Ray's Corner

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Second Quarter 2016

Economic and Market Commentary

Resting at the base of Chestnut Ridge, the westernmost ridge of the Appalachian Mountains, sits a small town that once served as a way station on the Cumberland Road. Originally called "Beesontown" nicknamed for Henry Beeson, the town's founder, it was officially named Uniontown on July 4, 1776, unbeknownst to town leaders on the very day the United States Declaration of Independence was ratified.

In the early years, the town's small population served the needs of Fort Necessity only a few miles away. The Fort had served as a vital outpost during the French and Indian War, and still remained of such strategic importance that General Washington himself had visited it a number of times. By the mid-19th century, the population had grown fivefold, and now the town served as an important stop along the Underground Railroad, helping escaped slaves from the South make their way to Canada.

By the last quarter of the 19th century, the town grew by leaps and bounds as the coal mines and steel industry of Western Pennsylvania flourished. Around this time, Uniontown contained more millionaires per capita than anywhere else in the United States. But with prosperity grew violence, and in 1894, our young protagonist, George, born into a middle-class Uniontown family, was witness to the bloody "Bituminous Coal Miners' Strike when 15 "enforcers" hired by the Bituminous Coal Mining Company armed with carbines and machine guns held off 1500 strikers, killing five and wounding eight. The strike shattered the United Mine Workers Union, and by late June, the mine workers returned to work. It would be another 25 years before John L. Lewis would turn the mine workers into a successful union again.

A Remarkable Life Takes Form

Our young George actually came from an old Virginia family who could trace their roots back to a distant relative of note, Chief Justice of the Supreme Court, John Marshall. Young George was quick witted but slight, but by the time he entered the Virginia Military Institute (VMI) in 1897, he had filled out enough to play first string tackle on their varsity football team three years in a row. His service at VMI was distinguished, and as a senior, he was appointed "first captain of the corps." Soon after graduation, he was posted overseas and saw his first service leading men in wartime.

Off To The Philippines

Although the Spanish-American War officially ended with the signing of the Treaty of Paris in 1898, armed conflict continued for another 15 years in the Philippines. Here in the United States, a great debate arose over the prospect of our country maintaining possessions around the world. The whole concept of expansionism resonated too closely with the colonization practices of the old world from which we had broken away barely a hundred years earlier.

At the time of the Spanish-American War, the Philippines had been under Spanish rule for 333 years. A war for Philippine independence from Spain had been going on, and a temporary truce was called in light of the new war with Philippine political leaders agreeing to self-imposed exile for the duration. That didn't mean that the Filipino soldiers couldn't serve as allies to the Americans and fight at their side against their common foe, and that's just what they did. Regrettably, just as the war was won with the American victory at the Battle of Manila, the collaboration ended when the Americans took control of the city and prevented their Filipino allies from entering. In August 1899, the American Congress voted to retain control of the Philippines, possibly granting independence in the future. Thus the stage was set for America's first guerrilla war in Southeast Asia.

A Second Lieutenant Takes His Command

By the time Lieutenant George Marshall was posted in the Philippines, the Philippine Organic Act was passed by the U.S. Congress, and Filipinos were granted "limited self-government." This by no means was satisfactory to an island people oppressed for more than 300 years. The new Tagalog Republic was formed grouping diverse people like the Moros and Pulahanes with guerrilla hostilities fought on dozens of islands.

Tens of thousands of people died from hunger, disease as well as combat. New languages were introduced, religions changed, and a young lieutenant served honorably and learned lessons in helping a country rebuild itself that would serve him greatly in the years ahead.

Back in the States

After his service in the Philippines, Marshall was transferred back to the United States to Fort Leavenworth, and then to the Army Staff College, where he distinguished himself over the next nine years.

By now, World War I had been raging in Europe for more than three years and America was ready to join the fray. With his keen analytical and organizational skills, Marshall was assigned to help oversee the mobilization of the first division for service in France. By mid-1917, Marshall was in France with the responsibility of planning the first American attack and victory of the war, the Battle of Cantigny. From there, it was on to the headquarters of the "American Expeditionary Force," where he was at the side of General John Joseph Pershing . (Parenthetically, it was Warren Pershing, the general's son, who started Pershing LLC, your custodian, in 1939.) Together they worked on the "end game" to World War I. Marshall worked tirelessly on the planning and coordination of the Meuse-Argonne offensive, which contributed to the defeat of the German Army and brought closer the end of the war.

Between the Wars

With the War over, Major Marshall returned home to numerous postings throughout the country, all developing him for the challenges that lay ahead. He was named General Pershing's aide de camp. He went to China during their Civil War. He was elevated to Colonel. He came back home again charged with learning and teaching modern mechanized warfare. In 1934,

Colonel Marshall authored a training book titled *Infantry In Battle*. It was an infantry officer's bible in World War II and is still used today. By 1936, he became a general and was responsible for the Civilian Conservation Corps (CCC) throughout the Pacific Northwest. This began a love affair with America's Northwest that lasted the rest of his life. Those in Washington knew a war was brewing in Europe and called Marshall back to Washington in 1938. The day Germany launched an invasion of Poland, September 1, 1939, was the day general Marshall was sworn in as Chief of Staff for the U.S. Army under President Roosevelt.

