, symbol VXX, will rise in price.

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# CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

April 1, 2012

## Energy and Manufacturing... ...Revitalization in America

*Long-term trends in US energy production give reason to expect that America is moving toward 'energy independence', in which the country would produce more energy than it consumes. The low cost of US natural gas may attract manufacturing from Europe and Asia, to the further benefit of the US trade balance. The US is also likely to increase its exports of foods.*

*These factors may presage a stronger and richer period for the United States in the coming years. Will these dispel the gloom that has enshrouded the country during the last decade of wars, recessions and political bickering?*

*May it be so.*

**By**

**Jack Mayberry**

After a long and disheartening period of a declining manufacturing base and ever-greater dependence upon oil imported from unfriendly countries, the tide seems to be turning for both. Manufacturing in the United States will probably grow in coming years and America appears to be moving toward energy independence. Energy first.

**Energy.** A range of factors is at play, including new drilling techniques that dramatically increase the productivity of old oil fields, development of enormous natural gas fields through hydraulic fracturing, and declining gasoline consumption arising from fewer miles driven and greater fuel economy in the nation's automobile fleet. The recent recession played a role in declining consumption of gasoline and other fuels, but increased domestic production and fuel economy are long-term, not economic-cycle phenomena. At its peak in 2005, the United States imported 60 percent of its liquid fuels; in 2011, imports had fallen to 45 percent. Increased production of oil and of natural gas both arise mostly from techniques involving hydraulic fracturing ('fracking') and horizontal drilling; expansion of drilling on federal lands since 2005 legislation is another factor.

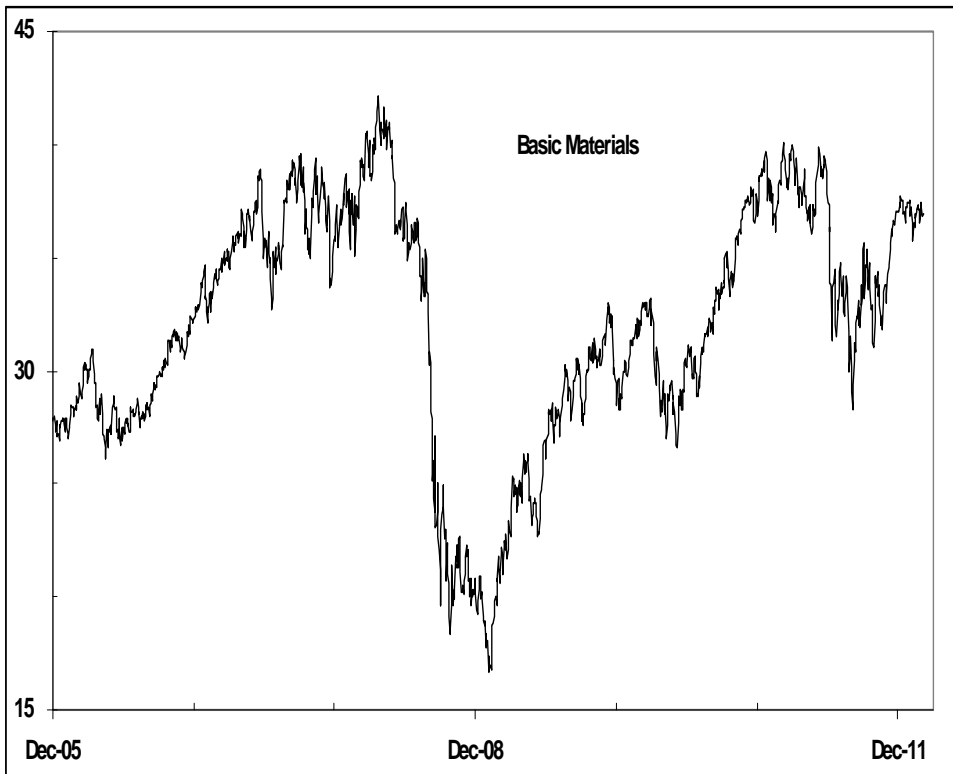
Environmental problems associated with increased production generally and with fracking in particular are serious and contentious; they will not go away. For now, however, the oil and gas industry largely prevails and production is growing. Increased domestic production and decreasing imports of oil have a very beneficial effect on the trade balance in America. Cutting oil imports increases America's security by decreasing the flow of American treasure to the unfriendly oil-exporting countries of the Middle East.

