CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

November 27, 2013

Fiscal Squabbling on the Back Burner...
...Markets Placid and Positive

Since last month's letter, written after the end of the government shut down, things on the fiscal front in Washington have been quieter, especially with attention focused on the utterly botched health care website. The deal to end the threatened debt default and shutdown provided for, among other things, negotiations between the House and the Senate on a federal budget. There are indications that something constructive may emerge from those talks, and, given the bruises from the debt default farce, it seems likely that the new year will not bring another round of that. Meanwhile, President Obama's nomination of Janet Yellen, Vice Chair of the Federal Reserve, to succeed Ben Bernanke as Chair was approved by the relevant Senate panel with some Republican support, suggesting that her approval by the Senate as a whole is likely. Given that Ms. Yellen is fully in support of the Fed's policies and, perhaps, even somewhat more 'dovish' than Mr. Bernanke, the expectation is that the Fed will continue with the policies that have been so supportive of asset markets, especially the stock market.

Recently, some prominent economists, including Larry Summers, the former Treasury Secretary, and Paul Krugman of Princeton (and the *New York Times*), have discussed a disturbing idea, namely that low economic growth is not just a function of the aftermath of the fiscal crisis, which induced individuals and companies to save more and invest less and spend less. Rather, Professors Summers and Krugman put forward the notion that relatively low growth and low capital spending began a few decades ago, suggesting that these are not just the problems of this business cycle, but of a longer-term ('secular') nature. Add to this the inclination of governments in developed countries also to invest less (in infrastructure, public works, education, research and the like) and to restrain discretionary government spending. This combination of fiscal austerity in the public sector and less investing and spending in the private sector may cause economic growth to remain quite weak for a long time. If that is so, then we may expect the central banks of the US, Europe and Japan to continue their exceptional monetary policies, which policies clearly benefit financial and real estate markets, whatever is their effect on the 'real' economy.

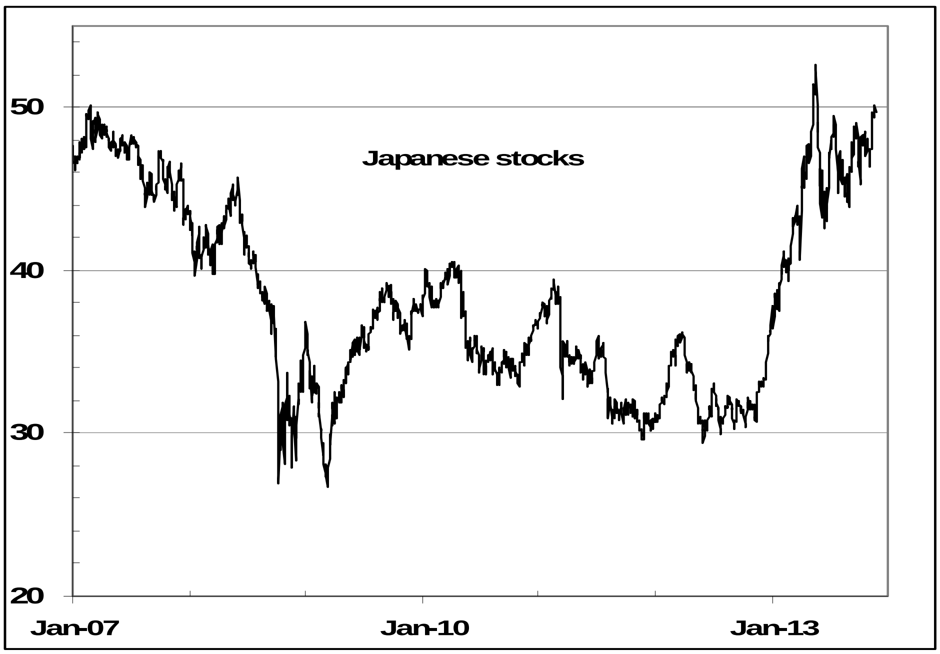
By

Jack Mayberry

Low growth, high rates of private sector savings, and the concomitant disinflationary--if not deflationary--effects have produced an environment in which financial assets have flourished. From the perspective outlined here, a continuation of favorable stock market action is quite likely. As a result, Core is maintaining its fairly high level of equity investments. As we have discussed, among these are some hefty investments in Europe and Japan. (On the next page is a chart of Japanese stocks.) After the seemingly endless episodes of crisis and temporary resolution in Eurozone matters, calm has prevailed and most Eurozone countries are returning to modest growth. (We are not arguing that Europe has resolved its problems with its common currency, merely noting that in the calmer environment, the economies of most Eurozone countries have stabilized and turned to modest growth.) We expect our European and Japanese investments to continue to appreciate. We have avoided equity investments in developing countries, in large part because of the expectation that the Fed's planned decrease in the rate of its asset purchases, now running at $85 billion per month, will and is hurting such investments, by inducing investors to withdraw capital from those countries.

Japanese stocks began to climb late last year, as Shinzo Abe's victory came into prospect. After some fallow months recently, markets see further actions by the government and the Bank of Japan, its central bank, to stimulate the economy. Another leg up appears to have begun.

In this connection, we recently sold a portion of the emerging market debt fund investment, precisely for the reason that the Fed's anticipated actions are causing investors to shun the region. We may sell more of that position, despite its large and safe dividend. Similarly, we recently sold Starwood Property Trust, a REIT that holds mortgaged-backed securities. About half of the enormous monthly Fed asset purchases have been of mortgage-backed securities; Starwood appears vulnerable to the coming reduction in the rate of these purchases. We have invested a portion of the proceeds of these sales in the Loomis Sayles bond fund and another portion is a fund that holds US companies that consistently increase their dividends.



Dissonance at Thanksgiving. Winter descends upon New York, where I write this. It was close to 20 degrees and quite windy as I began composing this. A storm is threatening. There is an uncomfortable irony in describing the ways in which the present is favorable for investors, in that globalization and other forces have given rise to a situation in which labor--work by people--constitutes a smaller portion of the expenses of businesses. This 'increased productivity' means that a greater proportion of corporate revenue flows to owners of businesses than to those working in those businesses. This favorable setting for investors spells hardship for people. As the season turns cold, people suffer. Fiscal austerity, which manifested itself recently in an effort by Congressional Republicans to cut food stamps very sharply, may have a favorable outcome for investors of capital, but…. We are investing fairly heavily in Europe as the crisis recedes. But the management of the Eurozone crisis has given rise to terrible levels of unemployment--27% in Spain and in Greece, and 12% in the Eurozone as a whole. Income inequality is the rather dry phrase used to describe the situation in which economic benefits flow disproportionally to capital at the expense of labor. That all is well for those with money does not seem quite enough with Thanksgiving at hand and the year-end holidays immediately ahead.

