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

January 8, 2016

Turning the Page

Major stock and bond markets were essentially flat in 2015, while currencies, emerging markets and commodities fell sharply. Weak global demand will continue this year.

China is finding it difficult to change its economy to one less dependent upon export of manufactured goods. Its efforts to loosen control over its stock market and its currency are counterproductive. Its policy blunders spook markets around the world.

However, with its vast resources, China can survive its mistaken policies.

By

Jack Mayberry

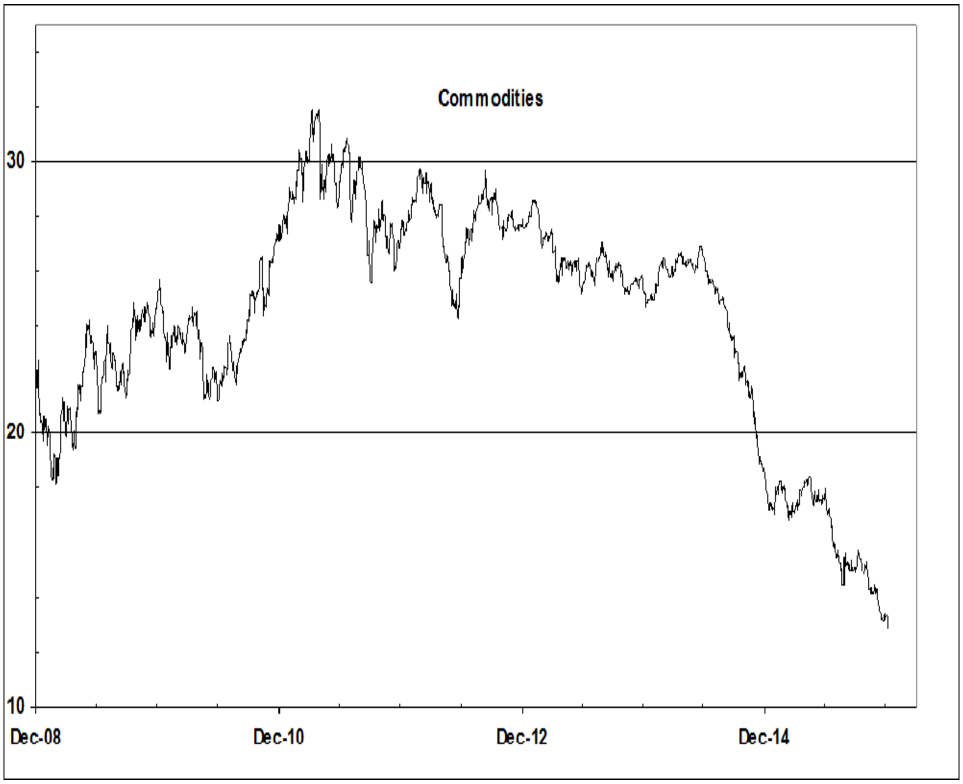
As the calendar turns to 2016 comes the occasion to look backward to last year and forward to this new one. First, the look backward: The principal US markets ended up the year essentially where they began. In unusual fashion, the S&P 500, the principal US stock benchmark, gained a mere 1.2% including dividends, while the Barclays Aggregate bond index of all tradable US bonds gained 0.5% including interest. (It was only dividend and interest payments that made returns barely positive; the indices were both in the red before dividends and interest.) Money market funds yielded essentially zero. For global investors like ourselves, there was not much else on offer. Using the MSCI All-Country World Equity Index (a well-respected and widely followed index), a portfolio balanced with 60% stocks and 40% bonds would have returned nothing, even if one had hedged European and Japanese currency exposure, as Core does. (Because of the strength of the US dollar, returns of non-US stock markets, when expressed in dollar terms, were decidedly negative.) To state the obvious, it was a rather difficult year to make money.

However, it was an easy year in which to lose money. Some notable markets, which were very strong in the last decade, had sizable losses in 2015. Crude oil has fallen from its June 2014 level of $115 per barrel to $33 as of this writing! Oil was not the only commodity to fall in price: Industrial commodities lost about 21% in 2015; agricultural commodities about 16%, and gold about 10%. In fact, 2015 was the fifth straight year in which commodities as a group declined in price. Stock markets in developing countries--the 'emerging markets,' as we call them--lost about 16%. Virtually all foreign currencies fell in relation to the dollar's value, as they have for a couple of years. Although these statistics look backward, they have some bearing on what is to come.

The underlying forces behind the markets last year and this remain the actions of the major central banks and weak global demand. The US economy shows persistent strength, at least when compared to Japan's and those in Europe. As a result, the Federal Reserve has begun (after some hesitation) the process of raising interest rates and tightening monetary policy. Meanwhile, against the backdrop of those weaker economies, the Bank of Japan and the European Central Bank both are deeply engaged in ultra loose monetary policy actions. Big producers of oil and industrial commodities, including Canada and Australia among developed economies, as well as emerging economies like Russia, Brazil and Indonesia, have experienced very sharp declines in their currencies against the dollar. Russia and Brazil, with separate other problems (sanctions in Russia's case and terrible mismanagement in Brazil) suffer sharp and prolonged recessions and steep stock market declines.

The chart below shows the large decline in overall commodities prices in the last five years, a decline that has accelerated in the last two.
This decline will end and will then offer investors fine returns. Emerging markets and foreign currencies share these characteristics.