**Energy prices and manufacturing.** The price of crude oil and, hence, of gasoline is set in global markets, but US-produced natural gas is a commodity the price for which is essentially a local, US price. The US price, having fallen sharply in recent years, is less than \$3 per million BTUs. By contrast, the cost of natural gas in Europe today is more than \$12 per million BTUs. This remarkable price advantage for energy in the US is likely to have real effects on the locus of manufacturing activity. To the extent that energy is a significant cost in a manufacturing process, the United States is the attractive place to conduct that manufacturing. Given its other advantages, including the size of the American market and a generally well-educated work force, the US will probably see more of a shift of manufacturing activity to this country from Europe and Asia, reversing trends that have prevailed over recent decades.

The chart below shows a sub-group of the S&P 500 that includes some of the types of companies that stand to do well in the era of cheap American natural gas and growing agricultural exports. These include chemical and fertilizer companies.

It is entirely possible that, as Chinese labor costs continue to grow and US energy costs decrease, certain types of manufacturing will shift even from China to America. Another favorable trend for the United States generally is the growing wealth of people in the Asian developing economies, a process that increases the demand for meat and grains. America's vast and productive farm lands supply grain and other agricultural products to Asia and elsewhere, another factor that benefits the US trade balance and adds to this country's wealth.

**Investment implications.** These are long-term trends with important implications for investors. The years-long weakness in the value of the US dollar may be coming to an end. Stocks of energy-intensive manufacturers, e.g., chemicals, aluminum and other basic materials, may flourish. Domestic energy producers may also do well. And, as manufacturing and agricultural activity grows, the country's employment and general level of wealth grows, with positive investment effects across many companies and markets.



In short, and despite serious environmental problems associated with increased production of oil and gas, these big trends are favorable and they bode well for America, her economy and her financial markets for some years to come. Surely the partisan political squabbles in the country present problems; the long process of deleveraging after the credit boom and the financial crisis will continue to restrain economic activity here; Europe's unresolved sovereign debt crisis continues to pose risk to the banking system and financial markets. Against these real problems, however, is the favorable path toward American energy independence and the likely increase in US manufacturing. With patience and an eye to the risks, investment gains lie before us.

**The Eurozone crisis.** A few comments: Greece did default on its government bonds, the first default by a developed country in many decades. However, the event was so long negotiated and so fully understood, that it went off without a whimper in the markets. The calming effects of the ECB's massive (€1 trillion) bank loan program (the LTRO) continue to obscure the reality that more European trouble lies ahead. Portugal has unsustainably high government bond yields and looks certain to require another bailout. Spain is a very large economy in very great distress and is now feuding with European Union ministers about the required fiscal austerity measures that are sending it into deep recession. Greece itself is likely to require another round of financing or another default to survive in the Eurozone. In short, the ECB's LTRO and Greece's 'successful' default have solved nothing, but have only created calm conditions as Europe marches inexorably toward the next phase of the crisis.

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# CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

March 4, 2012

## Europe: Calm Now... ...Social Unrest Lies Beneath

*The ECB's Long-Term Refinancing Operation, truly enormous in its scope, has effectively removed risk of a banking crisis for the present. This safer environment has permitted European policy makers to proceed with their actions to mitigate the sovereign debt crisis.*

*Unfortunately, the approach is flawed economically, by imposing austerity when growth is needed, and procedurally, by its undemocratic imposition important matters on Greece and other countries by heads of governments of other European countries, especially Germany.*

*Social unrest, anger with Germany, strikes and riots will punctuate 2012.*

**By**

**Jack Mayberry**

It is beyond question that the massive low-interest loan program by the European Central Bank (ECB), exceeding €1 trillion, to hundreds of European banks has essentially eliminated the risk of a banking crisis in Europe—at least for the time being. From the brink of catastrophic crisis in November and December, calm has been restored, permitting policy makers in Germany, the European Union (EU), the International Monetary Fund (IMF) to fashion their new arrangements to lend to Greece. This, in turn, has—at least for the time being—removed the risk of a disorderly default by Greece on its sovereign debt. This is all for the better. These conditions have permitted Core to invest more in growth-oriented assets and to cut our positions in the most risk-averse assets.

