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

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"They Call it Stormy Monday…"

By

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As warning signs of a weakening economy and a highly priced and vulnerable stock market became evident over recent weeks, Core reduced at-risk positions, including by selling another third of our original position in Nvidia. The reckoning has arisen from Japan, from the very highly priced stocks involved in artificial intelligence ("AI") and from weakness in employment, with the concomitant notion that Fed is, once again, quite far behind the curve. I will take these one by one, beginning with the Fed.

Is the Fed behind the curve again? Yup. When inflation began to rise in the aftermath of Covid--with its supply chain disruptions and Federal government largess in handing out big checks to ameliorate hardships of Covid lockdowns—the Fed took the position that inflation was 'transitory.' Indeed, inflation was 'transitory,' but it lasted longer than would be expected from a 'transitory' event. But, as is quite clear now, inflation is no longer an issue; it continues to decline. Indeed, deflation, not inflation, may now become the problem. There are three states to price level changes: Inflation connotes rising prices; disinflation connotes a slowing rate of price rises; deflation connotes falling prices. After the persistent and rising inflation levels, the US economy settled into a steady process of disinflation, such that the Consumer Price Index (year over year rate of change) has fallen from a rate of 9.1% in June 2022 to 3.0% in June 2024.

Well and good on the inflation front—although we are all paying more for everything than we paid not long ago. (Inflation is a rate of change in prices, not a measure of the level of prices. That is, if inflation rates decline, as has been happening, it does not mean that prices are falling. It means that the rate of increase in prices is slowing. Deflation means prices are falling.) Whereas the sellers of goods to us happily raised prices during and after Covid days, now price increases do not work. Many people find that they can ill afford what they used to be buying and, as many retailers glumly report, people are 'trading down,' that is, spending less for high-priced goods and buying lower-priced goods.

The inclination to buy fewer of highly-priced branded goods and less frequently to eat out, even at McDonald's, reflects worsening employment and earnings. Last week's disappointing jobs report demonstrated this for all to see. The markets' reaction was swift and pointed: bond prices rose decisively; stock prices fell. After a weekend to think about it, investors continued to express their expectations of slower growth. Thus, on Monday stock prices fell sharply around the world, while bond prices rose further.

And then, Japan. Japan is the world's third biggest economy and a very important actor on the world's economic and investment stage. As you may recall, in the late 1980s, Japan was at the apex of strength; it appeared able to buy up everything around the world. Then, things went backwards and Japan suffered decades of deflation. Only in the last couple of years have prices stopped declining and Japan's central bank is now in early stages of <u>increasing</u>, at the most modest levels possible, the interest rates in Japan. It is relaxing its 'yield-curve control,' by which it suppressed interest rates on its long-term bonds.

By suppressing interest rates for such a long time, the exchange rate between the US dollar and the yen had reached levels not seen for four decades. Until only a couple of weeks ago, it took more than 160 yean to buy one US dollar. Under such circumstance, the earnings of Japan's big companies rise sharply: they earn profits by selling their goods in the US or Europe, then translate their dollar and euro profits into the very weak yen and yen-denominated profits rise markedly. As I have written in earlier *Core Comments*, restructuring of Japan's corporate practices since Shinzo Abe's term in office have impelled Japanese companies to return earnings to shareholders, instead of holding on to them. This was a delicious environment for US investors to buy Japanese stocks. We enjoyed it. However, on a dime last week, things changed in Japan, when its central bank initiated a miniscule interest rate increase. Suddenly, the value of yen against the dollar rose sharply and the promise of future high profits from translating dollar profits to yen terms evaporated. Our Japanese investment declined in value.

AI generally and Apple particularly. The excitement about AI and, especially, profits enjoyed by the 'picks-and-shovels' AI companies has entranced investors for more than a year. It is certainly possible that the rewards for AI may be slow in forthcoming, whereas the expectations have been sky high. In addition to the signals about lower consumer spending and general economic weakness, we learned over the weekend that Warren Buffett, the world's greatest investor, had sold half of his huge position in Apple stock. Investors did not like the notion that Mr. Buffett is no longer favorably inclined to Apple; in addition, it has been known that Mr. Buffett's company, Berkshire Hathaway, has also reduced its very large position in Bank of America. Mr. Buffet is expressing the view that high-flying tech companies and the bread-and-butter banking stocks have become less attractive. This means that, according to Mr. Buffett, tech stocks are over-priced and that the general economy is weakening.

Core's actions. As noted above, we had reduced our position in Nvidia last week and we closed out the rest on Monday. Similarly, we closed our longstanding winning position in Japanese stocks. In your portfolios, you now hold a large cash position.

As reported in earlier *Core Comments,* Core purchased and holds a position for clients in a fund that 'shorts' the Russell 2000 index. That means that as small US stock companies fall in price, our position rises. In Monday's big stock market selloff, the position rose by 3.3%. As you also know, your portfolios hold a big position in long-term US Treasury bonds. Prices of Treasury bonds rise and fall, but the United States does not default on its debts. Moreover, as the economy slows—and it is slowing—prices of long-term US bonds rise. These prices have risen significantly since last autumn. There is more to come. I plan to add to our Treasury position with the cash proceeds of our recent sales.

Another long-standing position in our portfolios is an oil pipeline company. It pays a very large dividend and has provided good gains during our holding period. In recent days, it declined in price, without any diminution in its ongoing business or prospective profits. I may buy some more of it, the Alerian Master Limited Partnership.

We have held a position in gold for some time and, within the last month, the price of gold has risen to a new high, at something above $2400 per ounce. In our fractious world, both in American politics and the geopolitical problems between Iran and Israel, and between Russian and Ukraine, gold offers a store of value, disconnected from the currency moves engendered by central banks—consider Japan.

They call it stormy Monday, as the song goes and as Monday's trading went. **And Tuesday's just as bad**, the song continues. Tuesday was far better than Monday, not **just as bad.** Our economy rises and then slows and, sometimes, contracts. Then comes another robust dose of economic expansion. **The eagle flies on Friday,** as the song continues.

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