CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

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Bonds Rally, the Economy Slows and Stock Markets Stumble

The complexion of financial markets has changed abruptly this month. Conflict with China has scared stock investors, while government bonds have rallied vary sharply. Bond prices tell us that the economy is weak now and will weaken further.

By

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Since my last letter in April, the long-term Treasury bond market has risen sharply in price and yields have fallen to lows not seen since September 2017. The stock market made a nominal and short-lived new high on April 29th but has fallen sharply all month since then. The US economy has continued to show signs of weakening, suggesting that a recession is on its way--or may already have begun. The growing hostilities between the United States and China have expanded beyond the realm of trade, as the Trump administration has moved to stop certain important Chinese tech firms from doing business with American firms. A few weeks ago, the US and China appeared to be moving close to an agreement on these matters and the sudden escalation in hostilities created shock in global stock markets.

As you will remember, we took a very cautious investment position in the second half of 2018, increasing our holdings of long-term Treasury bonds, cutting stock positions to zero, building money market fund holdings and taking a small position in gold. Thus, Core's accounts have appreciated with Treasury bonds and avoided losses in the stock market havoc this month. Having said that, one must admit that my aversion to stocks this year caused us to miss the very strong stock market recovery that began immediately after Christmas and continued for four months. As the stock market rallied early this year, my caution looked misplaced; so be it. Erring on the side of caution is, I strongly believe, the right investment approach for this year, as I explain below.

The headlines about the US economy suggest that it is quite strong; the underlying reality tell us otherwise: Firstly, the recent estimate of economic growth in the first quarter of the year shows GDP to have grown at a rate of 3.2 percent on an annualized basis. What the cheerleaders fail to note is that a sharp rise in inventories (for the third straight quarter), net exports, as food exports surged and imports fell, and an increase in defense spending accounted for 2.1 percent of the increase, while real consumer spending only increased at 1.2 percent. Building inventories now borrows from future manufacture; inventories will be subtracting from GDP in future quarters. The report showed that the basic components of the real economy--namely consumer spending, non-residential construction, business capital spending and housing--slowed to 0.9 percent.

The second major recent report that ostensibly shows our strong economy is the monthly payroll report, showing unemployment and aspects of the work and jobs. The headline was that in April the unemployment rate fell to 3.6 percent, the lowest in decades. Amidst the cheering for this, the following factors were ignored: the labor force contracted as many people left the job market,

full-time jobs contracted, average weekly earnings fell, total employment as measured by the so-called household survey contracted, and aggregate hours worked fell. The unemployment rate fell to 3.6 percent solely because of a huge drop in the labor force participation rate--i.e., people dropped out of the labor force. If labor force participation had held constant, the unemployment rate would have risen to 4 percent. The employment market is not strong; it is weak and weakening.

The enormous rally in Treasury bonds reflects the reality of a weakening economy, not a strong one. On October 1, 2018, the yield on the ten-year Treasury was 3.248%; as I write it is 2.266%, almost exactly a full percentage point decline. If the economy were strong or growing stronger, the demand and prospective demand for borrowed money would cause rates to rise, not to collapse in seven months. The sharp decline in yields results from the following: real personal income (excluding government transfers) peaked in December and has declined since; household employment peaked in February and has declined since; real business sales peaked in February, industrial production peaked in December and both have declined since.

Despite signs of the slowing economy and weakening corporate earnings, the stock market staged a very impressive four-month rally. What accounts for this? To my mind, the largest factor is the Federal Reserve, which in January announced a 'pause' in its short-term interest rate increases and has declared since that it will be 'patient' in its next moves. This appears to have been enough to assuage stock market anxiety and stimulate an impressive rally.

However, the 'trade war' between China and America, which may be morphing into a serious, long-term and expansive contest, has shaken the insouciance of stock investors. Stocks appear now to be reflecting the disruptions that the China and US fights may cause and the generally weakening economy. Hence, Core's investment approach--avoiding stocks and investing in long-term Treasuries--is bearing fruit and preserving our capital in a rather dangerous time.

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