The European crisis is by no means over; two key matters loom ominously. Firstly, Germany (and the EU and IMF) have imposed a regime of fiscal austerity—cuts in government spending and increases in taxes—as the means of resolving the debt crisis. It is abundantly clear already that this austerity is causing the economies of the highly-indebted countries to shrink. Austerity worsens the indebtedness of the countries; growth is needed. The most recent example is offered by Spain. Despite adhering to the EU-imposed scheme, its deficit in 2011 was higher than agreed to and it projects worse for 2012. Unemployment in Spain exceeds 20% and is nearly 50% for young people. As a result of the almost-certain economic contraction that flows from austerity, Greece and Portugal will need new rounds of loans. Spain's worsening recession suggests that it may also find itself in the bailout queue. Today's calm and confidence will give way to further bouts—minor or major—of anxiety.

The second matter concerns the anti-democratic process by which the radical regimes are being imposed on the indebted countries. Since the austerity measures are rightly seen by citizens as cutting their living standards, and because the austere conditions are, for practical purposes, imposed by Germany and its allies, the Netherlands and Finland, people are becoming increasingly restive about giving up to Germany fundamental decisions about taxation and government spending. There have been periodic riots in a number of countries over the last two years. The anti-democratic nature of the decision-making process and the increasingly straitened conditions of the so-called 'peripheral' countries make it very likely that more and worse social unrest lies ahead. The democratic fabric in Europe is being abraded. This is not a good thing.

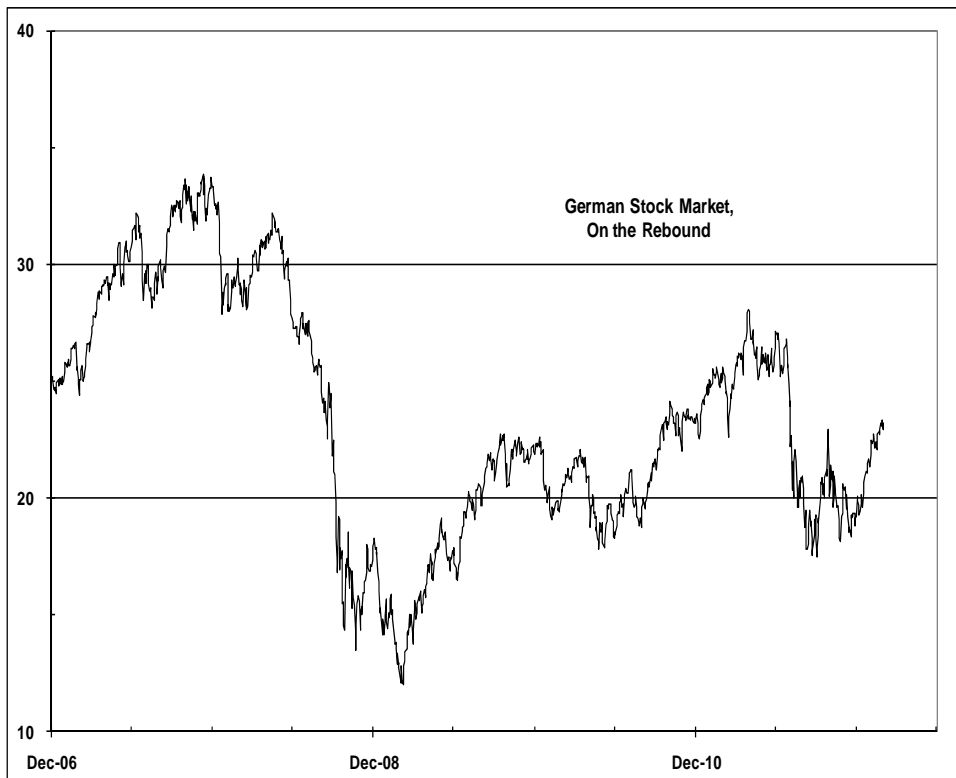
**Core's investments.** Since the first round of the ECB's bank financing at the end of December and as fears of a Lehman-like banking crisis have receded,