China is a force in the world's economy and financial markets that cannot be ignored, even if one holds steadfast to the view that investing directly in China is to be avoided. It has become the second largest economy in the world and, for a decade or more, was the engine of global growth. Now its economy is slowing, as it attempts to change from an export-driven economy to a more domestically oriented one. Meanwhile, having piled up a huge store of treasure (some $3.3 trillion in foreign currency reserves), it seeks to be a full participant in world markets and to challenge the role of the US and the US dollar in those arenas.



As we discussed in Core's September 2015 letter, China's handling of it currency and its stock markets is amateurish and ham handed. It is unwilling to permit the markets to determine price levels of its currency and its stock market. It announces policies to restrain market declines, but is forced to withdraw those policies within days because its actions worsen declines and heighten price swings. The actions are deeply unsettling to global markets, as demonstrated again in this first week of the new year. Twice this week, China closed its stock markets after sharp declines. Its experiment with 'circuit breakers' ended in four days. This week has also presented a widening between the value of its currency in its domestic and controlled markets and those off-shore and uncontrolled markets. As in August, this demonstration of China's ineptitude has unsettled financial markets far away from the Middle Kingdom.

For 2016, and putting aside the immediate China problems, we can expect more of the same: relatively weak global growth, falling commodity prices, strength in the US dollar and modest growth in the US, Europe and Japan. As a result, Core is maintaining your investments in the US, Europe and Japan, while avoiding currencies and emerging markets and maintaining somewhat high levels of cash. However, before too long, these trends of falling commodities and the rising dollar will come to an end. We will then have the opportunity to invest once again in foreign currencies, in commodities, and in emerging markets—at prices far below those that prevailed when we sold our positions last. You will remember that, in the years preceding the 2008 - 2009 recession and financial crisis, oil, the oil stocks, foreign currencies and emerging markets, especially those with connections to China, were strong as new rope. Although China is very unlikely again to see the rate of growth it experienced during those years, the adjustments to its slowing growth and changing economic structure will have occurred. Currencies, commodities and emerging markets will again find their time in the sun. We Core investors will participate.

CORE Comments

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

January 19, 2016

The New Year Begins. Yikes!

Strong selling in stock markets around the world, sharp declines in oil and industrial commodities, some wild swings up and down in prices: welcome to 2016.

The beginning of a bear market? The onset of a recession? Is the sky falling?

From Core's perspective this is not the beginning of a bear market. A recession in America seems unlikely.

By

Jack Mayberry

Given the unsettling start to this very young year, let us consider the implications, specifically the likelihood that the selling presages a real bear market in stocks. In the first two weeks of the year, the S&P 500 fell by 8%. The magnitude of the selling makes it the worst start on record to a new year in American stocks. However, the decline—dramatic as breathless new reports characterized it—has only brought the S&P to the level of the lows it made in the August squall of selling. As of this writing, the S&P stands a mere 13% below its all-time high set in May of 2015.

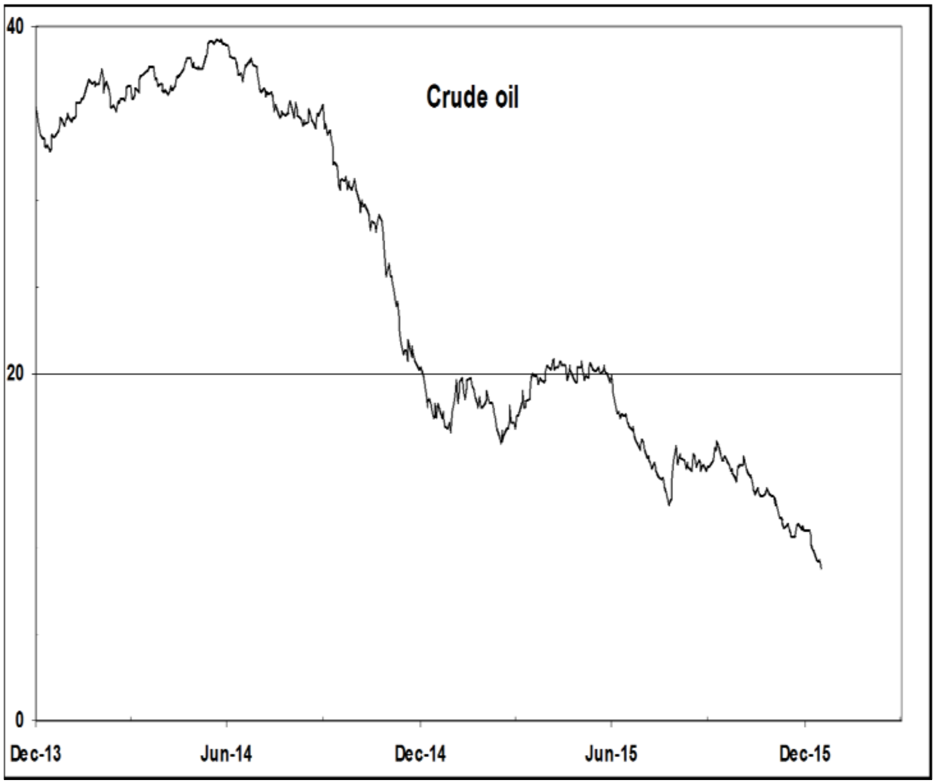
Of course, the fact that this year's decline is just 8% in itself gives no comfort: It is a tautology (of a kind) to say that the 2000-2002 and the 2007-2009 bear markets--of 50% and 58% respectively--both began with declines of a just 8%. Other factors may be more relevant: Bear markets generally begin in the context of economic recessions, either underway already or soon to begin. What is the likelihood of a recession beginning soon in the US? From our perspective recession is not imminent. Economic growth is modest but fairly steady, notwithstanding the likelihood that growth in last quarter of 2015 will be shown to be quite slow. Job creation (happily) remains robust; consumer spending is reasonably strong; there do not appear to be significant imbalances in the economy as a whole. Remember, for example, the house price mania and the mad mortgage lending practices that characterized the run up to the Great Recession. Nothing similar is before us now.

