CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

May 7, 2023

Slowly Going Forward

By

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Much remains similar to conditions described in this letter last month. Banks remain a problem, debt ceiling risks get closer by the day, and the economy shows signs of stasis. As a result, financial markets have changed little in these last weeks.

Banks. It is quite clear that bank problems are far from resolved. Last weekend was consumed with the drama of First Republic that resulted in its acquisition by JPMorgan Chase. This time, there was no federal government guaranteeing of all deposits as happened with the Silicon Valley Bank and Signature Bank failures; that's a good thing. But severe problems remain. Many regional banks face huge losses on commercial real estate lending; many face ongoing deposit withdrawals from nervous customers. The former problem—with commercial real estate (CRE)—makes it likely that some banks will fail as CRE losses are recognized. The latter—deposit withdrawals--raises the risk of more bank runs. It is entirely reasonable for depositors to withdraw their funds: most bank deposits pay essentially no interest, whereas the market rates are now well above four percent. (As discussed previously, in the accounts Core manages, we have large cash balances, because of uncertainties in financial markets. However, we have invested that cash in a government securities money market fund, the yield of which at present is 4.55%. This fund has no credit risk—very short-term US Treasuries are its sole holdings.)

The financial markets have responded to these problems, beginning with Silicon Valley Bank, with a sustained selling in the stocks of all but the biggest US banks. See the graph on the next page of this letter. I do think there is much more bad news awaiting us from the banking sector.

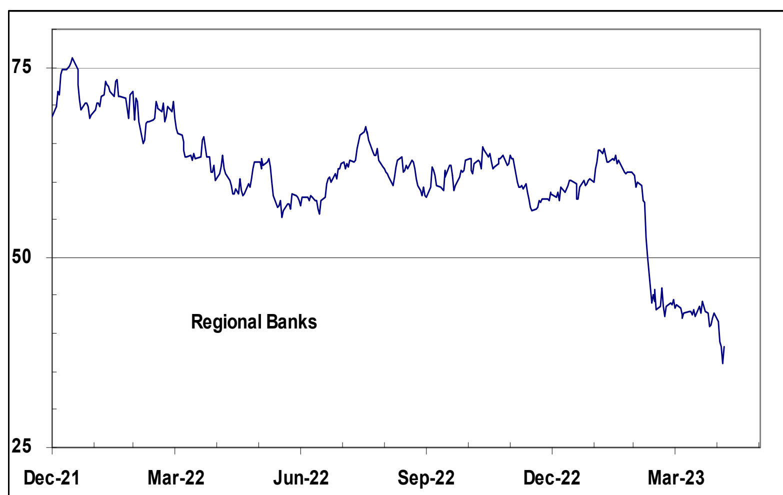
The economy. Banking problems bleed into the general economy. Because the Fed has raised interest rates so sharply since March of last year, many CRE borrowers are faced with significantly higher interest payments. In response, banks' credit managers have increasingly tightened their lending standards. This credit tightening, in combination with the Fed's extreme monetary tightening, curbs economic activity. Many businesses and people who would like to borrow are now unable to do so; they are left on the sidelines.

As discussed last month, a near-term recession is, in my view, a certainty. Indeed, we may learn that a recession has already begun. A private group of economists, acting as the National Bureau of Economic Research (NBER), is the entity that determines the start and end months of recessions. The results of its determinations are often announced long after the date that a recession begins or the date the economic expansion begins—the end date of a recession.

The chart below shows the price of an exchange-traded fund that holds shares in so-called Regional Banks. These are banks smaller than the giants, Chase, B of A, Citi and Wells Fargo. Regional banks declined in price in 2022, along with the rest of the market. But, come March and the failure of Silicon Valley Bank...oops! As can be seen, another leg down came last week with First Republic and the expectation that more banks are in trouble.

On Friday, there was great excitement about the strong Non-Farm Payrolls report, the monthly report on jobs, employment and unemployment. The new jobs announced were 253,000, far greater than the consensus estimate that there would be 185,000 new jobs created. This monthly report—as with many other economic reports—is always subject to revision; indeed the jobs report is notorious for frequent and large revisions. And so it was this time. April's new jobs were estimated to be 253,000, but the February and March numbers were revised downwards by 149,000. With these revisions, the level of total new jobs was some 81,000 less than expected. The other headline news from this report was that the unemployment rate dropped to 3.4% from 3.5%. This is the lowest jobless rate since the 1969; since 1953, the unemployment rate has never been lower than this.

What does this report tell us about the economy and about the prospects of a recession? Unemployment always goes lower during economic expansions and unemployment is always low as expansions end and recessions begin. The NBER has a very telling graph of unemployment rates over time and where they stand as recessions begin. I cannot reproduce the graph here, but I can point you to it and summarize it: You may see it at https://www.nber.org/research/business-cycle-dating. It shows very clearly that the unemployment rate always declines steadily until a recession is about to begin. (This is hardly surprising.) Lows in unemployment always presage a recession.



The debt ceiling. Although there were good historical reasons for such a thing when enacted, the debt ceiling matter has long passed its 'sell-by' date. It appears that the Biden administration and Democrats in the House have means of going forward to get America's bills paid, even if Mr. McArthy and the rather far-out gang pushing him do not come round. What a waste of time. How can it possibly be a good thing for the United States to default on obligations made into law by the Congress? If this goes to the wire, expect some wicked declines in financial markets. If the matter is not resolved, expect far worse. These are strange political times in this country.

Our investments and a comment on Schwab. Core has made no investment changes since the last letter. Our Treasury bonds are still doing very well. Gold, in which we have a small position, is close to all-time highs. We are still biding our time with our short stock market positions.

I have been asked a few times about the safety of our assets at Schwab. Without hesitation, I say that they are safe. Schwab's stock price has fallen sharply since the Silicon Valley Bank troubles. It has problems shared by other banks, in that many of its customers—including all Core client accounts—have invested in safe, but high yielding money market funds. This has hurt Schwab's earnings. A good deal of Schwab's profits have come from paying essentially nothing for its customers' cash balances, while investing the cash, for its account, in higher yielding securities. Schwab's stock holders are unhappy, but the safety of its customers assets is not affected in the least by this.

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