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

August 4, 2019

Economic Weakening and Geo-political Disturbances

A quantification of the week, the month and the year for long-term Treasuries, gold and stocks:

Long-term treasury bonds rose by 4.0% on the week, by 2.6% in the last month and by 18.1% in the last year; gold rose 1.7% on the week, by 1.9% for the month and by 18.7% in the last year ; while the S&P 500 fell by 3.1% this week and by 1.4% in the last month and gained 3.7% in the last twelve months.

A striking week in financial markets has drawn to a close and, although I prefer to write from a longer perspective than the week, I wish to put forward a brief summary of certain asset classes in which we invest (or avoid investment) during this week, this past month and the last year. A bit of background for the week: the Federal Reserve held its every-six-weeks Federal Open Market Committee meeting and, on Wednesday, for the first time in over a decade, it lowered the interest rates it controls directly, the Fed funds rate, by one-quarter of one percent. On Thursday our president, who had already expressed his disapproval of the Fed's move, announced new tariffs of ten percent on $300 billion of goods imported to the US from China to take effect on September 1. On Friday morning came a tepid monthly report on employment from the Commerce Department.

The US stock market was unhappy on Wednesday as Fed chairman Jerome Powell discussed the Fed's deliberations and actions at his post-meeting press conference and stocks fell quite sharply. On Thursday, US stocks were recovering from the previous day's Fed swoon, when Mr. Trump--Tariff Man--declared in his customary way the new threatened tariffs. US stocks liked that even less than Wednesday's Fed actions and Mr. Powell's discussion; stocks fell quite a bit further. On Friday morning came the jobs report; the stock market, responding to that and to the previous day's disturbances fell further.

Meanwhile, all this news caused the price of US government bonds to rise quite dramatically in price and to fall in yield on each of Wednesday, Thursday and Friday. Gold was less one-direction: it fell on Wednesday with the Fed's announcement, rallied very strongly on Thursday, then slipped back a little on Friday, but not before setting new six-year highs. In a sense, this week punctuated the trends of the last year. The graph on the next page expresses this in different form.

What has gone on? It has become evident this year that what matters to the US stock market is not the economy, but expectations of what the Fed can and will do. Whatever had been the case in the past, it is patently clear that the link between the actual economy and the stock market is weak. In no small way, this comes about because interest rates, by which investors value future cash flows from companies, have sat around zero for the short term and three percent and falling for long-term bonds. The lower the interest rates, the higher the prices that can be supported by the discounting of future cash flows.

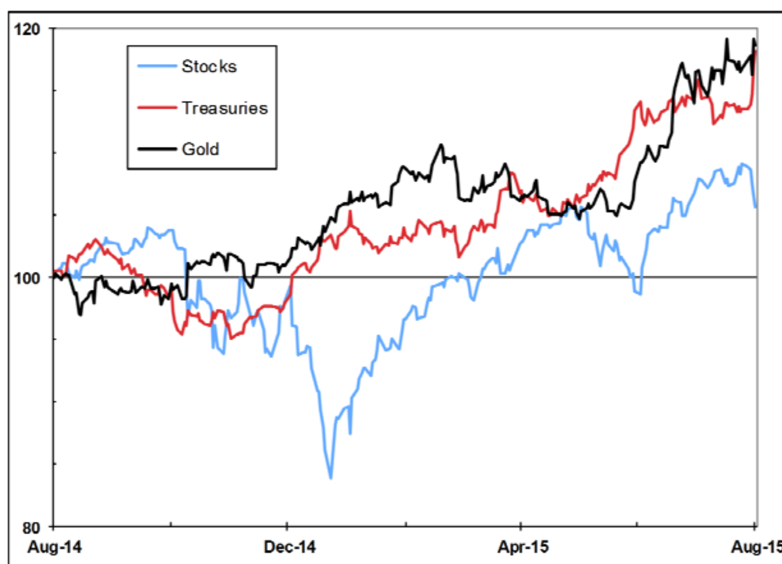
It is also clear that the persistent buying back of shares by public companies has enhanced earnings per share, despite declining profits. To give a simple illustration, if a company has 100 shares outstanding and earns ten dollars, its earnings per share are 10 cents. If its earnings fall to nine dollars, but it buys back 20 of its shares outstanding, its earnings per share will be 11.25 cents, $9 divided by 80 shares. Thus, despite a 10 percent decline in profits, there is a 12.5% increase in profits per share. For the economy as a whole, the 10 percent decline in profits is a negative, for the holder of the shares, the 12.5% increase in earnings per share will justify a higher stock price.