Two major disturbances to stock markets are the relentless decline in oil prices and the unsettled conditions in China. First, oil prices: On Monday, when markets in the US were closed for the Martin Luther King holiday, crude oil fell to $27.67 per barrel (as measured by Brent crude, the international benchmark). This represents a decline of 25% in this young year and a decline of 76% from the high in oil prices in June 2014! This remarkable collapse in prices is now being fueled (pun intended) by a number of factors: Saudi Arabia decided not to cut its production, as it has done in the past, with a view to driving higher-cost producers, including US shale oil producers, from the market. As of Monday, after sanctions on Iran were lifted in connection with last year's nuclear deal, Iran has begun to ship oil. It intends to increase its production from one million barrels a day back toward its old level of 2.5 million per day. Given that demand for oil is barely growing across the world, the supply of oil is far greater than demand. The prospects for immediate decreases in supply are not evident; indeed, with Iran coming back to the market, supply is about to increase further. We may soon see Brent crude changing hands at less than $20 per barrel, before some equilibrium is restored to production and demand.

The chart below (of an ETF that tracks crude oil prices) shows the collapse since the beginning of 2014. Crude oil had traded above $100 for few years before the decline that began in mid 2014. The price decline has exceeded seventy five percent so far.

The economic effects of these far lower oil prices include savings to consumers who pay far less for gasoline, heating oil and natural gas, but also significant cuts in capital spending by oil companies, with a concomitant loss of jobs in the oil patch. For the US economy, the benefits of lower prices for fuel probably outweigh the drag from cuts in capital spending and job losses in oil-producing regions. Thus, the sharply lower crude oil prices are unlikely to pull the US into recession.

China is undergoing disruptions in its currency and stock markets and difficulties in its transition from its booming, export-driven growth of the recent decades to a more balanced economy. In our letter in September and the one earlier this month, we discussed China's actions and their global effects. As in August of last year, it has made matters worse for itself (and global financial markets) by desperate and ill-conceived attempts to prop up its overpriced stock market. And, similarly to last August, it is handling revaluation of its currency poorly. Loss of credibility in China's policy makers is driving capital from China in large amounts and China is spending hundreds of billions of dollars of its (vast) reserves in its doomed efforts to control the markets for its currency and its stocks. Given the importance of China to the world's economy, the loss of credibility in China's policy makers is deeply unsettling to global financial markets.



Core's investments. We began this year with Core's clients' portfolios in a defensive position, which has mitigated the effect of the stock market's decline. A typical account held about one sixth cash and more than one quarter in bonds and preferred stocks. The overall decline in accounts has been about 4% or half the declines in stocks.

Although we do not expect this year's selling to become a major bear market and although we think that the US economy will continue to grow this year, we have no illusions about our ability (or anyone's) to make accurate predictions about these things. We have done no buying as the markets have tumbled, mindful of the old warning against trying to catch a falling knife. Opportunities will surely present themselves. We will be mindful of risk and alert to these opportunities.

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CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

February 21, 2016

A Foolish Consistency….

Emerson reminds us that 'a foolish consistency is the hobgoblin of little minds.' In the last month, I have changed my mind about economic and stock market conditions. I now think that the risk of a further sell off in stocks is high enough to warrant reducing risk in Core's clients' portfolios.

This letter attempts to explain the negative factors that give rise to my sense that market risk is high.

By

Jack Mayberry

Since writing last month, conditions in markets have remained sour. Although we entered the year with Core's portfolios positioned more conservatively than in several years, I decided recently to reduce remaining equity positions. As I perceive things now, the risk that a substantial bear market may be in the offing has become uncomfortably high.

As is always the case, there are both positive and negative factors to the stock market. It is not hard to make the positive case for the market and economies; I made such in the letter I wrote last month. In brief, the points were that the US economy is still growing steadily (if unspectacularly) and that the monetary policy of the Federal Reserve is still quite accommodative, despite its having begun to raise short-term interest rates. Against these factors is a rather long string of issues that weigh on the market and give rise to the intense bouts of selling. In no particular order, I discuss some of these.

Oil prices, as is well known, have declined very sharply since mid 2014 when crude oil was selling at about $115 dollars per barrel. The Saudis, who had often in the past been willing to cut production to support prices, declined to do so this time, so as to force down the price and persuade high-cost producers (including shale oil producers in the US) to cut production. This strategy caused the supply of oil to exceed global demand by a large amount and drove prices lower, reaching a low in January below $28 per barrel. Although low oil prices are a boon to consumers and to countries that import oil, they cause losses for oil producers and associated industries. The decline, which has seemed unstoppable, rattles the markets. Prices of many other industrial commodities--iron ore, copper, and the like--have also collapsed. Over supply is an issue in industrial commodities beside oil, but there is a concomitant weakening of global demand for these commodities. Stock markets are fearful of these signals that economies around the world are slowing.

