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

November 23, 2018

Whence and Whither?

After quite intense selling in stocks in October, a brief rebounded unfolded in the last week of the month and in the first week of November. On the day after our election, the modest advance came to its end and selling resumed. By Tuesday of this week after two intense days of selling, the US market, as measured by the S&P 500, reached its October lows. What brought about this selling and for how long will it continue?

I hope that everyone had a fine Thanksgiving, although it may be hard for the many newly-homeless in California to recognize their bounty.

Although the US stock market made a new price high late in September, it had begun to weaken internally earlier. In January when the stock market made a high prior to a wicked bout of selling, virtually all sectors of the market were rising, as were most individual stocks. Many issues were setting new highs. The market labored forward during the summer and in September exceeded the late January highs, but without nearly such broad participation: many fewer stocks were rising and many fewer were making new highs.

Slowing economic activity is a perfectly good reason for the selling that we see in stock markets across the world. 2016 and 2017 were characterized by so-called 'synchronized global growth.' Despite the signs of a reasonably strong US economy, 2019 will likely be characterized by synchronized global weakness.

In the US economy, GDP growth exceeded four percent in the second quarter of this year and, by current estimates, by something above three percent in the third quarter. This level of growth is relatively good, though not anywhere near the best ever, despite our president's report. The very sharp tax cuts in December, especially to corporate profits, coupled with the rather substantial increase in federal spending enacted early this year, boosted growth from the range around two percent that has characterized the last few years. Estimates by Federal Reserve Banks for growth in the present quarter are much lower, back to the two percent range. What we observe is that retail sales are slowing and the big retailers like Target and others are putting forward grim projections. The stocks of retailers have fallen sharply and steadily in recent weeks and stand more than twenty percent below recent highs. Various measures of the housing market, an extremely important part of the overall economy and always a leading indicator of where the economy is heading, have been weakening markedly. Housing starts, permits for new houses, sales of homes--all are slowing markedly. None of this augurs well for growth in the next year.

Similarly, the great technology-related growth companies--Amazon, Apple, Microsoft, Google and others--that led the charge for the last few years, offered somewhat uninspiring projections in their recent quarterly reports. This group and its companions have fallen sharply in price in recent weeks. (Technology stocks had been Core's biggest equity position for clients for the last couple of years. I am glad to report that we sold that position in two tranches, the first in early September, the second in the opening days of October. Whew!)

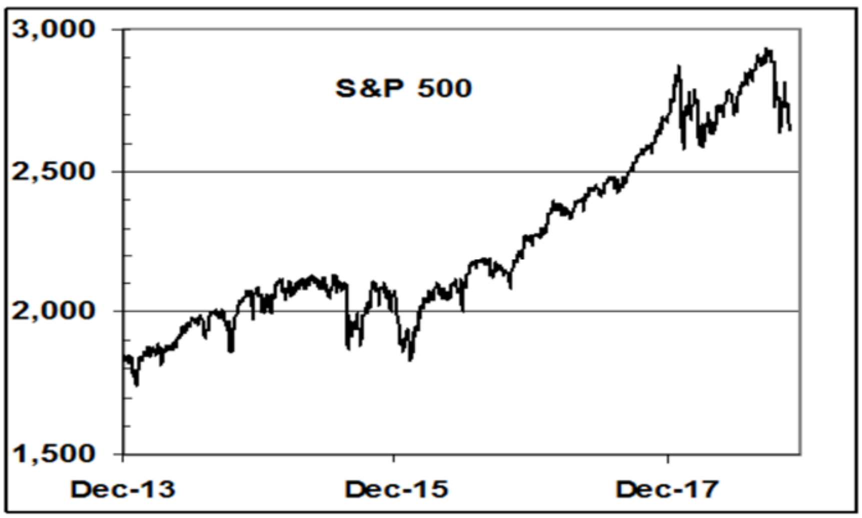
By

Jack Mayberry

The chart below shows the first bout of selling in January and February this year, then the recovery to the beginning of October.

A much further decline may unfold in coming months. The Fed is no longer the supportive friend to the stock market, indeed, it may be said that much of the market's gains in recent year were created by the Fed's exceptional monetary policies.

Behind the decline in the economy stands the Federal Reserve Bank. In a few weeks, we mark the third anniversary of the Fed's rate-raising. During and after the great recession of 2008 and 2009, the Fed cut the short-term rates it directly controls essentially to zero percent. There things stayed until December 2015, when Janet Yellen's Fed began the slow process of raising rates toward historically normal levels. In the aftermath of the financial crisis, the Fed embarked on what we now call 'quantitative easing,' whereby the Fed bought some trillions of dollars of mostly government securities to lower long-term interest rates and to shift investors' attention to 'risk assets' like stocks, in its effort to revive the prostrate US economy. Assets on the Fed's balance sheet quintupled to four trillion dollars. The Fed is now reducing the level of those holdings, in the process of returning things toward what used to be normal. In December, the Fed's Open Market Committee meets again and will, as is widely expected, raise Fed funds by another one-quarter percent.



The Fed's actions are, in my view, entirely appropriate. What we see, however, as always happens as the Fed tightens monetary policy, is that the economy slows and the stock market falls. And so it is again this time. Mr. Trump appointed Jerome Powell as chair of the Fed, instead of reappointing Janet Yellen. However, he has criticized the Fed sharply for its tightening of monetary policy. The irony is that Mr. Powell appears less cautious in his monetary policy than was Ms. Yellen. Mr. Powell has spoken in recent years against the exceptional policies that the Fed, under Ben Bernanke and his successor, Ms. Yellen, initiated. When Alan Greenspan (Mr. Bernanke's predecessor) was chair of the Fed, there arose the notion of the Fed 'put.' By this was meant that the Fed would step in to stop sharp declines in risk markets when things got bad. The Fed put, if this is what it was, was exercised during the savings and loan debacle in the early nineties, in the dot-com collapse early in this century, and again during the 2008 to 2009 financial crisis. The Fed, in those instances, cut rates sharply and eased monetary policy aggressively. Mr. Powell has criticized these actions. Now we are in early stages of another bout of anxiety in 'risk assets.' What now? Mr. Powell speaks a couple of times in the next couple of weeks. Listen carefully.

As either Yogi Berra or Mark Twain remarked, it is perilous to make predictions, especially about the future. Forewarned is forearmed, because here we go with predictions: As reported in recent letters, Core has reduced clients' holdings in stocks very sharply and those we do hold--utilities, consumer staples and health care--are quite defensive in nature. My view is that we are entering a bear market in stocks. This is not, as I see it, merely a 'correction.' If this view is the right one, then we can expect months more of bouts of selling and big swings in stock prices. An unusual feature of this episode is that Treasury bond yields have held quite steady during the stock market selling in October and November. Typically, in sharp stock market declines of the kind we have watched, Treasury bonds rise in price and their yields fall. Not this time. This suggests that long-dormant inflation awakens and that the deflationary threat of the last decade is over.

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CORE ASSET MANAGEMENT
PO Box 1629
108 Caledonia Street
Sausalito, California 94966
(415) 332-2000 • (800) 451-2240
fax (415) 332-2151
www.coreasset.com
info@coreasset.com