Core's business is managing the capital for its clients and we seek to earn a decent return on capital while subjecting our clients' assets to as little risk as reasonable. The environment for capital is fine; increasingly the same environment is a hostile one for many people.

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CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

October 29, 2013

Brinkmanship in Washington, But Markets Move Higher

By

Jack Mayberry

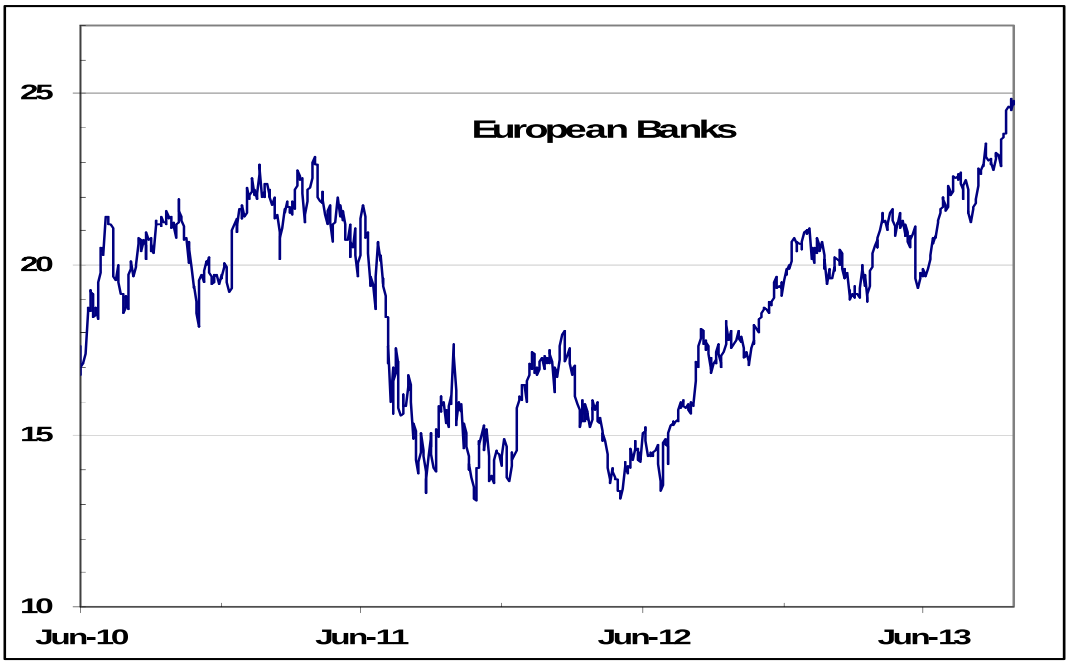
The country endured an utterly unnecessary and costly shut down of the federal government and an utterly unnecessary and very, very damaging walk to the precipice of default. The result was another eleventh hour deal that reopened the government and raised the debt ceiling to permit the Treasury to sell more bonds to finance obligations of the United States. However, in typical fashion, nothing was really resolved and we face unappealing deadlines in December, January and February, deadlines that threaten to give rise once again to this mad display of failed governance.

And, the response to all this from financial markets? Misguided insouciance? The stock market trembled at little--but only a little--during the latter part of September and early in October, but the general expectation was that default would not happen. Indeed, in the early days after the shutdown began on October 1, it was reported that House Speaker John Boehner had told his caucus that he would not permit a default on US debt.

Perhaps it was not unwarranted optimism that pushed the US stock market higher in September and October. Although default by the United States would have been a disaster for economies and financial markets around the world, it was a reasonable bet--one in which Core joined on your behalf--that not even the House Republicans would permit such an outcome. Core held its stock market positions through the debacle; we have been rewarded for it with very strong results for September and October.

What next? It is foolhardy to guess what may unfold in Congress in coming months. The Republicans play a weak hand effectively. Although the party only controls the House, it has imposed its brand of shrink-the-government with shrewd strategic and tactical moves. It uses a combination of irrational and destructive threats from its Tea Party wing with implacable opposition to all things put forward by the administration and the Democrats in the Senate. This strategy gives us the damaging chaos of early October, but it also forces the spending cuts that Republicans want and a refusal to countenance increased spending on education, public works, medical research and the like. However one views the merits of these goals--it is probably clear that I think them poor--one must admit that the Republicans are accomplishing the fiscal austerity they relish.

The estimates are that the government shutdown will have cut economic growth by 0.6%--a meaningful shortfall when growth is only around 2% per year--and perhaps 120,000 jobs. Despite the real economic costs of the shutdown and the threat of default, there is an ironical benefit to the owners of capital in all this, namely that the Federal Reserve is quite likely to keep buying treasury bonds and mortgage-backed securities for a longer period than had the DC debacle been avoided. For many months, the Fed has been purchasing $85 billion per month of these securities. In May, Fed chairman Ben Bernanke been to discuss the 'tapering' of these purchases. It had been expected that the 'taper' would begin in September. As discussed in our last letter, at its September meeting the Fed decided to continue the $85 billion per month pace. The shutdown and deficit-ceiling mayhem, with the slowdown in growth that it appears to have engendered, makes it more difficult for the Fed to begin to reduce its rate of asset purchases. Although these purchases seems to have only a modest effect on the real economy, they have a very salutary effect on the prices of assets--including stocks, bonds and real estate.



The Fed's dual mandate concerns inflation and employment. The recent employment report for September, i.e., before the partial government shutdown, painted a picture of weak job growth in recent months, notably weaker than in the months preceding Bernanke's first comments about tapering. Moreover, recent inflation reports suggest that deflationary forces are stronger than inflationary ones. Both factors suggest that the Fed will be slow to reduce its rate of asset purchases. This is a distinct benefit to investors in equities. The party goes on.

Europe. We have written in recent letters that we expect the stock markets in Europe to do better than the US market and that we have increased our equity investments in Europe to capture some of this. Europe's outperformance is underway. Strong as US markets have been recently, German and other European markets have been stronger still. The nearby chart shows price action of the European banking sector in the last three year, and the strong gains since the summer of 2012 at one of the crisis points in Europe. Our expectation is that this process will continue; we believe that the portfolios we manage will benefit from the larger investments in European stocks.