China. As discussed in our last *Core Comments* in January, China's rather ham-handed actions in trying to prop its stock market and to 'adjust' the value of its currency roiled markets last August and then again this year. Very recently, China has kept the exchange value of its currency quite constant in dollar terms, so as not support the belief that the yuan will depreciate. Given that almost all currencies in the world have fallen when measured in dollar terms in the last couple of years, and given that China competes against other east Asian countries to manufacture goods for America and Europe, China probably should allow the yuan to depreciate. The expectation that the yuan will fall in value against the dollar has given rise to enormous capital flight from China, recently at the rate of $100 billion per month! China's well-founded concern about capital flight and its desire to prop up its over-priced stock market have given rise to rash and ill-considered actions. China has the resources and tools to manage its problems, but it lacks the experience to craft the right strategies and to communicate those strategies to the world. The world's markets have become quite concerned and expressed those concerns by somewhat indiscriminate selling. Such are the problems of China's having become a very important country.

Central Banks. Most people recognize that the major central banks, especially the Federal Reserve, prevented economic depression and disaster to the global financial system by their actions during and after the financial crisis of 2008 and 2009. The central banks engaged in previously untried and quite extraordinary actions, including vast asset purchases, referred to as quantitative easing, guarantee of all money market fund deposits (in the immediate aftermath of the Lehman Brothers collapse) and, most recently by the European, Japanese, Swiss, and Swedish central banks, negative interest rates. The asset purchases <u>certainly</u> raised asset prices (including stocks, bonds and real estate) and <u>probably</u> helped real economies grow in those fraught recent years. But there are now real doubts about the efficacy of recent central bank actions, especially the negative interest rates.

A couple of weeks ago the Japanese Central Bank surprised markets by announcing a version of these negative rates. Among other things, such an action should have caused the yen to fall in relation to the dollar, and so it did for a day or two. Then, within a week, the situation reversed and the yen appreciated by about 10 percent against the dollar, a huge move. This is a stark example of the new distrust of central banks. Another is the rather loud clamor to declare the Fed's December increase in the fed funds rates (to a near stratospheric 0.25%) to have been a mistake and to warn the Fed not to make further increases as now planned. If the markets can no longer count upon the central banks to keep the markets and the developed countries' economies reasonably strong, what hope have we? With the exception of Japan, governments of developed countries are unwilling to loosen the fiscal purse strings for much-needed infrastructure investments and other public programs that could stimulate economies. Fiscal austerity has been the unvarying rule for several years, so markets have looked to the central banks to keep things moving forward.

Perhaps the most unsettling factor confronting markets is the sense that central banks' monetary policies are no longer effective in stimulating economic activity or supporting asset markets.

Corporate earnings in the US peaked in 2014 and were slightly lower in 2015. As last quarter earnings for 2015 are being announced, it appears likely that these will trail those for the last quarter of 2014 by 4 percent or so. Projections for future revenues and earnings being discussed by corporate executives suggest that the present quarter will be weaker than the last. Among other things, workers are being paid somewhat more, after some years of wage stagnation. This is all to the good, but for the fact that higher pay for workers increases corporate expenses and decreases profit margins. We can expect the somewhat higher wages for workers to be spent, hence expanding overall economic activity. The markets, however, look to the here and now. They see lower earnings. Selling ensues.

Weakening economies. In the paragraph above on oil and industrial commodity prices, I noted that, in part, low prices reflect lower demand. This may be a sign that economies are weakening around the world. (It may also reflect the possibility that economies can produce a unit of output with less energy and other resources than before.) Many indicators show declines in manufacturing in the US and around the world, although service-related sectors remain more robust. There is palpable fear about weakening economies, which finds expression in stock market selling.

The bond market, especially long-term government bonds, have been very strong, with rising prices and falling yields. This is well and good, except that it may itself presage economic weakness. The fall in borrowing costs--that is the yield--on long-term bonds suggests that borrowing demand will be low in the long term. If that is not a prediction of generally weak economic activity in the future, I don't know what it is. The rise in long-term bond prices and the falls in their yields present a challenge, to say the least, to rising stock markets.

The list of issues could be extended, but let us leave it here for now. As problems and uncertainties have mounted, I conclude that the risk of another real bear market is high enough to warrant a sale of stocks. Core is investing the proceeds in US bonds, including high-grade corporates, long-term treasuries, and the Double Line bond mutual fund, which we have held for some time. The cross-currents and uncertainties that abound make for very volatile and nervous markets. When we perceive a lessening of risk, we will make new investments in equities, but for now, in what we regard as a dangerous time for stock investments, we will be cautious.

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CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

April 29, 2016

Uncertainty and the Central Banks

After weeks of intense selling in stocks, in oil and other commodities as the new year began, markets have recovered in recent weeks. The dramatic plunge in oil prices from above $110 per barrel in the first half of 2014 to below $28 per barrel in January of this year caused acute economic stress in oil producing countries and was accompanied by similarly sharp declines in other industrial commodities.

With extremely low oil and commodity prices, many economies in the developing world face recession conditions

By

Jack Mayberry

At the worst of the financial crisis in 2008, in the days after the collapse of Lehman Brothers, the major central banks, lead by the Federal Reserve, undertook a series of hitherto untested actions to prevent an utter collapse of the global banking system. These included guaranteeing all money market funds and extending essentially unlimited lines of credit to the central banks of other developed nations. Although it is impossible to demonstrate what would have happened if the Fed had not taken such extraordinary measures, it is widely believed that the Fed's actions were decisive in preserving a functioning banking system and keeping the world from falling into an economic depression.

