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

March 24, 2009

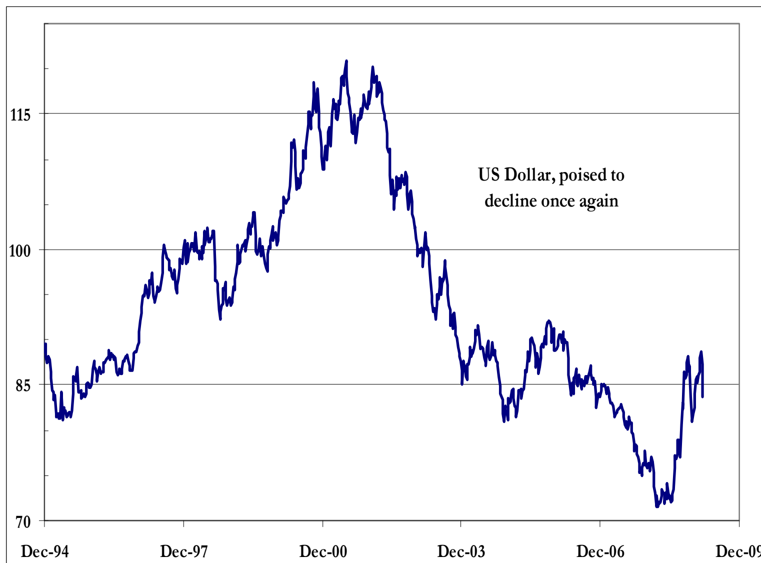
The Fed and the Treasury Roll out Bigger Artillery

The Fed and the Treasury are acting forcefully and effectively to restore the banking system and revive the economy. Their efforts will bear fruit.

One outcome of the Fed's efforts to reflate the economy is the resumption of the dollar's long-term decline. We have begun a slow move back into foreign-currency investments.

The spirited stock market rally from its 666 low in the first week of March is welcome, but unremarkable. The distance from that low to its high Monday at 823 amounts to a rally of 24 percent. Bear markets produce sharp, swift and fleeting rallies. In November, after the (first) Citibank low, the market rallied 26 percent to its high in January. After the October 10 low, the market rallied by 24 percent in *two sessions*. The present rally, now in its third week, may carry further. As we write on Tuesday evening, this seems likely.

More remarkable than this rally was the Fed's announcement last week of the enormous expansion of its balance sheet. The Fed will purchase $300 billion of US Treasury notes and bonds in the next six months, an additional $750 billion of mortgage-backed securities, and another $100 billion of debt of Fannie Mae, Freddie Mac and other federal agencies. These actions are designed to reduce the risk of debt deflation and to spur economic growth. Monday's articulation by Treasury of its joint public-private program to aid the balance sheets of the banks burdened by holdings of impaired mortgage securities demonstrates its co-ordination with Fed actions. These acts will hasten the re-emergence of private capital for the banking system.



Their likely impact on the economy and investment markets is straightforward: They will bring closer the day of economic growth and the restoration of a functioning and reasonably capitalized banking sector. The risk of deflation remains serious. Although housing prices will decline further and the job market will worsen, the actions by Treasury and the Fed will almost certainly shorten the recession and hasten the recovery.

Reflation of the economy is now in prospect. With economic recovery will enter its attendants: dollar depreciation and the appreciation of many investment assets. Among these are low-grade bonds, equities, commodities, and commercial real estate (REITs).

By

Jack Mayberry

The ongoing efforts of the Fed and Treasury bring closer the day that marks the bottom of this dreadful economic recession, the horrific collapse of the banking sector, and the ferocious bear market in stocks and commodities. But, as it seems to us at Core, economic recovery and the bull market still lie

in the future. While we are planning the investments that will prosper as things recover, we are treating this welcome rally in stocks as the opportunity to sell certain equity positions that we still retain. We fear that short-term risks remain large.

The rush into US Treasury bonds and bills by foreign and domestic investors is abating. The dollar will fall as the Fed succeeds and the crisis subsides.

The process of recovery--in the economy, in the banking system, and in investment markets---will take time, but it has begun.

The dollar. As the graph on the first page shows, the financial crisis of 2008 reversed the dollar's years-long decline and caused a tremendous rally since last summer. (One of our best, but quite invisible, investment moves last year was the closing of all of our foreign currency positions before the stampede to the dollar began. The investment action was invisible because we measure our investments in dollars. Thus, if we avoid dollar losses by closing our euro investments, for example, the losses avoided don't show up anywhere. However, if we had kept our once-large foreign currency investments, you would have seen the losses.)

For various reasons, as the crisis unfolded, demand for dollars rose enormously, as US investors (ourselves included) repatriated capital from abroad and foreign investors sought the safety of US treasury bills. These flows are reversing. In January, net foreign purchases of US treasury bills turned negative, while US investors became net buyers of foreign securities. The Fed's aggressive action to drive down interest rates on US bonds will likely strengthen these very new trends and push capital away from the dollar. We are probably in the early stages of the dollar's next move down. We made an initial foreign currency investment today by buying a small position in a euro-denominated short-term fixed-income fund. Last week, we made a small investment in gold, via an exchange-traded fund, when gold traded below $900 per ounce. This is a dollar depreciation investment, as well. We foresee resuming our investments in other assets favored by a falling dollar, including other commodities and commercial real estate.

Our view of the world is consistent with our recent letters: The economy will recover and the banking and credit system will be repaired. But recovery has not yet begun and more pain lies ahead. More jobs will be lost. Housing prices will fall further. More mortgages will fall into default or foreclosure. More mortgage-backed securities, now held by banks, will lose value. More banking losses will be recognized. The actions by the Fed last week and the Treasury's announcement this week lessen the likely severity of these problems and shorten the duration of the pain. However, Fed Chairman Bernanke and Treasury Secretary Geithner both are quite forthright in their recognition of the likely persistence of the problems.

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Investments after bear markets. It is not a novel insight to remark that this is a terrible economic recession and a wicked bear market for almost every imaginable investment asset. Our letters discuss our efforts to preserve capital in the still risky environment that lies directly ahead. It is worth raising our sights from the abyss immediately before us to consider what lies on the other side. There is good data about stock markets in the United States, Britain, Europe from the middle of the nineteenth century. Financial panics, deep recessions and grinding bear markets have been a recurring feature in these countries in the last century and a half. The history of the aftermaths of these gives reason to cheer now. The best returns for investors have come after the worst bear markets have run their course. History suggests that, from the very low valuations that prevail now for so many investments, we will enjoy an extended and very profitable investment period.

We are prepared to begin buying. We have a full roster of proposed investments and a view of what the next cycle of recovery and expansion will offer to us. This very difficult period will yield to one of significant reward for careful and patient investors.

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