In short, the combination of these and other factors--that the Fed will continue to provide enormous liquidity to asset markets, that economies in Europe will continue to recover, that the US economy will grow modestly, that asset prices are not yet at dangerously high levels--suggest the strong stock markets in Europe and the US will continue. We are alert for changes but optimistic.

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CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

September 23, 2013

The Fed Waits to 'Taper'

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

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

By

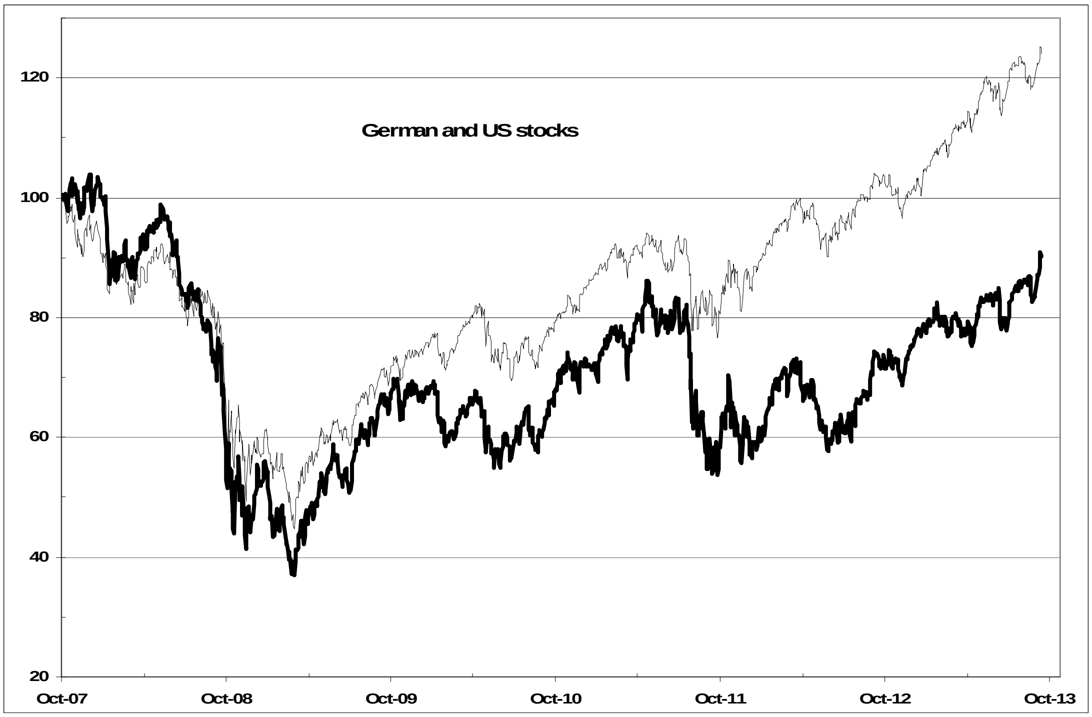
Jack Mayberry

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

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

Dysfunctional governance. The immediate threat to global growth and investment markets is located in the US House of Representatives, where the Republican majority is in thrall to its utterly irresponsible Tea Party wing that threatens to shut down the government and to prevent the United States from meeting obligations to its creditors if 'Obamacare' is funded. A discussion of the causes of this insane threat is beyond the scope of this note and I am quite sure that readers are well informed on this subject. For those who care to read more, I direct your attention to an article by Elizabeth Drew in the recent New York Review of Books. http://www.nybooks.com/articles/archives/2013/sep/26/stranglehold-our-politics/ Should the benighted House Republicans persist in their threat, the global economy, America's standing in the world, and the vast but immeasurable financial advantage that America has possessed for nearly a century as the issuer of the world's reserve currency will be damaged. (We will discuss the value of *seigniorage* in another letter, if the worst comes about.) Financial markets will appreciate none of these outcomes. One hopes that saner Republicans will manage to pull their nutty colleagues back from the brink. They may not accomplish that.

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



For good reason, European stock markets underperformed US markets miserably in these last few years, but, as things turn in Europe, we expect recent strength in European markets to continue. Anticipating this, we have been making large investments in European markets, including in its banking sector. In the adjacent chart, we show a comparison of performance of US and German stocks since the pre-crisis peak in October of 2007, having rebased both indices (the S&P 500 and the DAX) to 100 at that point. The German market is shown in bold; it has trailed the S&P by an historically wide margin. The Eurozone crisis is entirely the cause of the weakness in European stocks. An astute colleague points out that it is quite enough for terrible conditions to turn slightly better for financial markets to sniff out the trajectory. Improving conditions, in Europe's banks and in Europe as a whole, are with us. (Does this contradict my derisive comment about the 'wisdom of the markets?' No.) We expect European stocks to produce better returns than American ones.

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

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

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CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

August 12, 2013

The Markets Adjust to Tapering

The process and timing of the Fed's 'tapering' of its asset purchases appear to have been accepted by markets without too much stress. Bond yields have risen--and will surely rise further--but most stocks have recovered from their sharp declines of May and June.

The slowing, then the cessation of asset purchases by the Fed, then, presumably, the raising of short-term interest rates, are the markers for the end of the three decades long bull market in bond prices.

