CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

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As Things Turn

By

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The strong stock market rally that began in October and continued into the early months of this year is slowing markedly with suggestions that a reversal is at hand. As a consequence, Core has reduced its investments in stocks and taken a modest-sized position in a security that will rise in price if the broad stock falls. The reasoning is that by the end of the intense rally from Octobers lows, stocks had risen by about 28 percent (as measured by the S&P 500) to their late-March highs, while underlying corporate earnings had barely budged. Hence, stocks had become much more expensive and much more vulnerable to adverse conditions.

And, adverse conditions exist. Consider interest rates: As the year began, the expectation was that the Federal Reserve, having raised interest rates considerably in the fifteen months to July 2023, would lower rates by one and one half percent during 2024. (Given that the Fed, except in the most unusual circumstances, raises or lower interest rates by one quarter percent at a time, the one and one half percent increase implied six moves during the year.) The rate of inflation had been falling steadily throughout 2023, but, in the first three months of this year, it turned upward again. Meanwhile the labor market in America appeared to be quite strong, surprising many observers. The Fed's dual mandate involves inflation and the labor market. In the opening months of this year, both restrained the Fed's impulse to begin to lower rates and loosen monetary policy. In recent weeks, the expectation of six rate cuts melted to just one.

Ongoing economic reports--on inflation, jobs, retail sales, consumer confidence, and rates of overall economic activity--change these expectations almost on a daily basis, but the clear trend this year has been for interest rates to stay 'higher for longer.' Thus, the valuations of stock prices measured against interest rates turned quite negative by the end of March. Although excitement about artificial intelligence has propelled the earnings of a handful of stocks considerably higher (including Nvidia, which we own), the effect does not extend through the broad market. In fact, by a significant number of indicators, stock prices had reached levels of excessive valuations by the end of March that only had been exceeded on a small handful of occasions. Those occasions all preceded significant stock market declines. Hence, Core reduced stock market positions.

The high level of interest rates is fine for our holdings in money market funds that provide a meaningful after-inflation rate of return. But the expectations of 'higher for longer' do not help our long-term Treasury bond investments. This investment has declined in price this year, but we are being paid to continue to hold this and wait for the Fed to reduce rates. The dividends paid on this investment also exceeds the rate of inflation, so we can be patient while we wait for the Federal Reserve to ease monetary policy.

Gold. Meanwhile our investment in gold has risen by more than ten percent this year. The geopolitical problems—the wars in Ukraine and in Gaza and the hostility between America and China—raise the risks to which gold generally responds positively, as it has this year. The uncertainties in America, with protests and police action on a number of important universities and with the upcoming and divisive general election in November, also contribute gold's advances. Most importantly for gold has been the large-scale increase in gold purchases by central banks in China and other countries. After Russia's invasion of Ukraine in 2022, America and Western European countries immediately sanctioned Russia in various ways. Among these was the freezing of Russian government assets in the United States in Europe. Russia has been denied access to nearly one half trillion dollars of Russian reserves held in European and American financial accounts. These sanctions seem to have persuaded a number of countries to switch the investments of their reserves from US Treasury bonds and the like to gold. Usually gold declines in price as US interest rates rise, in large part because one does not receive dividends from holding gold. The price increases in gold in the recent couple of years run contrary to that pattern, suggesting that geopolitical tensions may count for more now.

Japan and India. We have held successful investments in Japan and India; Core reduced those positions in our process of lowering equity risk. Japanese stocks have appreciated greatly in the last year and, although its prospects remain good, it had become riskier as its stock prices grew so fast. India presents less of a case of overpricing, but I also chose to reduce our holdings of that security in the process of lowering our equity holdings.

Where from here? In the long run, of course, American stock prices rise. That will continue. But, in the course of the long run, there come punishing declines of thirty to sixty percent or more. Consider 1987, 2001-2002, 2007-2009, the pandemic and lock down bear market of 2020 and the 2022 selling from January until October. Sometimes brief, as in 2020, sometimes extended as in 2007 to 2009. As these unfold, one cannot know how they will resolve themselves. We only know that after the fact. Stock prices increased to unusually excessive valuations earlier this year. How this round plays out is unknowable now, but reducing risk, after a nice run in our portfolios, seems useful.

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