*We recently invested in German and Swedish stocks. A chart of Germany's stock market is shown below. Both countries' markets fell sharply in 2011 as the Eurozone crisis worsened. Despite our expectation for weakness in its economy, the German stock market should continue to rebound from the lows of late last year.*

Core has made a series of investments in equities. A goodly portion of these are in American stocks. The economy here, and especially the labor market, has been improving. Moreover the United States is not engaging in drastic contractionary austerity programs as are the Europeans and the British. We have invested also in German and Swedish equities, despite the situation there. European stock markets generally fell very sharply as the crisis worsened last year, far more than US markets. Even though economic growth in these countries will probably be weaker than in the US this year, their stock markets are likely to rebound well from the deep selling in 2011. We may add other equity positions in the weeks ahead, but we are mindful that risk from the Euro-zone crisis is still with us. Although we have reduced the positions, we still retain our ultra-cautious 'safe-haven' investments in the Japanese yen, the US dollar and long-term US treasuries. For our Capital Preservation portfolios that hold no equities, we added positions in high-yield US corporate bonds and mortgage-backed

securities, positions that will benefit from the better economic environment.

**Housekeeping matters.** Certain of the investments Core has made in recent years have been in securities that are required to report investment income to investors on Forms K-1. Most of you will have received one or more of these in this tax-reporting season for 2011. There is no investment significance to this form of legal organization of the underlying security that gives rise to the tax requirement to report income on Form K-1. Most securities in which we invest report dividend and/or interest income on Forms 1099. The K-1s include an explanation of where on tax returns the various entries go. This is simply one more demonstration of the complexity of America's taxation system.



Remember that we can provide concise and accurate information for your tax returns about realized capital gains and losses. Simply call or email us if you require this or other tax information.

Also recall that Schwab offers extremely low transaction fees (commissions) for accounts that elect to receive reports electronically rather than by regular mail. In general, the difference is between \$20 per trade for paper confirmations and monthly statements as against \$9 per trade if one elects the so-called eConfirm approach. Under Schwab's rules, we cannot make this election for you, but we can walk you through the fairly simple process. The cost savings are substantial; we urge you to take advantage of eConfirms if you have not yet done so. Call us if you wish to set up eConfirms or if you have questions about this. Note that we can readily print and mail to you any monthly statements from Schwab you may need, in case things should go astray on your computer system.

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# CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

January 22, 2012

## The ECB Buys Time for Europe

The World Bank published its forecasts for the world's economies this past week. Because of the Euro-zone crisis, the World Bank now estimates lower growth for the world in 2012 than its previous estimates, and predicts recession in Europe. It warns of the risk of financial system chaos and economic crisis from the Euro problems, and urges developing countries to prepare for such a crisis, by 'assessing their vulnerabilities and preparing for contingencies.' This is good advice from the World Bank--for all countries and for all investors.

*The massive loan program by the ECB has lowered the risk of an banking crisis in Europe by providing an enormous amount of funding to hundreds of European banks. This gives policy makers in Europe time to better the sovereign debt crisis.*

*Unfortunately, the German approach --extreme fiscal austerity in the heavily indebted countries--chokes the economies of those countries. Austerity is unlikely to solve the debt problems and it may well cause very serious social and political unrest.*

As discussed in our last letter, the December action by the European Central Bank (ECB) to provide nearly one half trillion Euros in low-interest, three-year loans to about 500 European banks (the Long-Term Refinancing Operation or LTRO) significantly lessens the risk of an imminent banking crisis. A second round of the LTRO will commence in several weeks, perhaps even of greater scale. This massive infusion of liquidity into the banking system is a clear indication that the new ECB head, Mario Draghi, is using the facilities of the ECB to ameliorate the awful situation arising from the sovereign debt crisis in Europe. (This provides a very sharp contrast to actions of his predecessor, Jean-Claude Trichet, whose crabbed, Scrooge-like interpretations of the ECB's mandate exacerbated the crisis.) The relative calm that has prevailed in markets and at recent auctions of bonds for France, Spain, and Italy, is almost surely a result of the LTRO.