By

Jack Mayberry

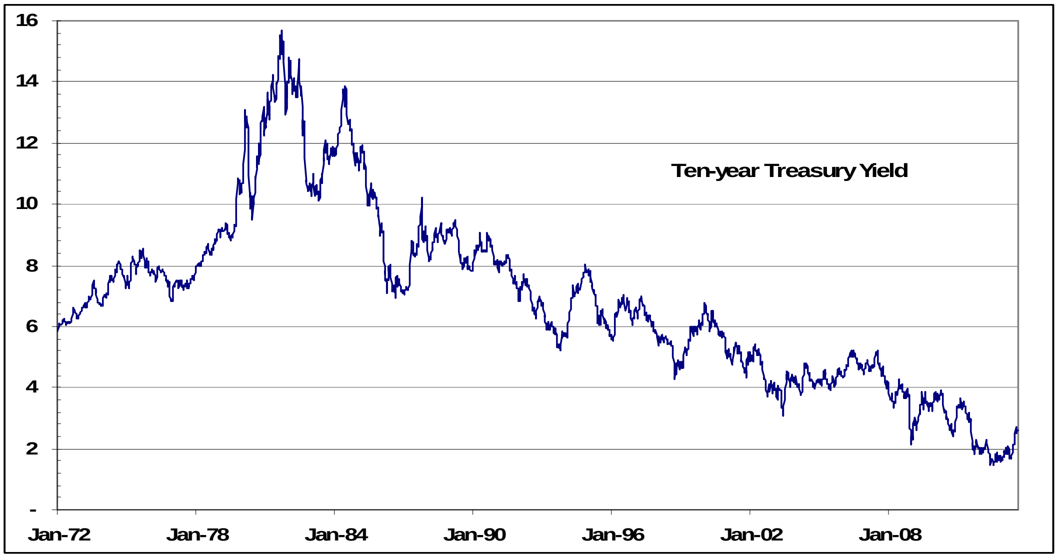
In our last letter, we wrote of discussions by Federal Reserve Board chairman Bernanke about the ending of the Fed's policy of buying $85 billion per month of US treasuries and mortgage-backed securities, the so-called 'QE3.' With his first comments in May on what has come to be called 'tapering' of the rate of these purchases, prices of bonds around the world fell sharply and yields rose. Stock prices stumbled for a period of weeks, especially in emerging markets. This wrought a significant change in the justification for investments: The one-decision 'flow trade', whereby investors were willing to buy investment assets of all kinds on the assurance that the major central banks were providing abundant liquidity, gave way to the realization that the flow of excess liquidity would come to an end and that investment decisions need be supported by fundamental considerations of economic growth, corporate earnings, and the like.

Since the sharp decline in all assets in the weeks after Mr. Bernanke's first discussion of the matter, bond markets have stabilized. US stocks have done better, fully recouping the late spring losses and moving to new highs. Mr. Bernanke and other Fed officials have discussed their plans more fully and the view has developed that the Fed may begin to 'taper' next month. Because Fed officials have insisted that the commencement of tapering is dependent upon evidence of sustained economic growth, weaker than expected economic reports would probably push the beginning of tapering beyond September.

The actual date of the beginning of the tapering is probably not terribly significant in itself. In fact, it was the announcement of the inevitable, if gradual, ending of the Fed's unprecedented series of monetary policies occasioned by the financial crisis and recession that put an end to the extraordinary, once-in-a-lifetime bond market rally. This has long-term consequences for investors; I begin a discussion of these in this letter:

The ten-year US treasury bond, the world's bench mark for essentially all tradable bonds, stood around 1.7% in May before Mr. Bernanke's first comments. In the last few weeks, it has traded around 2.6% most of the time. While this is a very large percentage increase in its yield (and gives rise to a correspondingly large decrease in its price), its yield is still quite far below what it would normally be without the Fed's monetary largesse. The yield on the ten-year treasury should roughly approximate nominal GDP, that is economic growth without accounting for inflation. Nominal GDP is now about 4%; thus we might expect most bonds to move lower in price and higher in yield, barring significant changes in the economy, over the next many months. The move may be halting and irregular, but such is the likely path.

The long bull market in bonds. It is perilous to announce the end of a bull market, but it is tempting to look back and note its extent and duration. Recall the term 'stag-flation' that gained currency in the 1970s after the Arab oil embargo that followed the revolution in Iran. Stag-flation described the miserable combination of high inflation, partly a result of the quadrupling of oil prices, with economic stagnation, marked by the long mid-70s recession and the pair of early-80s recessions. In 1981, bond yields on US treasuries were at unheard of levels, 15.2% on the thirty-year and 15.7% on the ten-year. Paul Volker had recently been appointed chairman of the Fed (by Jimmy Carter, as we might remind readers). He began his long and ultimately successful campaign to wring inflation out of the system and the expectation of ever-higher prices out of our ways of thinking. His monetary tightening brought on the second of the pair of early-80s recessions, but it began the process of lower and lower interest rates.



The nearby chart illustrates the falling yields on the ten-year treasury bond from then to now. Apart from noting that as bond yields fall, the prices of bonds rise, there is nothing to say about the chart except Wow! In May 2012, the yield on the ten-year fell to 1.4%, a level we are unlikely ever again to see. At this writing, the yield has risen to 2.6%

Core's investments. The end of the bull market in bonds means various things. Among these is that bond investors must be discerning in their fixed-income investments. Moreover, conservative investors like ourselves may no longer reflexively view bonds as safer investments than stocks. A more nuanced view is needed. In light of the changed environment, we have cut our overall investment in bonds, but we have added to our investment in dollar-denominated emerging market government bonds. Our reasoning is that the high yield on these, now 8.1%, is quite safe and unlikely to be cut any time soon. This is a closed-end fund and is now trading at a 10% discount to the underlying value of the bonds in its portfolio. This discount is considerably wider than its average discount. It will likely narrow in coming months, causing its price to rise. The decline in the price of this fund was far greater than warranted by the increase in the yield on the ten-year treasury, and reflects a somewhat mindless stampede of selling in all emerging markets investments.

In a similar sell-first-and-think-later approach, Mexican stocks fell sharply in May and June, tarred with the same emerging market brush. We have added to our investment there, on the thesis that US manufactures are increasingly using Mexican facilities rather than Chinese or other Asian manufacturers, because of the advantages in shipping and speed in handling small changes. We have added to our equity investments in Germany. Europe's economy, while still weak, appears to have emerged from recession. European stocks trade at an unusually large discount to American ones--understandably so in light of the Euro crisis--but one which is greater than seems warranted. We have taken a position in large US banks, ever the villains of the piece, but likely beneficiaries of the rise in interest rates.

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CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

June 21, 2013

The End of Quantitative Easing is in Prospect

Mr. Bernanke's discussion of the Fed's plans to reduce and then to cease its asset-buying program, referred to as 'quantitative easing,' sparked a steep sell off in bonds and stocks.

The market's response may have been overdone, since Mr. Bernanke made it clear that the so-called 'tapering' would begin only after economic growth warranted the reduction in the Fed's purchases of Treasury bonds and mortgage-backed securities.

When those conditions--including meaningful gains in job growth--have been achieved, economic growth will be self-sustaining and there will be less need for Fed purchases to support that growth.