After the immediate crisis passed, the Fed began several rounds of asset purchases, which came to be called Quantitative Easing or QE. Within a few years, these purchases expanded the Fed's balance sheet from $800 billion as the crisis began to $4 trillion now. The purpose of the bond purchases was to stimulate economic growth. In time, the European Central Bank (ECB) and the Bank of Japan (BoJ) followed the Fed's lead and began their own QE program and other strategies.

The exceptional monetary policies by Fed and the other central banks were not complemented by correspondingly bold fiscal policies. ('Fiscal policy' refers to spending, investment and taxation policies by governments.) The financial crisis caused the worst recession of the post-war era. Spending by individuals and companies slowed precipitously in the crisis and recession and private savings grew by large amounts. In this situation, economic recovery was sure to flag unless governments would take up the slack and increase their own spending. After the fairly large stimulus package enacted shortly after Obama took office in 2009, Republicans in Congress opposed further government spending and argued in favor of fiscal austerity. The ostensible reason for the Republican position, apart from the ideological preference for small government, was that increased federal spending would lead to ballooning federal deficits, increased borrowing costs, and hyperinflation. In Europe, the same arguments prevailed and fiscal austerity was the rule.

The basis for the austerity argument was soon shown to be without merit. Inflation fell, deflationary pressures increased, borrowing costs (i.e., yields on government bonds) fell to historically low levels and the budget deficit fell. Meanwhile economic growth remained anemic in the US and, in Europe, economies drifted in and out of recession. Despite the evidence against it, fiscal austerity remains the rule in Europe. In the US, some hard fought battles between Obama and Congress have increased federal spending by a bit. Nowhere, however, are governments availing themselves of the inexpensive borrowing to make investments in infrastructure, despite the crying need for highway and bridge repair and the need, especially in the US, for better internet connectivity.

The remarkable monetary policy actions certainly helped financial markets in the last few years; probably they helped to stimulate economic activity. Now though, as the economic recovery and stock market rally enter their seventh years, it becomes clearer that the central bank tools are not magic wands for economic growth or financial markets. The apex of confidence in central banks came in 2012, when ECB president Mario Draghi promised to do 'whatever it takes' to assure that the eurozone crisis would be contained. In the event, Mr. Draghi's promise was sufficient; the ECB was not called upon to take the actions Mr. Draghi had outlined.

Central bank magic appears to have run its course: Earlier this year, the BoJ expanded its policy of negative interest rates. Very tellingly, the Japanese yen rallied rapidly and strongly against the US dollar, precisely the opposite of the expected and intended result. And, ever since last summer, the Federal Reserve has been forced to back away from its planned increases in the short-term rates it controls directly, despite reasonably strong growth in the US. Volatile financial markets and China's policy missteps have stayed the Fed's hand, showing the limitations of the Fed's ability to set policy and shape economic outcomes.

Investment implications. This matters for investment markets now, because underlying fundamentals are weakening. To discuss the US alone, note that corporate profits are falling while stock valuations are rather high. Although economic growth has been persistent here, it is far from robust. (Yesterday's estimate of US GDP growth in the first quarter of the year was an underwhelming 0.5% annualized.) Job creation in America has been steady and strong, but most new jobs have been quite low paid and wage increases have been vanishingly small. The very sharp rise of the US dollar in 2014 and early 2015 depressed US corporate profits and effectively tightened monetary conditions here. The Fed would like to raise rates, but it is fearful that rate increases will cause market turbulence, weaken economies in developing countries, and cause the US dollar to rise even higher. In recent speeches and announcements, Fed members have expressed concern about the effects on the US of policy actions taken by other countries, especially China.

Market participants are well aware of the Fed's problems and the somewhat different ones that face the BoJ and the ECB. Noting the doubts about the efficacy of monetary policies undertaken by the major banks and the persistence of weak economies, commentators have begun discussing a yet-untried, even more remarkable policy, so-called 'helicopter money.' The phrase comes from a famous speech given by Ben Bernanke 2002, before he became the Fed's Chair, discussing various unused monetary policy tools. In current parlance, it refers to the possibility of a central bank making direct transfers of cash to citizens, with a view to forestalling deflation and encouraging spending. This is a bold approach to the problem of stagnating economies; its very radical nature testifies to the intractability of economic problems. To me, it suggests that the economy and financial markets are fraught with risk, the solutions for which defy central bankers and government policy makers.

In the last two months, the S&P 500 essentially recovered all the ground lost in the intense selling early this year. However, other measures of the US stock market (e.g., small company stocks) and virtually all major non-US stock markets are still well below their highs from 2015. Stock markets may well go higher from here—the general rule about stock markets is that they confound virtually all participants. We see our primary work as safeguarding the investment capital of our clients. At this juncture, a low allocation to stock markets is in order.

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

June 21, 2016

The Politics of Displaced Anger

The abrasive tone adopted by Mr. Trump in his campaign resonates with some. It appears to stir latent angers and grievances and to validate actions expressive of those prejudices, angers and grievances.

The campaigners for 'Brexit' in the UK give voice to related anti-immigrant and nativist views.

