

# CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

November 25, 2019

## Disjunction

The disjunction between economic reality and stock market prices becomes more remarkable by the week. While America's economy and the global economy are weakening persistently, stock markets, including America's, have risen substantially in recent weeks. What accounts for this? First, a look at the economy, then to stock markets.

*The stock market expresses hope. The bond market deals in reality.*

*While the economy has weakened over the months, the hopeful mantra has been that we are in an economic 'bottoming process.' Maybe.*

*The Federal Reserve and the world's other major central banks are loosening monetary policy in a determined way. The central banks observe the economic weakness and try to ameliorate things. Stock investors bet that the central banks will be successful. But between here and the ultimate success of central bank efforts looms a precipice.*

*For Core's investors, I have decided not to fall into that precipice.*

### How fares the economy?

For 21 consecutive months, leading indicators of the global economy have weakened. In the US alone, leading indicators have declined for 17 consecutive months. For much of this year, the industrial and manufacturing sector of the US economy has contracted. Corporate profits of the companies in the S&P 500 have declined for three quarters in a row and the likelihood is that there will be a further decline in profits in the final quarter of 2019. Consumer spending, which comprises the largest part of the US economy, has been positive so far this year, keeping the US from falling into recession. The monthly employment figures have shown growth in non-farm employment. But, as shown by the US Bureau of Labor Statistics in its monthly JOLTS report (Job Openings and Labor Turnover Survey), layoffs have increased while job openings, hires, and voluntary quits have fallen. Voluntary quits by employees are a meaningful measure of the robustness of labor markets: if people are willing to quit a job, this probably results from a perception that a better job is available. Voluntary quits fall when workers expect a worsening chance of getting a better job. Wage growth has also declined; declining wage growth invariably leads to lower consumer spending, a matter well documented in recent reports. The economy is slowing.

### What impels the stock market higher?

**Stock buybacks.** The US economy has expanded since 2009, when the Great Recession ended. This has been a long-running expansion, but a weak one. Moreover, the expansion has been accompanied by an enormous increase in the indebtedness of companies such that the level of corporate debt has never been higher. Much of the borrowing has been used to repurchase stock. That is, public companies have borrowed at the very low interest rates that have prevailed in recent years and used the proceeds of the borrowing to buy back their stock. Shrinking the numbers of shares outstanding has the effect of increasing a company's earnings per share. The poster child for share buybacks is Apple, which bought more than \$50 billion of its shares in the first three quarters of this year. Over the same period, its total earnings were declining from year-earlier levels. But, with the fewer shares outstanding, its stock has appreci-

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ated significantly this year.

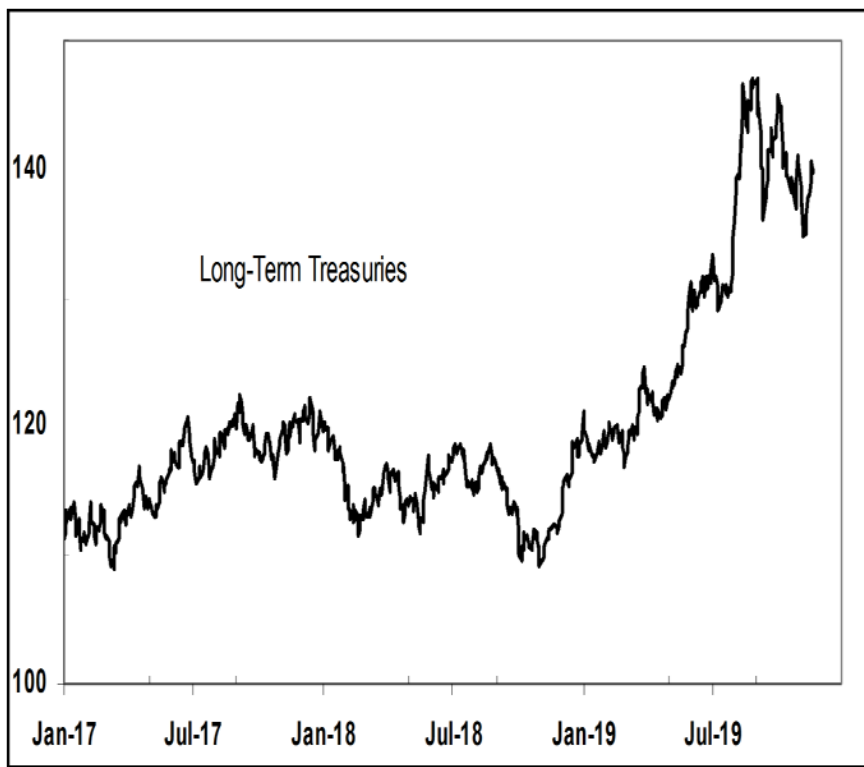
*The chart below, showing the prices of long-term US Treasury bonds over the last three years, shows that the Treasury market foresaw the weakening economy and foresees the coming recession. Treasury bond prices rise when the supply of credit exceeds the demand for credit.*

*A company does not need to borrow to expand production when the demand for its products falls.*

Apple generates an enormous amount of cash and, although it also borrows, it maintains net cash (total cash less total debt) of over \$100 billion. Given its huge earnings, it can still pay large dividends and repurchase shares while it engages in substantial capital spending and research and development. Few companies have the financial strength of Apple, so, as corporate profits fall and the broad economy weakens, we are very likely to see companies fail to meet their interest and debt repayment obligations. At the very least, the need to meet debt obligations is likely to reduce the level of stock buybacks upon which the US stock market has come so much to depend.

**The Federal Reserve.** Apart from stock buybacks, the Fed's actions this year have supported the stock market. As discussed in earlier letters, the Fed's monetary tightening cycle from 2015 to 2018 probably went too far, as shown by the deep and swift market sell off in the fourth quarter last year. And, as also discussed,

the Fed's actions on the economy act with a significant lag. But, there is not such a lag with the stock market and, when the Fed did a 180-degree turn after its December 2018 meeting, the stock market accepted the strong Fed tail wind and rallied. Apart from its three cuts in the Fed funds rate in its last three meetings, the Fed suddenly announced in September, in response to ructions in the bank inter-lending market, that it was buying vast amounts of short-term US Treasury bills. In the twelve weeks since, it has purchased some \$280 billion of T-bills, an astonishingly large sum. This is not, we are told, a resumption of 'quantitative easing,' but it is certainly a close cousin to it. Thus, although the economy is still weakening and may well weaken further, the Fed has let stock market participants know that it 'has their back.'



### Core's investments

Despite the recent stock market rally, Core has continued its holdings in long-term US Treasury bonds, in gold and in cash, while avoiding stocks. Although the Fed and the massive stock buybacks have buoyed the stock market, the bond market continues to express the weakness in the real economy and to suggest that a recession lies ahead. The chart above shows the price action in long-term Treasury bonds. The bond market knows that a recession is coming; to the extent that the stock market paints a different picture, I'm sticking with bonds. The bond market is usually right.

When the recession comes, stocks will certainly fall, probably swiftly and sharply, while Treasuries and gold will retain their value or, more likely, appreciate further. At this very late stage in the economic cycle as the economy continues to sputter, preservation of capital is of paramount importance.

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