By

Jack Mayberry

On Wednesday, Fed Chairman Ben Bernanke held a press conference at the conclusion of the Fed's two-day meeting of its Open Market Committee (the FOMC). His explanation of the FOMC's action proved consequential: he described the Fed's plans for concluding its extraordinary monetary policy actions. About a month ago, during testimony before the joint Congressional committee for financial services, Bernanke discussed, but without specifying the steps, the process of 'tapering' its buying of treasury and mortgage-backed securities. Recall that for almost a year, the Fed has been buying these securities at the rate of $85 billion per month--about one trillion dollars per year--to foster economic growth and to stimulate the employment market. This is the third round of the Fed's 'quantitative easing' by which it has been buying such securities; it is now more than five years since the Fed began its radical policies during the financial crisis in 2008. Since then, the Fed has undertaken several actions to deal with the deep recession and very slow economic recovery.

As discussed in earlier letters, the central banks of the other major developed economies, the European Central Bank, the Bank of England, and the Bank of Japan, have all taken extraordinary measures in these years. It is quite likely that central bank actions have forestalled serious damage after the financial crisis and have helped global economies struggling under the weight of widespread deleveraging and tight fiscal policies by many governments. Recall that in recent months, Japan's government and its central bank have undertaken coordinated, concerted, and aggressive action to stimulate Japan's long-sagging economy. Of the major economies of the developed countries, that of the United States is the strongest. The European Union countries mostly languish in recession, some quite deeply, some less so. The Fed has a dual mandate to control inflation and to support employment. Since the announcement of this latest round of quantitative easing, QE3, as it is called, the employment picture in the US has improved. Just under 200,000 new jobs per month have been added in the last six months; the unemployment rate is falling, and the participation in the job market--the proportion of the working-age population that is employed or actively seeking employment--has begun to improve. The housing market is making a meaningful recovery.

In light of recent economic improvement and in light of the Fed's expectations for economic activity in the coming year, the FOMC announced its intentions to slow the rate of purchases of treasuries and mortgage-backed securities from its current $85 billion per month. As Mr. Bernanke discussed in the press conference, the FOMC's current plan is that the economy's strength will permit a reduction in asset purchases around the end of the year and will permit the full cessation of those purchases by the middle of 2014. Only after that will the Fed begin to raise short-term interest rates from the near zero level that has prevailed since the end of 2008. However, Mr. Bernanke stressed the point that the timing of the decrease in asset purchases will depend on economic conditions, not on the calendar.

As you are certainly aware, the hints about all this dropped by Mr. Bernanke in his May Congressional testimony, followed by his very explicit discussions on June 19, have stopped the placid advances in bond and stock markets and thrown all kinds of markets round the world into hyperactivity, mostly involving a rush for the exits. Most dramatically, the yield on the ten-year Treasury bond, the world's benchmark bond, has risen from 1.66% on May 1 to 2.51% today. This is an enormous increase and represents the highest yield (and lowest price) for the ten-year since August 2011. Because the prices and yields of other bonds around the world are tied to this benchmark bond, almost all bonds fell in price and rose in yield in similarly dramatic fashion.

Investment considerations. Mr. Bernanke was at pains to say that the timing of the decrease in asset purchases, the cessation of them, and the subsequent increase in short-term interest rates would be a function of economic conditions. He explained the Fed's current economic forecasts, and mentioned dates for these steps based upon those forecasts. He stated--as he and other Fed officials have remarked before--that if economic conditions should weaken, or if inflation should remain below the target level of two percent, the Fed could well <u>expand</u> its asset purchases, rather than begin to cut them. From these remarks, I conclude that prices of US stocks will rise from current levels.

I reason that, if the economy improves as the Fed now projects, the increased activity will enhance corporate profits. As a result, stock prices will probably rise. If, on the other hand, economic activity is weaker than now expected by the Fed, it will continue--or even increase--its level of asset purchases. We know well that these asset purchases have caused stock prices to rise over these recent years. Hence, as it appears to me, stock market investments, particularly those in the US, should continue to fare well over the next year. And so, despite the recent selling in bonds and, to a lesser degree in stocks, Core intends to hold or build upon the stock positions in its clients' portfolios.

Bonds are a different matter: The market has already driven interest rates up quite dramatically, and, if the Fed's projections are correct, we may expect to see yields rise further. For five years, bonds have been a delicious one-way bet: prices have risen and yields have fallen. Deep recession, terribly slow recovery, persistent de-leveraging in the private sector, and (more recent) fiscal austerity have produced a heady tonic for fixed-income investments. This has come to an end. Although there will likely be good rallies in the bond market, the low yields of the last year will, I believe, not be seen again in our lives.

During the last month, we sold our entire position in high-yield US corporate bonds, an investment that has earned splendid returns since 2009. We have reinvested some of the proceeds in dollar-denominated government bonds of developing countries, another long held investment of ours. This security has fallen sharply in the last few weeks, far more than warranted by external conditions. Its yield is high and, I submit, quite secure. We have cash on hand, and are making plans to take advantage of the opportunities offered by the very turbulent markets, probably tilting more toward equities than bonds.

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CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

May 22, 2013

Japan, the Central Banks, and Stock Markets

A startling change has come to Japan since the November election for the lower house of its parliament, which gave Shinzo Abe and his Liberal Democratic Party a large majority. Since then, Mr. Abe has appointed a new head for the central bank (the Bank of Japan), increased government spending substantially, and begun far-reaching structural reform of governmental activities. The Bank of Japan (the BoJ) duly announced a truly enormous program of asset purchases, proportionally much larger than the Federal Reserve's programs. This new dynamism in Japan has had stunning effects on the value of the yen and the Tokyo stock market and has already given a significant lift to Japan's long-dormant economy. The yen has fallen in value against the dollar by more than one fifth in the six months since Abe's election seemed assured; the Nikkei index of Japanese stocks has risen by two thirds in the same period; the first quarter 2013 GDP for Japan rose at an annualized rate of 3.5%.

Recall that Japan's development was extraordinarily robust for decades after World War II as it became one of the world's leading manufacturers of automobiles, electronics, and other industrial equipment. Its stock market and property markets reflected Japan's wealth and success; by the late 1980s, the total value of Japanese stocks exceeded America's. Near the end of 1989, Japan's principal stock market index, the Nikkei 225, stood just under 40,000 and Japan Inc seemed to by buying up America. Then the property markets and stock market collapsed; the economy fell into a series of recessions, and price deflation set in. Last year, China's economy surpassed Japan's as the world's second largest. With its aging population, hostility to outsiders (reflected in a policy of essentially no immigration), and the failure of its Fukushima reactor after the earthquake and tsunami, Japan was moribund. It actions and inactions since 1989 have been studied by prominent economists (including Fed chair Ben Bernanke) as examples of what not to do. Indeed, Shinzo Abe himself, as prime minister a few years ago, was an undistinguished failure.

