CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

March 12, 2022

Two Weeks On

The third week of Russia's dreadful war against Ukraine has begun. The suffering and destruction is unimaginably awful; it appears that Ukrainians are putting up an extraordinary defense of their country against the cruel invasion. Given the large day-to-day swings in prices since the war began, I think it useful to write another letter discussing the effects on our investments and the prospects.

There are four shocks to asset markets unfolding now. First, inflation is higher than in decades. Last week's report described conditions before Russia's invasion, that is, before the additional increases to oil and food prices. Increases in prices for gasoline, heating oil, and food act as a tax on individuals and cause many people to cancel or defer other spending. This impinges on demand and slows the economy.

Second, the stock market losses already incurred, e.g., 13% for the S&P 500 and 21% for the Nasdaq, have decreased the wealth of investors. As things get worse in the stock market, as is likely, the shock will be worse.

Third, the horrific geopolitical shock unfolding now in Ukraine has raised the uncertainties and fears enormously. Mr. Putin's threats, including the use of Russia's nuclear arsenal, the example of his historical use in Chechnya of blistering attacks on civilians, and the reckless attacks in Ukraine's nuclear facilities pose worse outcomes than we have observed in the first two weeks of the war.

Fourth, the plans of the Federal Reserve, as reaffirmed by Fed chair Jerome Powell in his recent Congressional testimony on March 2nd, after the war began, will certainly depress demand in the interest of reducing inflation. Mr. Powell asserts that the Fed will raise interest rates, will cease buying Treasury bonds and mortgaged-backed securities, and will reduce the assets on its $9 trillion balance sheet. Fed interest rate increases almost invariably lead to recessions. (In its twelve rate-raising episodes since the 1950s, recessions followed eleven times—the exception was in the early 1990s.) Recessions always involve significant stock market declines of at least 20 percent. The average decline in recent decades has been 36 percent. A return to the long-term averages of stock prices to in relation to earnings would bring about a decline of more than 50 percent from the very elevated levels that prevailed at the start of this year.

By

Jack Mayberry

Core's investments are aligned with the likely outcomes, namely a weakening economy and a bear market in stocks. We have maintained our large investments in long-term Treasury bonds, high-grade US corporate bonds and gold. As to the former two, the returns are negative this year, less so than stock mar-

kets, but negative none the less. However, long-term Treasuries have always generated positive returns in the recessions of the last sixty years. If the Fed is to bring inflation down to its target levels around 2 percent, it will only be able to accomplish this by crushing demand--unless it has the tools for planting and harvesting wheat and increasing oil production in American. Crushing demand will cause a recession and will cause deepening stock market losses. This will lead to higher prices for our Treasuries and our high-grade corporate bonds.

The dreadful war itself that is already causing higher oil and food prices will continue to drive investors to safe-haven investments. Gold, a large holding for Core's clients, has been a primary beneficiary of the flight to safety occasioned by the war, already up by more than 8 percent this year.

Core has retained its investment in American utilities. Utilities are down very slightly this year, but represent the kinds of investments that we can expect to outperform the stock market in times of high inflation and weakening economies. Payments to utilities companies that provide the electricity and oil for our homes are hardly the kind of discretionary spending that hard-pressed consumers can forego.

These days, the world is a dangerous place and asset markets reflect its dangers. Two years ago, as the plague was emerging, rewards were handed out to those taking investment risk. Then, the Fed offered the strongest imaginable tailwinds. Now, alas, those Fed tailwinds have reversed and we face headwinds. Similarly, the Trump administration and the Treasury department showered America with fiscal largesse in 2020. That process continued in the opening months of Biden's administration. Twelve months ago, the federal government passed the cookie jar once again. Fiscal handouts are now in the rear view mirror. In this new environment of a very dangerous war, of monetary tightening by the Fed and of sharply shrinking Federal spending, the likelihood of strong equity markets is slim, very slim. Because of this, the investment portfolios that Core supervises are conservative in structure.

There are plenty of able investors who now suggest that, after the selling that has already occurred, it is time to load up once again. By contrast, we are being guided by the advice of Nathaniel Rothschild, who is said to have declared that he became rich by buying too late and selling too early.

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