These expressions are not those of civilized discourse in democracies, but they are front and center now.

The enormous achievements of the European project are at risk, because of its recent failings (notably in its inept handling of the euorzone crisis) and because of the economic stagnation in recent years.

By

Jack Mayberry

In the days following the massacre at the Orlando night club were calls that the event should not be 'politicized,' that we should not comment upon its being an attack at a night club for Latino members of the LGBT community, an attack by a self-declared follower of ISIS and an attack effected by an easily-purchased assault weapon whose sole purpose is the killing of many in a short time. We are told that, rather than 'politicize' the act, instead the response should be the demonstration of quiet grief. But the Orlando rampage was a political event in the same way that lynchings were political. Let us grieve for the victims in Orlando, but let the grief be married to political action. The Civil Rights movement of fifty years ago was the necessary response to Jim Crow and Black Lives Matter is the needed response to contemporary manifestations of America's racism. So let us now take political action against this awful crime in Orlando that combines anti-Hispanic and anti-LGBT hatred with the insane availability of weapons of mass murder. Political action is the way to honor the Orlando victims.

The paragraph above has its place in an investment letter because the political environment this year imposes itself upon decisions about how safely and productively to invest. In the UK comes on Thursday its referendum on whether to remain in the European Union or to leave it. In the campaign, those who would have Britain leave the EU, the 'Brexiters,' find their support most readily in nativist and anti-immigration arguments. By stirring those feelings, they inflame the ugly sentiments against the Other that give rise to the horrific rampage in Orlando and the murder of the young Yorkshire member of Parliament in her district last week. At his arraignment, the accused killer of Jo Cox gave his name as "Death to traitors, freedom for Britain."

Forget that the decades-long European project has kept the peace in Europe after centuries of war. Forget that free trade and free movement of people across Europe have enhanced the social and economic well being of Europeans. Forget that Britain has been a special beneficiary of the EU, in that it has grown economically at a greater rate than have the other big European countries, France, Germany, Italy and Spain. Instead demonize migrants from Eastern Europe and the Muslims who have entered Britain, demonize the bureaucrats in Brussels imposing for constraints on British life and business. Instead, fantasize about a splendid pure England, Scotland and Wales. Apart from the damage that a vote for leaving the European Union will cause to the UK, it is likely also embolden those in other EU countries with their own (but similar) grievances to seek to pull their countries out of the EU. The nearly seventy year old European project could unravel. David Cameron's blithe calling of the referendum to assuage anti-EU members of his Conservative party was an act of stupidity. He has opened Pandora's box.

In our country, we have a bigoted, ignorant and vulgar nativist who will be the Republican's nominee for president, who threatens to expel illegal immigrants from the country and to keep Muslims from entering, who accuses of bias a federal judge hearing a case in which Trump University is defendant because the judge is Mexican--the judge is American and was born in America—and who threatens to pull America from NATO and its invaluable alliances.

For the British and for Americans, the always-improving living standards for the middle class that characterized the decades after the Second World War came to an end around the turn of the century. Median income has been stagnant. For all its benefits, globalization has caused some of this, as well-paying jobs have moved overseas, where the work can be performed more cheaply. Technological change has eliminated the need for the numbers of workers for many tasks. Resentments over economic stagnation engender some of the nativist and anti-immigrant sentiment from which Trump and the Brexit folks draw support. It is this that touches on the investment matters that is the subject of our writing in these letters.

Should those like Trump and the angry nativists in Britain and across Europe come to power, there could be radical changes to the economic order, changes likely to create obstacles to free movement of people, of goods and of capital around the world. This would shrink opportunity in America, in Britain and Europe and diminish of economic activity. Nor is it likely that the changes Trump and others may try to bring about will improve the lot of those who support them now. Support for Trump and his ilk arises from the aggrieved white middle class and others, whose well-paying jobs have been lost to globalization and who resent the 'elites' in positions of power in government, banking and business. Trump has been good at firing up their anger, just as the 'Brexiters' have proved adept at turning the question in the very consequential referendum to one about immigrants and bureaucrats. Neither offers serious plans to ameliorate the problems to which they give voice.

In the absence of fiscal policies to support economic growth, especially infrastructure spending in Europe and America, economies on both sides of the Atlantic will be unnecessarily weak. Without this, middle class living standards will probably continue to stagnate.

In this environment, stock markets will not thrive. Bond markets will do well. Core's portfolios are structured to take advantage of these conditions.

Core's investments. As discussed in recent letters, the US economy moves forward at a modest pace, even though the employment report for May showed a marked slowing in new jobs. Japan and Europe are weaker and struggling to rouse economies constrained by years of deflation in Japan's case, and fiscal austerity in Europe's. The frustrating ineffectuality of central banks' attempts to solve their countries' economic plight with monetary policy alone was illustrated most recently when the Federal Reserve had to admit that it could not raise short term rates by another 0.25% presently because of the weak employment report and the looming, possibly disruptive UK referendum on leaving the EU.