Does the remarkable new dynamism on display in Japan presage a real change in Japan? Will Tokyo's stock market continue to appreciate? Will Japan's economy grow after its two decades of slumber? Or, more ominously, is this one more important central bank engaged in an unsustainable policy of asset purchases--'quantitative easing'--destined to end very unhappily?

By

Jack Mayberry

Despite nearly stagnant nominal economic growth since the early 1990s, Japan's mild deflation (i.e., falling prices) actually served to maintain the buying power--a real measure of wealth--of Japanese people. (Two percent deflation and zero percent 'nominal' economic growth means two percent 'real' economic growth.) And, although the yen kept rising in value against all the other

The Tokyo stock market rose enormously in the 1980s, only to begin a long collapse from 39,000 in the Nikkei 225 index in 1989 to 8000 in 2003 and 7000 in 2009. The recent torrid rally has brought the index well above 15,000.

With the yen falling markedly, the reinvigorated corporate sector in Japan may fuel higher stock prices. Core has a meaningful investment in Japanese stocks.

major currencies in the world, Japanese industry adjusted to higher the higher exchange rate by improving efficiencies. Hence, Japan continued to be a formidable export power house all through these recent decades. Perhaps Japan has been jolted into action by the increasingly assertive actions of its gigantic neighbor. Two insignificant islands long claimed by Japan, lying south of Japan in the East China Sea, are the subject of a territorial dispute in which China has taken ever more aggressive and provocative steps. There is a stridently nationalistic tone to Mr. Abe's rhetoric; the interplay between his nationalism and his fiscal, economic and monetary policies is not terribly clear. At all events, Mr. Abe and his policies are very popular and an upcoming election in Japan's upper house of it parliament will give his party a large majority there, enabling the government to enact its legislative agenda without meaningful opposition.

The central banks and the stock market's rally. We may not be able to parse the interplay between Mr. Abe's nationalism and his economic plans, but we can make sense of the interplay between central bank actions and the world-wide stock market rally. The four major central banks of the developed economies, the Federal Reserve, the Bank of England, the European Central Bank, and the Bank of Japan, have at various stages in recent years undertaken ever more aggressive monetary policies, first to lower the risk to the stability of the banking and financial systems, and second to stimulate stagnant economies. The most dramatic has been the recently announced policy of the BoJ of huge asset purchases. Smaller central banks have engaged in their own aggressive asset purchases; JP Morgan reports that one third of advanced country central banks now own equities directly. Recall that most central banks, including our Fed, generally held government securities only until the financial crisis.

With the BoJ announcement, it appears that many investors have finally concluded that, while the central banks continue to be buyers of so many investible assets, stock markets will continue to rise. The stock market advance has been slow and persistent. In the US, it has been supported by continuing growth in corporate profits, modest but real economic growth, marked improvement in the housing sector, decent if unremarkable job growth, and a distinct shrinkage in the federal budget deficit, as tax revenues increase, government spending falls, and Fannie Mae makes a large, one-time dividend payment to the Treasury. As things stand, and despite the big rally in the US over the last six months, valuations are not unusually high. When stock prices are measured against corporate earnings, the rally now is not like 1999 dot-com boom; it is restrained and supported by quite favorable ratios of earnings to prices.

For now, we at Core intend to maintain or build our stock market positions, particularly in Japan and the US, in the equity-oriented portfolios we manage. The bond portion of our portfolios are heavily weighted toward US corporate bonds, including high-yield bonds. We maintain our fairly large position in US dollar denominated emerging market debt, a very fruitful investment we have held for several years.

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ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

April 8, 2013

Slow Growth but Strong Stocks: What Gives?

On the last trading day of March, the S&P 500 set a new closing record, exceeding the previous high set in October 2007, just before the terrible banking crisis ushered in a serious recession and a huge bear market. Although that recession long ago came to an end in the US, economic recovery continues to be weak, with frustratingly slow improvement in the jobs market.

Fiscal austerity and monetary liberality. Taxation and spending policies by most of the governments of the 'developed' economies (i.e., Japan, the Western European countries, Canada, the US and Australia) have mostly fallen into the thrall of theories about the virtues of fiscal austerity, generally involving higher taxes or lower government spending or both. The calls for austerity have arisen in the context of higher government deficits. Deficits increased, unsurprisingly, in the financial crisis and recession as government tax revenues fell while the demand for unemployment insurance and other social spending rose. As a consequence of the loss of jobs and the declines in the values of homes and stock portfolios in the crisis, the private sector--that is, people and businesses--cut their own spending and increased their savings in an effort to rebuild their diminished assets. As the private sector cut spending and increased savings, the overall economy would necessarily shrink unless government spending took up the slack.

In Europe and among many in the United States, the government deficits--arguably entirely necessary as a response to private sector retrenchment--were considered quite alarming; clamor to cut government spending arose. The situation in Europe has been complicated enormously by the regime of the single currency. In the Euro-zone, the various calamities in Spain, Portugal, Italy, Greece, Ireland and Cyprus required support of the creditor countries of the Euro-zone, led by Germany. The German approach has been to impose fiscal austerity on these countries--higher taxes and sharply reduced government spending--as the price for loans. The cost to the 'peripheral countries' has been ever higher unemployment and contracting economies.

The United States has had less of fiscal austerity than Europe. However, the belief in austerity among Republicans is powerful; Republicans have used their control of the House to thwart Obama administration proposals for various kinds of spending and investment to ameliorate the contractionary effects of high private sector saving.

By

Jack Mayberry

The countervailing force against fiscal austerity is the easy monetary policy of the major central banks, the Federal Reserve (Fed), the Bank of England, the

European Central Bank (ECB) and, most recently, the Bank of Japan (BoJ). The central banks have engaged in distinct acts: cutting short-term interest rates close to zero, buying government and mortgage-backed securities, and promising to maintain these policies until certain economic targets (e.g., lower unemployment rates in the US) have been met. (In the case of the ECB, it has made a contingent promise to buy unlimited amounts of the bonds issued by troubled countries, but has not yet had to act on the promise.) The Fed has generally been the leader in these actions, but the ECB and the BoJ have in the last year taken dramatic actions with very salutary effects on financial markets.

