

CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

April 17, 2019

The First Quarter of 2019... ...Does Not Look Like a Bear Market

As written in recent months, I have taken the investment position that the September high in the stock market marks the peak of the long-running bull market, that a bear market began then, and that economic recession is at hand. The action in the US stock market so far this year belies those assumptions, but the weakening economic reports support my views. After falling more than twenty percent from the September high to the Christmas Eve day low, the S&P 500 has risen by nearly twenty four percent and stands only one percent below that September high.

Slowly the stock market continues to advance. Slowly, the US economy continues to slow its growth.

The Fed's actions and its words. The Federal Reserve began to change its monetary policy in December 2015. In the years-long period after the 2007 to 2009 financial crisis and the Great Recession, the Fed lowered short-term interest rates essentially to zero and engaged in a stupendous series of Treasury bond and mortgage-backed securities buying sprees (called 'Quantitative Easing') by which it quintupled the assets it held from \$800 billion to over \$4 trillion. Despite these exceptional acts of monetary easing, economic growth after the Great Recession was only modest. Thus, it was not until December 16, 2015, while Janet Yellen was chair of the Fed, that it began to 'normalize' monetary policy, by lifting Fed funds from the range of 0% to 0.25% (at which it had stood for years) to 0.25% to 0.50%. Slowly and haltingly, the Fed began to raise short-term rates; in 2018, it began to reduce the assets on its balance sheet. After Mr. Trump's nominee for Fed chair, Jerome Powell took office, he continued and accelerated Dr. Yellen's policies. Thus, at the December 2018 meeting of the Fed's Open Market Committee ("FOMC"), it raised Fed funds by one-quarter percent for the fourth time in 2018 and, in Mr. Powell's post-meeting press conference, he declared that the shedding of assets ('Quantitative Tightening,' I suppose) was on 'auto-pilot.' Within a few days of very sharp selling, the stock market reached its Christmas Eve low, twenty percent below the September all-time high.

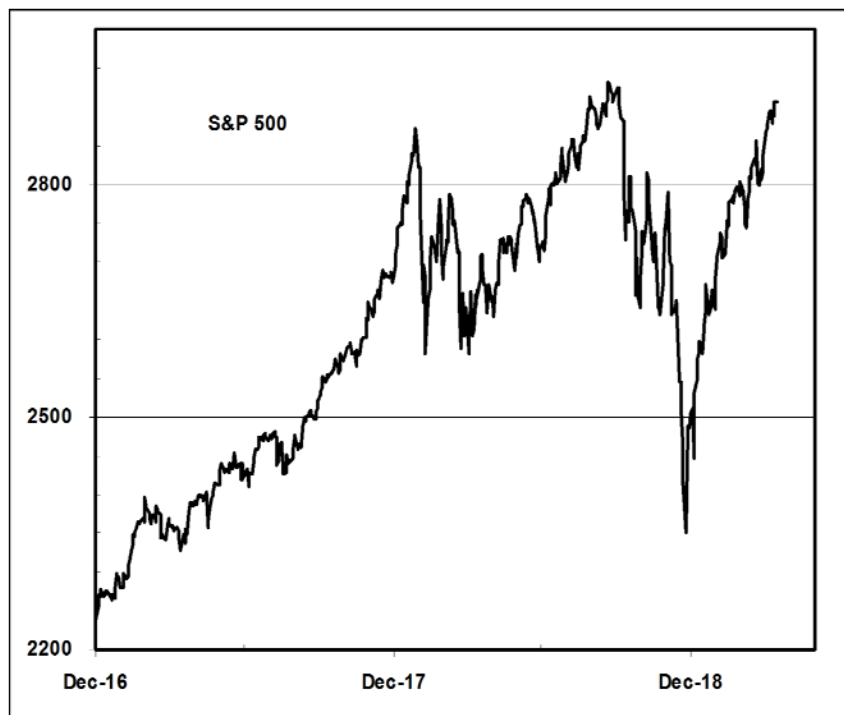
The market's rebellion and the distinct weakness in key parts of the US economy caused Mr. Powell's Fed to reverse course almost immediately. Beginning early in January, Mr. Powell and other key Fed governors assured the markets that it would 'pause' its 'normalization' and monetary tightening. At the late January meeting of the FOMC, the press release made it clear that the Fed had ended monetary tightening, at least for the time being.

By

Jack Mayberry

Other Central Banks. The Federal Reserve Bank is by far the most important central bank in the world, although the Bank of Japan and the European Central Bank loom large. Because the US economy has been stronger than Japan's or Europe's, the ECB and the BoJ both continued extraordinary monetary easing after the Fed began to tighten policy in 2015 and, indeed, had not begun to tighten be-

The chart below shows the movements of the US stock market in the last couple of years, featuring the January and September 2018 highs, the sharp decline last autumn and the recovery so far this year.



fore the Fed's January about-face. Some other central banks had begun modest measures to tighten policy, but, as soon as the Fed indicated its 'pause,' those banks either reversed to monetary easing or themselves 'paused.' Thus, none of the world's major central banks is now tightening policy.

Central bank actions fully explain this year's early stock market recovery. Now what? Once again, one must point out that the Fed's actions give effect to the economy with a significant lag in time. Thus, despite the ebullience evident in the stock market's rise this year, the economic results of the Fed's three-year period of monetary tightening are yet fully to be realized. Fed tightenings preceded all of the following: Penn Central's collapse and the early 1970s recession; Franklin National and the mid-

-1970s recession; First Penn, the Latin America debt crisis and the early 1980's recessions; the savings and loan crisis and early 1990s recession; the Asian crisis, Russia's default, Long-Term Capital Management's collapse, the dot.com bubble burst and the early 2000s recession; and the US housing and mortgage crisis with the 2007 to 2009 Great Recession. (No Fed tightenings are excluded from this list: no false positives.)

Yield curve inversion. The other connected problem is the inversion of the yield curve. Under normal circumstances, the yields of long-term bonds exceed the yields on short-term paper. This is reasonable, given the risks that may unfold during the life of the longer-term debt instruments. The yield curve is a graphic representation of the (usually) higher yields on debt securities of equal credit quality as their maturities increase. Beginning near the end of 2018, as

the Fed raised short-term rates, those short rates exceeded those of some longer-term paper. On March 22, 2019, the yield on three-month Treasury bills exceeded the yield on ten-year Treasury bonds for the first time since 2007. As the San Francisco Fed has pointed out, every recession of the last sixty years has been preceded by an inverted yield curve, and every inverted yield curve has been followed by an economic slowdown, and, except for one time, by a recession.

Corporate profits decline. The weakening economy has, in recent months, caused a significant number of public companies to report lower earnings and to project further declines. In an earlier letter, we noted that Federal Express, a major shipper of things in our economy, had issued a warning about prospective weakness. This report looks forward, not backward to previous strong results. FedEx is likely to be joined by many other companies with profit warnings as this reporting season unfolds.

And so, for now, I believe I am on the right side of the markets by investing your capital in bonds that will rise in price in our weakening economy and by avoiding stocks. I was wrong in the first quarter of this year about the direction of stocks, but I was right about the direction of bonds. We have all seen this movie before: the plot unfolds slowly, but, in the fullness of time, decisively. Core's client accounts earned modest positive returns in the quarter just ended. In my view, your accounts will continue to appreciate modestly and will avoid significant losses in the quarters just ahead.

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