

CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

September 29, 2017

The Quiet and Productive Year Continues

As autumn begins and we enter the year's final quarter, the quiet in markets and the fairly steady, if gentle, upward march in asset prices persists. This has been an unusual year: politics has been contentious and volatile, through the unstinting efforts of our provocative president, while financial markets have been placid, quite undisturbed by threats of from North Korea and general political noise. My recent letters could be repeated here with little editing.

The American stock market has continued to push to new highs every few weeks, including today, and European stock markets have been stronger still. Japan, where we also have investments, has been a bit weaker but still productive. We noted in *Core Comments* several weeks ago our surprise about the strength in the euro. It has drifted about two percent higher since I offered my prediction that the dollar would reassert itself. I still expect the dollar to resume its advance, interrupted early this year. So far, happy economic growth in Europe has outweighed the effects of diverging central bank policies. The Federal Reserve has four times raised the short-term interest rates and has announced that in October it will begin to reduce the securities it holds on its balance sheet. By contrast, the European Central Bank (the ECB) continues to buy securities ("Quantitative Easing") and to expand its balance sheet. It will probably be quite some time before the ECB raises rates, hence the difference between higher rates in the US and lower in Europe will most likely widen further.

A hoary old investing rule holds that one should not bet against central banks. So far this year, those who have bet on the euro and against central banks are ahead. For our part, Core has some of its European and Japanese stock investments hedged into dollars; some are unhedged, giving direct exposure to the euro and the yen.

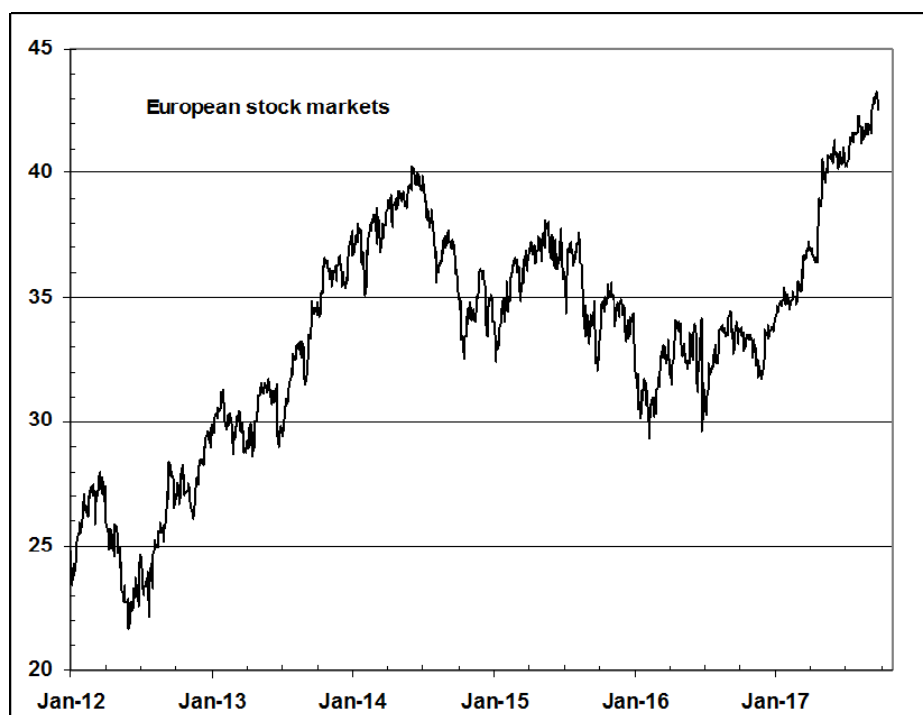
As expected, at last week's meeting of the Federal Open Market Committee, the Fed laid out its plans for slowly reducing its \$4 trillion dollar balance sheet, and it suggested that it would likely raise the Fed funds rate by another quarter percent at its December meeting. Slowly, carefully, and with full disclosure of its plans, the Fed is in the process of 'normalizing' its policies. Short-term rates will probably reach 3% and long-term rates will rise as well. At present, short rates are about 1% and the ten-year Treasury bond yields 2.32%. We can expect both to rise in the coming year to 18 months, implying lower bond prices.

By

Jack Mayberry

With economic growth steady, inflation well contained, and corporate profits growing, we can expect further gains in stock prices in the US. Similar factors obtain in Europe. Hence, a somewhat greater than normal allocation to equities is in order; they are likely to do better than bonds over the next six to

The chart below shows an index of large company European stocks. After substantial losses from 2014 to 2016, European stocks have rallied sharply. In our view, further appreciation lies ahead.



twelve months. It is often observed that this is a quite long bull market in stocks and a long period, at least in the US, of economic growth. Does the longevity itself suggest that a recession and a bear market for stocks is at hand? Doubtful.

The German election. After Brexit and Trump's election, there has been well-warranted concern about the rise of populist, nativist, hard-right politicians in Western democracies. Earlier this year, fears for those issues in Europe were dampened by elections in the Netherlands and, especially, in France, where Emmanuel Macron was elected president by a decisive margin over Marine Le Pen. But in Sunday's German elections, Germany's AfD party became the first right-wing party to take seats in Germany's parliament since the Nazis. The pro-Nazi, anti-immigration rhetoric of the AfD gives rise to considerations of a 'Fourth

Reich.' Although Angela Merkel won her fourth term as Chancellor, her party and the Social Democrats both lost votes as compared to earlier elections. Perhaps the mantle of European leadership shifts to France and Mr. Macron, from Germany and Ms. Merkel

US tax 'reform.' We have written about the limited extent to which the market-friendly policies on which Mr. Trump campaigned have been realized—and how little that seems to have mattered to the stock market. Infrastructure spending and tax 'reform' have not come before Congress; the administration and Congressional Republicans have devoted their energy to attempts to strip the poor and the sick of medical coverage. But with the latest failure to 'repeal and

replace' Obamacare this week, Mr. Trump and Congressional leaders turn their attention to cutting taxes on corporations and rich individuals. Although Mr. Trump spoke about the proposed tax plans this week, information about its content is still limited. From what can be discerned, however, tax cuts would flow to largely to the rich and to big corporations. For example, owners of tax pass-through entities—partnerships, S corps, and LLCs—will now be taxed at 25%, whereas most such taxpayers have been paying 39.6%. State and local tax deductions are to be eliminated, hurting tax payers in states like California and New York. The alternative minimum tax, which has swept many rich taxpayers back onto federal tax rolls, is to be discontinued. Similarly, the estate tax, long in the sights of rich Republicans, will be kaput.

In presenting the tax plan this week, Mr. Trump made the point that it is about tax cuts, not tax 'reform.' His candor is welcome. The overall plan favors the wealthy and its likely effect will be to increase the federal budget deficit. Republicans have generally opposed higher budget deficits, especially when they are caused by spending to support the poor. In the realm of tax cuts however, fiscal conservatives are mute. Investment implications are favorable for stocks, less favorable for bonds. But, what will be the outcome? Can the Republicans in Congress and the White House actually enact what is proposed? This year's experience suggests otherwise.

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CORE ASSET MANAGEMENT

PO Box 1629
108 Caledonia Street
Sausalito, California 94966
(415) 332-2000 • (800) 451-2240
fax (415) 332-2151
www.coreasset.com
info@coreasset.com