High levels of private savings, low demand for private capital investment, and zero rates on short-term fixed-income investments have driven capital into investments in stocks and long-term bonds. Thus, despite recession in most of Europe and tepid economic expansion in the US, stocks and bonds have rallied.

The ECB and the BoJ. We have written about the ECB's promise last year to do 'whatever it takes' to preserve the Euro. Before that undertaking, investors were (quite reasonably) obsessed with fear that another financial crisis, akin to that occasioned by the Lehman bankruptcy, would arise from the Euro-zone crisis. As markets absorbed the ECB promise, the fear of systemic collapse in the financial sector gave way to the realization that the ECB would prevent such a crisis. What has followed is an environment with low risk, low growth and central bank assurances of easy monetary policies for a very long time.

The new Japanese government of Shinzo Abe and the new leadership in the Bank of Japan have lit a fire in Japan after two decades of deflation and stagnation. Last week the BoJ announced a program of asset buying on a scale proportionally greater than that underway by the Fed. The explicit target for the BoJ is inflation at 2%, a very far cry from the persistent deflation of the last many years. Japanese stocks have soared in price in recent months (up by more than 40% since Abe made his intentions clear), while the always too-strong Japanese yen has been crumbling (down by 22% since September against the dollar).

The interplay of fiscal drag with radical monetary policies. It is certain that the actions of central banks are distorting markets by driving capital into riskier assets. The distortion is that these riskier assets--including stocks, corporate bonds, and other relatively high yielding securities--appreciate in price more than warranted by underlying economic activity. The aim of the central bankers is that the 'wealth effect' of higher asset prices will translate into greater economic activity and offset the economically depressing effects of fiscal austerity. It is not at all clear that economies are stronger because of central bank actions. But I suspect that, without the assurances of Mario Draghi of the ECB to do 'whatever it takes' and without the ongoing asset purchase programs, economies would be weaker than they are. Moreover, without the programs, it seems certain to me that stock and bond markets would be much more volatile and much lower in price than they are now.

Since January, Core has built a fairly large position (for equity-oriented portfolios) in a fund that invests in Japanese stocks and hedges away yen exposure. Hence, the fund delivers to us Japanese stock market appreciation without the drag of the sharply falling yen. This has been a good investment for us, as have a number of others. Both equity-oriented and fixed income portfolios we manage enjoyed a very healthy first quarter. Hats off to Messrs. Draghi and Bernanke and their colleagues.

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ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

February 27, 2013

Central Banks: the Positive Force Behind the Markets

Despite our dysfunctional government characterized by intense partisan squabbling and its failure to resolve even its short-term fiscal problems, stock markets in the United States moved steadily higher in recent months and the American economy continues its moderate growth. The private sector of the economy is finally showing more strength (notably, but not only, in housing) -- and a good thing too, because government spending is falling. European and Japanese markets have done well, despite their facing more severe problems and against the backdrop of contracting economies. Why the insouciance of asset markets during this long period of malaise in developed countries?

Fiscal and economic problems in Europe and the UK. As we have discussed in several letters, the actions and promises of the European Central Bank (ECB) last year proved to be a bulwark against systemic collapse of banks and the unraveling of the single currency. Borrowing costs for Italy, Spain and the other troubled 'peripheral' countries came down from impossibly high levels; markets have quite clearly decided to give the ECB the benefit of the doubt --or at least not to test its resolve. But recessions are deep in Mediterranean countries. More recently, the core countries joined in the recession. The entire Euro-zone economy is contracting. It is unrealistic to assume that economies of peripheral countries will be able to grow any time soon; the weakness in those countries adversely affects the stronger countries like Germany. Fiscal policies (taxation and government spending) are very restrictive across Europe; governments will do nothing to help economic growth. Keynesian economists are having fits and revising their textbooks with these further proofs that fiscal austerity is the last thing weak economies need. As a political matter, the election results in Italy show that tolerance for austerity, especially in the countries suffering from it the most, is absent. Are we surprised? Although it is too soon to predict what may flow from this election, it seems probable that the resolve of the ECB and the support from Germany will continue. The Euro-zone will remain intact.

The United Kingdom, which has its own currency and so does not face the terrible dilemma that plagues Italy, Spain and Greece, nevertheless has pursued policies of austerity for the entire life of its coalition government. Britain has slipped back into recession; Moody's downgraded UK government debt from AAA last Friday. (The Moody's downgrade does not give us any news, but it does exclaim the failures of Britain's austerity policy.)

By

Jack Mayberry

Changes afoot in Japan. In the last two decades, Japan has suffered persistent deflation and one recession after another. Until last year, the exchange rate of the Japanese yen kept rising, stifling Japan's exports. The new government of Shinzo Abe is seeking radically to change both the fiscal and the monetary policies of Japan. Alone among the developed countries, Japan is embracing expansive fiscal policies to stimulate the economy. Moreover, Mr. Abe is applying political pressure to the Japanese central bank for looser monetary policies. He will soon be nominating a new head for the Bank of Japan (BoJ) to support his hoped-for policies. In anticipation of sharp changes in BoJ policies, the yen has fallen sharply in recent months, while Tokyo stock market has soared.

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If you wish to have any of these reports, kindly give us a call or an email.

Meanwhile, in the United States, our central bank continues to pursue its very accommodative monetary policies, against the backdrop of ever-tighter fiscal policy. Fiscal policy here is not nearly as 'austere' as in Europe or the UK, but not for want of trying by the House Republicans. The early January 'fiscal cliff' deal increased income tax rates on the highly paid and raised payroll tax rates, which, unfortunately, mostly affect low-paid workers. The looming 'sequester'--yet another self-inflicted fiscal wound--will cut federal spending by about 1.5% to 2% of GDP, unless headed off by an eleventh-hour deal. But, as Fed Chairman Bernanke keeps reminding us, the Fed's policies of extremely low short-term rates and its persistent buying of bonds and other assets will support the economy, in which, happily, the private sector is showing increasing vigor.

The result of all this--the bizarre election in Italy, the grinding, recession-inducing austerity across Europe, and the rest--will be the continuation of favorable monetary conditions that support financial markets. However belatedly, the ECB finally last summer promised to fulfill its unique and indispensible role as buyer of last resort for government bonds of the European countries enmeshed in the frightening liquidity crisis. (Had it done so earlier, millions of the now unemployed in Italy and Spain and Greece might have jobs. Oh, well.) Mario Draghi's promise has, in effect, nullified the threat that the Euro-zone crisis would lead to catastrophic bank failures and another Lehman-like experience.