Central banks alone are incapable of restoring decent economic growth; governments must use fiscal policy tools to strengthen economic growth. The most obvious fiscal tool is spending on infrastructure, what we used to call 'public works.' Roads, bridges, airports, rail lines, ports, tunnels, and high-speed internet access throughout the US all offer opportunity for projects that will employ large numbers in well-paying jobs and will create long-term improvements for the country. Improving schools and paying teachers compensation commensurate with their importance to our future can lift the young toward better futures. Greater support for medical research and improvements in health care facilities large and small will foster a healthier population. Given that the US government can borrow for ten years at the rate of 1.6% per year, it is very likely that spending on public works, on education and on health care would show a very large return to the US Treasury and to the American people. In Europe, borrowing costs are even lower than in the US, so that such spending there would be likely to rouse the continent out of it economic torpor and provide more income to the poor and the middle-income people. A growing economy with equitably-shared wealth is the best weapon to fight the ugly nativism and bigotry that poison American and European politics.

Sadly, none of this is likely to come about soon, although, in America's November elections, there is opportunity. Meanwhile, we are faced with plodding economies and worried investment markets. In this environment of stagnant economies, restrictive fiscal policies ('fiscal austerity'), somewhat played-out monetary policy, a seven-year long bull market in stocks in the US, and a similarly long period of US economic recovery and expansion, it is hard to argue that we are poised for another strong upward movement in stock prices. Especially when we take into account the contentious, anger-filled political process and the loss of confidence in the ruling classes (to use that old expression) to guide things in a way that benefits everyone, it is easy to argue that the next big move in stocks will be down.

Core's portfolios began the year with more cash and safe bonds than we have held for a long time. In the turmoil that marked the beginning of the year, we reduced stock positions further and clients' portfolios have been very conservatively structured for several months. We see no reason to take on more risk until there is a meaningful sell-off or a convincing move to new highs. We think the odds of the sell off are quite a bit higher than the odds of a sharp and sustained rally in stocks. So, for now, we wait and watch the rather dispiriting political events unfold.

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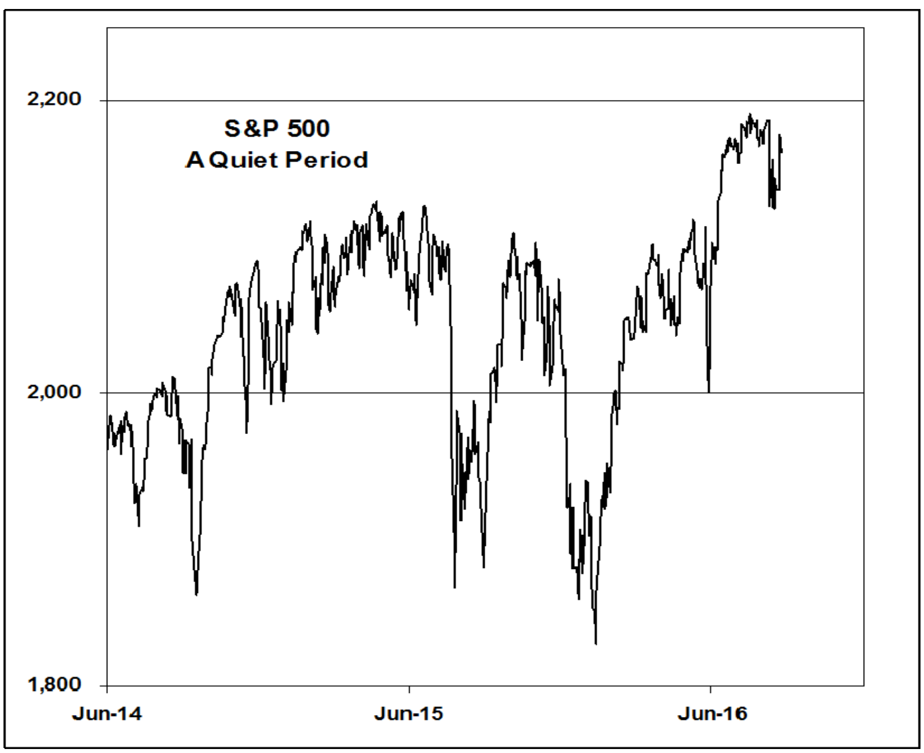
ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

September 24, 2016

Slow and Steady

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

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



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

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

By

Jack Mayberry

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

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

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

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

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

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

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

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

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ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

November 11, 2016

Investing for a Trump Administration

Mr. Trump ran a radical campaign. What will his administration do and how will its actions affect investment markets?

Mr. Trump promises large-scale spending on public works. This will stimulate the economy, causing the Fed to raise rates. This, in turn, will cause the dollar to appreciate. In general, infrastructure spending will be a boon to US stocks.

A risk to American investments is the possibility that Mr. Trump will interfere with the Federal Reserve. His campaign rhetoric was ambiguous.

By

Jack Mayberry

Like most people, I was stunned with the election's outcome; like half of the voters, I was dismayed. This election campaign and the incoming administration will most likely alter many things, social and political, that many had taken for granted about America. However, I will leave it to others to discuss these political and social ramifications and, instead, discuss in this letter what are the investment issues now before us.

Trump's campaign, which can only be described now as brilliantly effective, was quite short on specific policies. However, a few policy prescriptions loom large: In a striking manner, Trump's campaign differed substantially from what we have taken to be orthodox Republican strategy. His campaign appealed to blue-collar white voters by blaming their job losses and low wages on globalization. He also departed from traditional Republican views by declaring that the federal government would engage in large scale public works spending and by abandoning fiscal austerity. His proposed tax cuts, coupled with his increased federal spending on infrastructure and defense will, if enacted, cut revenues and raise spending such that the federal debt might rise by $5 trillion, an increase of well over a third in only a few years. Ironically, with respect to these broad policy prescriptions, Clinton was the fiscal conservative in this campaign and Trump the free spending, big government liberal.