The World Bank is probably correct in predicting recession for Europe in 2012. Germany's economy itself appears to have contracted in the fourth quarter of 2011, as the effects of the austerity regime promulgated from Berlin to the ailing 'peripheral' countries, have cut German exports to its southern neighbors and restrained economic activity. Relentless rounds of tax increases and spending cuts in Greece, Italy, Spain, Portugal, Ireland and (even) France will almost certainly continue to depress those economies, while doing little in a constructive way to decrease the government debt burdens.

The present calm in markets and guarded optimism about the Eurozone crisis may not persist, despite the ECB's actions and related efforts by the IMF. There are fraught negotiations involving private holders of Greek debt to compel the 'voluntary' acceptance of substantial losses in their holdings of Greek bonds. Many private holders of Greek government bonds will have purchased insurance against their default. To expect these holders to forego the insurance coverage they have paid for while accepting losses of 50% to 70% of the face value of the bonds is odd, particularly when some public debt holders, including the ECB, are not being required to recognize losses. Risk of a 'disorderly' default of Greek debt, with unpredictable and disruptive consequences, is still

**By**

**Jack Mayberry**

high, despite published assurances that a deal is at hand. Additionally, the huge calendar of upcoming debt auctions by Spain and Italy presents real risks of chaos in coming weeks. And, although the present focus is on Greece and its debt, the unresolved similar problems with Portugal and Ireland are pregnant with possibilities for chaos as the year proceeds.

**Mr. Monti's lament--and warning.** The new and highly respected Prime Minister of Italy, Mario Monti, has been speaking widely in recent days, in a politic but pointed way, noting that Italian citizens (and, presumably, Spaniards, Greeks, and others) cannot be expected to go along with ever more stringent fiscal conditions imposed by Germany in the crisis, unless they see the long-term benefits for themselves in the grim regime of higher taxes, reduced pensions, increased retirement ages, diminished social services and shrinking economies. While pointedly avoiding criticism of Germany and the German-inspired austerity regime, he notes the political and social impossibility of such strictures, and points out that it is in Germany's interest that European economies grow. Mr. Monti speaks of growing "impatience-cum-hostility to the EU, to the ECB and to Germany." Let us hope that 2012 will not be remembered for widening social unrest in Europe.

**Quantifying the probabilities.** The World Bank warns of the risk to the world's economies from the Euro-zone crisis and urges developing countries to prepare to meet the crisis. It studiously avoids assessing the probability that things will morph into another systemic crisis. For investors, the key question is precisely that: what is the likelihood of a Lehman-like event? In the autumn, I assessed the risk as uncomfortably high and eliminated investments that I judged would suffer in such an event. In the last several weeks, various actions, notably the ECB's LTRO, has lowered the risk of calamity. Based on this assessment, Core has moved from its extreme risk-averse portfolio positions and made a few investments that will benefit in an explosion-free world.

One new investment is intriguing: last autumn, EU members demanded that European banks increase their capital and raise their ratios of risk-free (or less risky) assets to total assets. Given that raising new, fairly-priced equity capital in public markets is a near impossibility in present conditions, most banks are selling off assets as a means of meeting the new capital targets. As a result, very valuable books of high-credit, fully-performing loans are being offered for sale by banks at exceptional discounts, sometimes at 60 cents on the dollar. We have invested in a fund that trades on the New York Stock Exchange with billions in cash for such investments, KKR Financial Holdings. The fund is run by KKR, the big private equity firm; it has a handsome yield now (about 8%), and has said that it seeks to make such purchases from European banks. We expect, in a modest way, to be beneficiaries of the crisis in Europe's banks.

Given the environment of modest to fairly robust economic growth around the world, except in Europe, but with the risk of a Lehman-like crisis erupting within Europe, we have structured the portfolios Core manages hold two sets of investments. The first include the Japanese yen, long-term US treasury bonds, gold and the US dollar; these will likely appreciate in a calamity. The second set are comprised of more risk-oriented assets, including our infrastructure fund, other equities, and corporate bonds. These are likely to grow well in our slow-growth world if there is no calamity. Core's aim is to find the right balance between these two types of assets, so as to avoid disaster and to participate in growth.

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**CORE**Comments



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