With the risk of systemic collapse off the table, the characteristics of this environment are seen to be quite favorable to the owners of capital. One can hardly like the fact that labor markets are so weak and that compensation for labor is so subdued. But the unhappy labor market situation accounts, in part, for very strong corporate profits. Rising corporate profitability, combined with this favorable monetary environment of low interest rates and the high rates of private and corporate saving, almost necessarily leads to higher stock and bond prices. In his Congressional testimony yesterday and today, Fed chairman Bernanke restated the Fed's undertaking to keep interest rates exceptionally low and to continue its purchases, at the rate of $85 billion per month, of treasury bonds and other assets. (A report in today's Financial Times puts it, in a flip but cogent way: "[Investors] have inferred from his testimony...that such headwinds [i.e., the looming sequestration] only make it more likely that the Fed will stay looser for longer." The emphasis is mine.)

We continue to have fairly large equity positions (for our equity-oriented clients) in Europe and Japan and the US. Our fixed-income investments, including a REIT holding mortgages, emerging market debt, US high-yield and high-grade corporate bonds are all doing well; the policies of the Fed and other central banks favor these. So, despite the usual problems with governance of important countries (like ours) and somewhat dangerous countries (like Italy), we are positive in our outlook and our investments reflect the positive outlook.

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ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

January 7, 2013

From 2012 to 2013

Despite the quite sullen tone from Washington in the last weeks of angry posturing by the President and Congressional leaders, and the failure of the government to resolve the self-created 'fiscal cliff' problems, the investment environment is reasonably favorable as this year begins. The legislation that was passed in the early hours of 2013 involved taxes and unemployment benefits, and deferred the automatic spending cuts, previously scheduled to begin as of January 1 for two months.

The tax legislation. As for taxes, income tax rates established in the Bush tax cuts early in the last decade were made permanent, except for an increase from 35% to 39.6% on income above $400,000 per year for individuals and $450,000 for couples filing jointly. Also restored was the earlier phase out of deductions from income for those in the high income brackets. Capital gains and dividend tax rates increased modestly for high income taxpayers, from 15% to 20%. The 2% payroll tax 'holiday', enacted after the financial crisis, which reduced individual (not employer) Social Security withholding from 6.2% to 4.2%, was allowed to lapse. This two percent reduction in take home pay will have a meaningful impact on lower income wage earners and will probably reduce economic activity by a small amount. The legislation also provided for a modest increase in estate taxes.

Happily, unemployment benefits for the many long-term unemployed, set to expire at year end, were extended for another year, a very good outcome for the individuals who receive those benefits and for the economy, since, as is likely, virtually all those payments will be spent.

Spending and borrowing; the next round. The automatic spending cuts, a feature of the August 2011 deal meant to force Republicans and Democrats to negotiate something meaningful for government spending, were postponed for two months. Thus, we are faced with another miserable set of negotiations, which will also include the raising of the 'debt ceiling', the total authorized level of debt for the United States. Treasury Secretary Geithner announced near the end of the year that the US has reached the legislated limits of it borrowing power. Work-around solutions will permit further borrowing over the next couple of months only. Republicans vow to use the necessity to raise the debt ceiling to force long-term spending cuts in Medicare, Medicaid, Social Security, and other 'entitlement' programs. Obama declares that he will not negotiate. A couple of ugly months in Washington are in prospect.

By

Jack Mayberry

Apart from politics and governance, things look reasonably good. Despite persistent uncertainties about US fiscal policy--government's taxing and spending policies--economic growth, while not brilliant, has been reasonably solid. The employment situation is improving, as is the housing market. The development of new sources of low-cost energy is spurring domestic manufacturing and exports; corporate balance sheets are very strong, and the Federal Reserve continues to provide support for the economy and the financial markets through its very accommodative monetary policy.

In Europe, the salutary effects of the European Central Bank's promise, enunciated last summer by its president, Mario Draghi, have taken the crisis off the boil. Confidence is growing that the Eurozone crisis, harmful as it is to the legions of unemployed across the Mediterranean, will not spin out of control and cause a catastrophic banking and financial markets collapse. This has permitted the extremely depressed (in relation to US markets) European stock markets to improve. Our large investment positions in Europe are prospering.

The ever-larger roles of governments and central banks. It is hard to overstate the importance of governments and central banks on economies and financial markets since the onset of the banking and financial crisis in 2008. The Eurozone crisis and America's 'fiscal cliff' problems flow directly from that crisis, although other issues (e.g., ever-rising health care costs in the US and inherent problems of sharing a currency among countries without common taxation and fiscal regimes in Europe) contribute very meaningfully to these problems. It is quite likely that Europe's current recession results from the misguided--not to say pitiless--imposition of fiscal austerity on governments, e.g., the raising of taxes and the cutting of social spending by governments. Such prescriptions are an article of faith on the political right, despite the exceptional economic weakness in the UK and in major economies in Europe that have undertaken austerity measures too soon after the 2008-2009 crisis. The relative strength of the US economy, as compared to those, should persuade policy makers in Europe, the UK and America that fiscal austerity shrinks fragile economies. But now the US is embarking on its own premature austerity. Last week's tax increases are round one; looming spending cuts in upcoming negotiations will be round two.

Apart from the economic consequences of policy judgments is their effect on financial markets and investing. One is obliged to guess the effects on financial markets of decisions that may be made and actions taken by numbers of different policy makers. Core's recent judgment about year-end 'fiscal-cliff' negotiations, namely that something would be done at the last minute to avert the worst appears to have been correct; hence our portfolios, invested in line with that view, were untroubled. Last summer, by contrast, we feared that the Euro-zone crisis, then was driving up interest rates in Italy and Spain to impossibly high levels, would worsen and create another round of widespread selling across many financial assets. We underestimated the influence of Mario Draghi's words and his contingent promises to do what was necessary to prevent the crisis. Fearing a significant market decline, we turned Core's portfolios to a defensive posture to prevent significant loss in another wave of selling. The wave of selling did not come; Mario Draghi's promises were enough, and markets rallied. Our hedging position prevented Core's portfolios from participating in the summer-time rally.

We believe that our mandate from you is two-fold: to preserve your capital and to earn a good return on it. Often we achieve both goals; sometimes our capital preservation instincts hurt the returns our portfolios earn. Politicians do not make this job easier. On to the New Year!

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