CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

June 29, 2023

All Clear?

The debt-ceiling matter was resolved in an unremarkable and quiet way. The March bank failures of Silicon Valley Bank, First Republic and Credit Suisse appear not to have morphed into further rounds of banking disaster. Last weekend's march on Moscow by Yevgeny Prigozhin has, so far at least, caused little more than a ripple in financial markets. So, clear sailing for the markets? Perhaps. Perhaps not.

Japan. There certainly are fine investments to make and to hold. Japan is the primary example. For years since its stock market bubble burst in 1989, Japanese stocks have struggled and lagged far behind US stocks. Japanese companies were known for hoarding the cash they earned, instead of returning it to shareholders via dividends or stock buy backs. Japan suffered off-and-on deflation for decades. In the last decade, then prime minister Shinzo Abe put in place various tools to change all this. Although he is no longer with us, his successor Fumio Kishida continues his work. The period of Japan's lagging US stocks appears to be over. And Japan's prospects are favorable. The price-to-earnings ratio of Japanese stocks is far lower than that of US stocks, as is price-to-book value. Japan's companies are cash rich and, in its new environment, have ample scope to close the gap with US valuations. Moreover, Japan's economy is growing faster than is ours; its companies are raising dividends and engaging in stock buybacks at record rates.

Last month, Core began to build a position in Japanese stocks, one that shows a good gain already. If the Japanese stock market should fall substantially, our plan is to increase our investment in Japan.

At home. Things may be less happy in the United States. The much-anticipated recession has not yet been announced, but, if it has not already begun, it almost certainly lies a short distance ahead. Yesterday, Fed chairman Jerome Powell, on a panel with the heads of the other major central banks, suggested that the Fed will raise rates two more times, on the notion that inflation has still not fallen as the Fed wishes. The rise in rates since March 2022, when the Fed began its latest round, has been historically fast. Most forward-looking measures of inflation show it coming down rapidly, but the Fed cites backward-looking and contemporary economic data to justify its ongoing monetary tightening. The index of leading economic indicators (the LEI)—indicators designed to project future economic activity—are published monthly. The LEI has fallen in each of the last fourteen months. This has happened only twice in the last sixty years. In each of those instances came recession. So as not to bore readers with more specific reports, I simply assert that many measures of economic activity demonstrate economic weakening.

By

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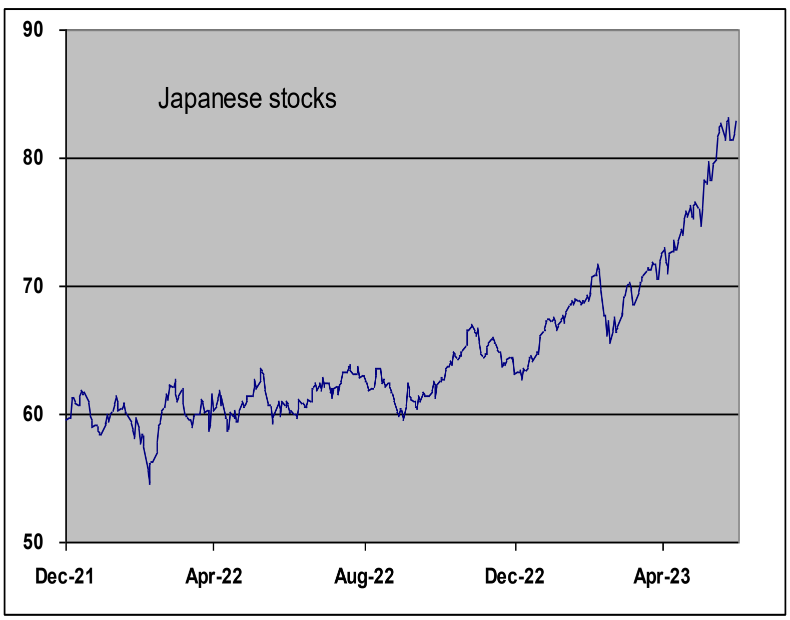
The chart below shows the dividend-adjusted return of the Japanese stock fund we hold. It did better than US stocks during the early stages of the bear market and has far out-gained US stocks in the recent rally.

The stock market has largely ignored such reports, instead focusing on the shiny new thing, artificial intelligence (AI) and ChatGBT. By far, most of the gains in the stock market this year have come from the very large tech stocks, Microsoft and Nvidia, for example, that are engaged significantly in AI. AI is hardly new this year and its promise is certainly meaningful, but the attention it has received has concentrated buying in a handful of stocks.

The narrowness of this year's rally is not the stuff of an enduring bull market. Instead, it has been an interruption in the bear market that began in January 2022. As I write, the rally from the October low in the market has been 43% as measured by the Nasdaq. A lot. Note, however, that in the dot.com bear market, of 2000 to 2002, the Nasdaq fell by 78% in total. Along the way it had counter-trend rallies of 41% and 32%. Results in the 2007 to 2009 bear market, accompanying what we now call the Great Financial Crisis, were similar. The strength in the small number of huge tech stocks is a misleading measure of the underlying direction and underlying strength of the stock market. A stock market led higher by an ever-narrower group of companies is not the characteristic of a rally that will endure.



The problems in commercial real estate, addressed in previous letters, persist. More and more property owners are 'handing back the keys' to their lenders. As for the lenders, the process of 'extend and pretend' is wearing thin. As lending rates continue to rise, it is ever harder for the lenders to 'extend' the terms of borrowing to property owners and to 'pretend' that things will work out. In New York City, in San Francisco and across the country, the work-from-home phenomenon has emptied office buildings even as the pandemic reasons for it are no longer salient.

Given that we are earning 4.81% in the Treasury money market fund in which we have a large investment, given that there is <u>no</u> risk in that investment and given that its yield will rise further as the Fed continues to raise short-term rates, we think we can wait to deploy those cash reserves. Our portfolio holdings in Japanese stocks, in long-term Treasury bonds, in gold, in the oil-pipeline ETF and in cash offer a very good balance of reward and safety in this market.

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