By

Jack Mayberry

More on the employment report: Average weekly earnings were flat in July and negative in real, inflation-adjusted terms. These measures are essentially the same to somewhat worse than prevailed in the period in 2007 just before the Great Recession. Aggregate hours worked for production and non-supervisory workers have fallen at the rate of 0.7% annualized in the last six months. Each recession the last three decades has been immediately foreshadowed by a decline consistent with this one.

Thus, the US stock market rallied very strongly from the Christmas Eve 2018 low and produced significant gains, despite the weakening economy. Throughout 2018, the Fed tightened monetary policy by raising interest rates and reducing its holdings of Treasury securities. At its December 2018 meeting, while the stock market was falling sharply, it raised rates yet again and declared that its reduction of its balance sheet was on 'autopilot.' By early January, the Fed's leaders realized that they had taken the 'normalization' of monetary policy too far and began to promise that easier money was on the way. Given the deeply oversold conditions that prevailed after the swift, twenty percent decline in the S&P, those soothing words gave stock investors license to buy without reference to signs of weakening corporate and personal income and the decline in corporate capital spending. By contrast, the US bond market is closely tied to the unfolding economic picture and, in particular, to what economic environment lies ahead. While stock investors have gone to the races and driven prices higher, bond investors have made the sober and clear-eyed judgment that the weakening economy will push long-term bond prices ever higher and long-term bond yields ever lower .



I have been asserting that the US economy is weakening, although the 'headline' numbers for employment and for gross domestic product and the like suggest otherwise. In these brief letters, it is impossible, and probably far too boring, to provide evidence for my assertion. However, a brief discussion of Friday's employment report for July: the 'headline' number, new jobs created in July at 164,000, was decent, although the previous two month's measures were adjusted downwards. What goes unreported, but is quite meaningful, is the measure of total hours worked, not the number of bodies working. Average hours worked per week fell by 0.3% to 34.3 hours. This decline in hours worked is equivalent to a decrease in numbers of people employed by 210,000. Total labor input is best measured by the amount of work being done, not by the numbers of people doing the work. Read more in the side bar.

We may expect, in our world of negative interest rates and geopolitical disturbance—consider North Korea, Hong Kong, Iran, and Washington, D.C.--that gold will continue to be a useful holding.

What lies ahead? Negative interest rates outside the US point to the direction of future interest rates here. Some 14 trillion dollars of bonds across the world now yield negative interest rates; on Friday, the yield on the benchmark European sovereign bond, the 10-year German *bund,* fell to a new all-time low of negative 0.50%. Thus, a buyer of the bond will experience a certain loss if she or he or it holds the bond to maturity. Negative rates arise from low and falling inflation and from weak economic growth or recession. In the US, the Fed has been unable for years to achieve its target rate of inflation: two percent. This spring, Mr. Powell called the shortfall in inflation a 'transitory' phenomenon. This 'transitory' phenomenon has persisted for years and it is worsening. Against the backdrop of weakening economy, the path for long-term US treasury bonds, Core's largest investment, is to higher prices and lower yields.

A smaller investment we hold for you is gold, the 'barbaric relic.' This soft and shiny metal gives us no income and its carrying costs, including storage, weigh against it. But, in an environment in which a third of all the bonds issued world wide carry negative interest rates, the cost of storage becomes far less significant. Moreover, of course, gold has been used since time immemorial as a hedge against the uncertainties of geopolitical disturbances. Our Tariff Man president is the acknowledged master of geopolitical disturbance, having threatened more tariffs against China on Thursday and withdrawn the US from the 1987 nuclear arms reduction treaty with Russia on Friday. It is not too surprising that gold is doing well.

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