We can probably believe that Mr. Trump will push forward on public works. He has business experience in debt-financed building projects and it will be a quite visible way of demonstrating support for those whose support propelled him in the election. If he acts on these policies and if the Republican majorities in each house support him, as seems likely, the investment effects will include lower bond prices and higher inflation. Given the crumbling condition of roads, bridges and the like, infrastructure spending will be very good for the country and for the economy. Inflation has been creeping up this year already and recently Core took a position in TIPs, inflation-protected government bonds. Then, after the election, we sold clients' remaining positions in US treasury bonds. (Note that when bond yields rise, bond prices fall.)

The incoming administration and the Federal Reserve. During his campaign, Mr. Trump was very critical of Janet Yellen, the chair of the Fed, and of the low-interest-rate policies of the Fed. This may have been campaign rhetoric and, indeed, at early stages of his campaign, Mr. Trump had declared himself to be a 'low-interest-rate guy.' Political independence of central banks is widely regarded as an important public good, but political attacks on the Fed are hardly rare. We have written extensively about the Fed and its policies since the financial crisis of 2008 to 2009; there is no question that Fed policy has been absolutely essential to the performance of investment assets, including stocks, bonds and real estate. If the new administration is hostile to the Fed, the result will be market turbulence and lower asset prices.

At present there are vacancies at the Fed, which the president can fill. His appointments may be an indication of his administration's real views. Moreover, the upcoming Fed meeting in December will show us whether the Fed is willing to act. Prior to the election, it had been deemed likely that the Fed would announce another quarter percentage point rise in the Fed funds rate. The state of the US economy appears to support an increase, but the condition of financial markets in coming weeks will be important. If they are very volatile, and in particular if stocks and bonds should decline sharply, the Fed may choose once again to wait.

Possible effects on stock markets. Mr. Trump's anti-trade and pro-tariff rhetoric was very striking. The question is whether his administration and Congress will act in ways consistent with his campaign rhetoric. A president has wide authority to act on his own initiative and without Congressional approval on matters relating to trade, to immigration, and to climate change and other energy policies. (Witness President Obama's executive orders relating to these matters.) It is widely reported that Mr. Trump's staff is working on executive orders, perhaps to be signed on January 20th, that will reverse many of President Obama's initiatives. If executive orders include such things as Mr. Trump's promised 45% tariff on Chinese goods, the economic effect may be dire. The Smoot Hawley tariffs enacted in 1930 worsened the Depression. High tariffs on imported goods would, of course, raise their prices in the US, hardly a benefit to those who voted for Mr. Trump. They might also kindle retaliatory actions by the exporting countries, including China, worsening geopolitical relations. At the very least, stock markets in the US and abroad would be adversely affected.

Mr. Trump's administration is likely to be more favorable to banks, oil and gas and coal companies than Obama's has been. Health care is uncertain.

Mr. Trump's campaign rhetoric criticizing the Dodd-Frank legislation was favorable to banks. Related to this was Ms. Clinton's harsh criticism of pharmaceutical pricing practices. Thus, pharmaceutical and biotech stocks, as well as banks, have risen in the three post-election trading days. Similarly, Mr. Trump's administration is likely to be more favorable to oil, gas, and coal industries than was Mr. Obama's, and far less favorable to clean energy and renewables. It is reasonably likely that these industry groups will prosper in coming years.

Anti-globalization and tariffs on imported goods were a key to his campaign. If Mr. Trump imposes high tariffs, the effects on the economy and markets will be negative.

Mr. Trump's campaign criticized the Affordable Care Act (Obamacare) in strident terms. Republicans in the Senate and House have opposed Obamacare since its enactment. What will be the outcome? Republican legislators would probably be loathe to repeal the legislation without meaningful replacement health care enactments. Twenty million people, previously without health care insurance, are now insured because of Obamacare; the pre-existing conditions obstacle to health care insurance is now history. Depriving the previously uninsured of their health-care coverage would seem to be a singularly self-destructive political act. Thus, as for healthcare in general, it is too early to make a judgment about stock market effects.

Even Mr. Trumps' most radical policies, if enacted, will not derail America's strong and resilient economy.

Core's investments. Although I had expected that Hillary would be our next president, uncertainty argued for a fairly conservative stance going into the election. As noted above, we sold clients' remaining position in long-term US treasury bonds after the election. The proceeds will be held in cash, on the notion that there are likely to be some very volatile trading days ahead of us as the world adjusts to the notion of President-elect Trump. It will be remembered that Mr. Trump often presented himself as thin-skinned when criticized and he startled all of us on many occasions in this last year. Although in the closing weeks of the campaign, he appeared to stick to the script and despite a circumspect post-election speech, there is no terribly convincing reason to believe that the volatile Mr. Trump is finished surprising us. His surprises are likely to trigger some wild days in financial markets.

A perspective. As noted, I supported Hillary Clinton and am disappointed in the outcome. Let us remember, though, that the United States has durable democratic institutions that have thrived over generations and through serious crises. It is possible that Mr. Trump, who has demonstrated political skills, may also reveal a capacity for governing well. More important, though, is the strength, success and resilience of the American economy. Mr. Trump may pursue policies detrimental to the economy, including the threatened imposition of tariffs. The American economy and our political institutions are strong enough to overcome the effects of poor policies. America's economic success will continue and investments in American assets will also be successful.

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