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

August 7, 2023

How We Got Here…
...And Where We Go Now

The Reasoning. When 2022 came to its end, the Federal Reserve was in the midst of it monetary tightening campaign to bring down inflation. The short-term interest rates it controls directly had risen from essentially zero to the range of 4.25% to 4.50%. It was very clear that the Fed would continue to raise rates in 2023 and so it has. At the recent meeting of the Fed's Open Market Committee, it raised rates by a quarter of a percent to the range of 5.25% to 5.50%.

The stock market was very overvalued as 2022 began and susceptible to the adverse effects flowing from the Fed's monetary tightening. Indeed, the market fell in 2022. As measured by the S&P 500, it declined by 25% to its lows in October 2022. As 2023 began, the economy was showing signs that the Fed's actions were beginning to suppress economic activity. The Conference Board's index of leading economic indicators—indicators chosen to show how the economy will change in the months ahead—had fallen by year end for nine months. This decline, which has continued each month in 2023, suggested that the economy was slowing and that recession lay ahead.

Another indication that a recession lies ahead, a matter discussed in previous letters, is the so-called inversion of the yield curve. The typical situation is that interest rates on long-term debt are higher than on debt that matures soon. For example, the interest rate of the 10-year Treasury bond will almost always be higher than the interest rate on the 2-year Treasury. Since July of 2022, this has not been the case, the yield of the 2-year has been higher than that of the 10-year. The meaning of the inversion is that rising short-term rates, reflected in the yield of the 2-year, will cause an economic slowdown, during which slowdown long-term rates, as reflected in the yield of the 10-year, will fall. Since the mid 1970s, this yield curve has 'inverted' seven times, counting this one. After each of the previous six, the economy fell into recession. Moreover, there have been no recessions, except for those following the yield curve inversion. In fact, the present inversion of the 2s-10s yield curve is the deepest and the longest since the early 1980s, when Paul Volcker engaged in his extreme monetary tightening to bring down the sky-high inflation of the late 1970s. He succeeded in his inflation effort, but, in the process, caused the two recessions of the early 1980s.

By

Jack Mayberry

Into 2023. With this backdrop as the present year began, my expectation was—and it continues to be—that a recession lies ahead of us. My expectation was that the looming recession would do its usual, that is, bring the stock market down further and cause long-term Treasury bonds to rise in price and fall in yield. Core's investment positions reflected my views. So far this year, my thesis has not produced good results. After the failure of Silicon Valley Bank and others in

March, the Fed's response was an immediate injection of new funds to the economy, to forestall a bigger set of bank failures. And then came the new flurry of excitement around artificial intelligence, this time around the release of ChatGBT. These two matters caused stock markets in the US to rally sharply after mid March.

Where are we now? Last week Fitch, one of the three principal credit rating agencies—the other two being Moody's and S&P—downgraded the credit rating of the United States from AAA (the highest rating) to AA+. Fitch noted in May that it was considering this move. In 2011, in the aftermath of the Great Financial Crisis of 2007 to 2009, S&P downgraded US debt to AA+ and has kept it there. Moody's continues to deem US debt to be worth its AAA rating. Fitch cited America's governance problems as well as its rising debt for its downgrade. Similarly, S&P had noted these problems more than a decade ago. Things have not improved since S&P's downgrade. It is worth noting that at the time of S&P's downgrade, interest rates were at rock bottom and the Fed was keeping monetary policy loose. Not now. Although unsurprising, Fitch seems to have focused minds on America's problems, especially during this period of the Fed's extreme monetary tightening. The result was the stock market's decline last week while Treasury bond prices fell and yields rose.

Meanwhile, our former president has been indicted again, this time for the most serious matter, his attempt to stay in office after the 2020 election. He faces three trials in 2024 during the presidential election year. It is likely that Georgia will soon indict him for his attempts to interfere in that state's voting in 2020. Congress is in recess, without having passed the funding measures needed to keep the federal government functioning after the end of its September 30th fiscal year. With the tiniest of Republican majorities in the House and with more than a handful of quite far-off-the-compass renegades apparently willing to shut down the government, America's governance problems are hard to dismiss. I received an email yesterday from a friend referring to America as the Divided States. America's political divisions do not augur well for our governance nor for financial markets.

Against the reality of political problems is the seemingly relentless tide of money into America, its financial markets and its general economy. America is the cleanest shirt in the dirty laundry basket, as is sometimes said. An investor must balance these forces: A strong economy so far this year against the Fed's relentless monetary tightening. Domestic political dysfunction against America's enduring global strength and leadership. Having begun this year with portfolios oriented for a continuation of 2022's bear market, we have reshaped things to a neutral stance.

Of course, the financial markets will not reward us for neutrality. The task now is to adjust Core's portfolios as things develop. The present balance--high-yielding money market funds, a goodly allotment of Treasury bonds, and a mix of long and short equity investments—gives us scope and resources for the investment, the geo-political and the economic environments that lie ahead.

CORE Comments

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