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

July 14, 2009

Economic Weakness Persists

Economic growth may not begin soon and will likely be tepid for a long time.

Despite poor economic prospects, investment markets are likely to be well higher in a year and two than now.

A terrible employment report for June, in which job losses were far greater than expected, may mark a significant sign post in our long financial crisis and economic recession. There had been hopeful signs that the recession was coming to an end and that the rate of economic decline was slowing. But the jobs report and other recent economic reports suggest that the recession is still severe. Economic recovery may not begin in this third quarter, as has been expected by many. It is almost certain that the recovery in the US, when it does begin, will be weak. Creation of new jobs and a decline in the unemployment rate may be quite far off. If job losses continue, it is likely that mortgage foreclosures will continue and housing prices will fall further. It is hard to envision strong consumer spending and an improving housing market when more people are losing jobs and wage growth is stagnant.

In Saturday's Financial Times is an interview with Lawrence Summers, the former Treasury Secretary and now the director of the Obama administration's National Economic Council. Of the recession, Summers said:

"I don't think the worst is over ... It's very likely that more jobs will be lost. It would not be surprising if GDP has not yet reached its low. What does appear to be true is that the sense of panic in the markets and freefall in the economy has subsided and one does not have the sense of a situation as out of control as a few months ago."

This comment suggests that (1) the risk of collapse of the global banking and financial is far less than last autumn and winter, (2) we appear not to face an economic *depression*, but (3) we still face the consequences and risks of our severe *recession*. Quite appropriately, there is discussion about the need for another package of spending to stimulate the economy.

By

Jack Mayberry

As an investment matter, things are more clear and, indeed, more promising. The strong, three-month rally in stocks, commodities and other 'reflation' assets ended in June. That rally began in March, when fears of collapse were acute. At that time, asset prices reflected the fears of banking collapse and global economic depression. As those fears receded, prices of investment assets improved. Now, prices for bonds, for stocks, for commodities, and for commercial real estate reflect, it seems to me, the severe economic recession in which we find ourselves. Prices do not yet reflect economic recovery, weak or strong, that surely lies ahead. Hence, it is quite reasonable to expect that prices for all these investment assets will be higher in a year and more than they are now.

Bear markets, whether 'normal' or very severe--no bonus points for guessing which this one is--are characterized by a sequence of sell offs and rallies. In this bear market that began in the autumn of 2007, we have had a series of lows, each lower than the previous one, in January, March, July, September, October and November of 2008, then in early March 2009. It usually happens, and it probably will again in coming months, that the ultimate low price for the bear market (now March 9, 2009 at 666 on the S&P 500) will be 'tested' again. If this upcoming sell off does not reach the previous low (our 666), then it will be a fair bet that the bear market is over, and a new bull market is underway.

Given the forceful actions by the Federal Reserve Board and the Treasury, their determination to prevent collapse of the system, and the recent ability of banks to raise large amounts of capital in the private markets, it seems likely that the 'Armageddon low' (if we can call it that) in early March really will prove to be the low point for the bear market. The banking and financial system will not fail. It seems likely, in the coming months, that stocks, low-grade corporate bonds, commodities and foreign currencies will fall back toward the March lows. When and if these various investment assets 'pass the test' and remain at higher levels than their March lows, we may, with some confidence, invest rather aggressively and buy the 'reflation' assets. This is our plan, and we expect a very favorable outcome.

The chart on the front page shows the course of the 2000 to 2002 bear market, and this one that began near the end of 2007. This bear market appears to be coming to an end.

Allow me to remark that this is 'our plan' now, and it is based on assumptions outlined above. Predictions about the economy and the financial markets are easy to make, but the outcomes are not certain to be realized in the ways predicted. We have our eyes open to reality as it unfolds and we will certainly adapt our plans to what really happens.

Housekeeping items. As you may imagine, Schwab has a business division dedicated to investment advisors like Core and their clients. We deal with Schwab on a daily basis (usually several times a day) on a range of issues; a team of people is assigned to deal with Core. Schwab also has a group, called Schwab Alliance, for the clients of investment managers. If you wish to contact Schwab directly, rather than through us, we suggest that you call this group at 800 515 2157, or by the internet www.SchwabAlliance.com. We suggest, however, that it will probably be more efficient for you to call or email us, and let us intervene with Schwab on your behalf. We can obtain quick and reliable answers and, of course, we can help you accomplish what you are seeking to do with Schwab. From time to time, we hear from clients about problems they have when they contact Schwab directly through an Schwab's regular 800 number for 'retail' clients. It is not a knock on Schwab to remark that not all of these exchanges are satisfactory to those who call in. Rather than practicing your skills with call centers, we suggest you enlist our help. You pay us to manage your capital; you also are paying us for our help in administrative matters relating to your investment accounts. Please call on us, if you wish.

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On another matter, Schwab recently sent a notice to some of Core's clients about a security held in accounts Core manages, called the Eaton Vance Tax-Managed Global Income fund, symbol etg. Schwab told its customers who hold this in a margin account that etg is no longer 'marginable. This is not relevant to us and it does not bear on the investment merits of this security. We almost never use margin, that is, the borrowing of money to make investments. When we do it, we only do so after a direct conversation with the individual account owner.

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