World War II Service

At the time Marshall was named chief of staff, America had no modern weaponry to speak of and a standing army roughly the size of the Dutch (who fell to the German blitzkrieg in less than a week.) Without hesitation, Marshall set himself to build a modern army and navy. He urged military readiness prior to the attack on Pearl Harbor. Calling on his 40 years of experience, he recognized the importance of a civil military relationship which earned him President Roosevelt's respect and the respect of all who encountered him.

The American services grew from less than 200,000 soldiers to more than eight million. Whether it was building, supplying or deploying, Marshall was involved in every aspect of the war effort. In 1944, he was given a fifth star to become the first five-star general. To many historians, General George Marshall is only surpassed by General George Washington in American military importance. When the War ended in 1945, Marshall resigned his post in November.

A World of Service Yet to Come

Although the War was over, it was Marshall's diplomatic skills that were now needed. Remember, he was there at the birth of the Atlantic Charter shortly after Pearl Harbor. He was there at Casablanca in 1943, Québec in 1943, Cairo and Tehran. He was at Yalta and Potsdam, then Truman sent him to China in early 1947. On his return, he was named Secretary of State and quickly became America's spokesperson for the State Department's ambitious plans to rebuild Europe.

One has to recognize that after World War II's end, Europe was devastated. What was once the industrial engine of the world now lay in ruins. Millions upon millions displaced, millions and millions killed. Its infrastructure was decimated— roads, bridges, factories, ports. Truly the only country left relatively untouched was "Island America," so shortly after the war we began giving modest loans, but the recovery was going painfully slow. In addition, Britain stepped aside in providing aid to Greece and Turkey in their fight against communism leaving it entirely up to the U.S. to provide support.

It started to become immediately clear to the United States that a European recovery was essential to a stable global environment. Stalin and the Soviets were chomping at the bit to fill the void left behind in central and western Europe. This possibility was unacceptable in terms of global security and could easily lead to the same type of global depression that had gripped the world for more than a decade just before the war.

A Speech that Changed History

In June, 1947, Secretary Marshall delivered a historic speech at Harvard University in which he outlined a program of economic aid to European countries to revitalize their economies by focusing on the creation of modern postwar industries and expansion of their international trade opportunities.

A brilliant and wonderful offshoot of the plan was the fact that countries that signed on to this plan would take the funds provided and purchase manufacturing and revitalization supplies from American companies. Talk about a win-win situation. Europe gets back on its feet and the American postwar economy is fueled in the process.

The original name for this legislation was the Economic Cooperation Act, which soon came to be called the "Marshall Plan" for which George Marshall would later earn the Nobel Peace Prize in 1953.

In The Beginning

All European nations were invited to participate in the plan, but the Soviets soon refused and prevented their allies from participating as well. (You might mark this as the official start of the Cold War.) The original 17 countries that did sign up were Austria, Belgium, Denmark, France, Greece, Iceland, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Sweden, Switzerland, Turkey and the United Kingdom and Western Germany.

To assist in coordinating the program, the European nations created the Committee of European Economic Cooperation which helped form a four-year recovery program. Countries participating in the plan experienced unprecedented growth of between 15% to 25% annually. Industry was quickly rebuilt and agriculture surpassed prewar levels. The economic boom served greatly in suppressing communist groups from gaining power within the participating nations, and an economic divide appeared quite apparent between the recovering, affluent West and the poor communist countries of the East.

Winston Churchill described the plan as "the most unselfish act by any great power in history." In truth, the U. S. had motives other than altruism. Some historians have referred to it as a form of economic imperialism, tying the Western nations of Europe to them just as the Soviets were doing in the East with an iron boot. Some of the plan parts the Soviets took issue with were:

1. Participating nations were required to be open to U. S. markets.
2. Sale of military items was banned to the Eastern block nations.
3. The plan was a first attempt to persuade European nations to act continentally rather than as a weaker divided group of independent nations. Think of it in many ways as the precursor to the European Union (EU).

Today, the Marshall Plan is widely viewed as a success. The economy of Western Europe rebounded significantly during its administration, which at the same time, helped foster economic stability in a postwar United States. Concepts of the Marshall plan laid the foundation for future economic aid programs administered by the United States, and some of the economic ideals that exist within the present EU.

The European Union

European alliances date back many centuries in military terms, but a continental alliance formed for financial prosperity and growth is far newer. Perhaps its earliest attempt dates back to 1923 and the birth of the "Pan European Union," whose basic goals were liberalism, Christianity, social responsibility and pro-Europeanism. Its earliest supporters included Conrad Adenauer and George Pompidou. Some 20 years later, an exiled Charles de Gaulle, leader of the Free France movement, called for a union.
Right after the War, the European Union of Federalists formed a campaign for a "United States of Europe." By the mid-1950s, NATO had already been formed, creating a military alliance of countries from North America and Europe promising collective defense. (Today, NATO

consists of 26 nations.) On January 1, 1958, the Treaty of Rome took effect creating the Common Market, the European Economic Community (EEC) and the European Atomic Energy Community.

Fast-Forward

It didn't take long for power struggles to emerge. In the 1960s, it was decided that unanimous agreements on key decisions were necessary, in essence giving every member of the European Economic Community veto power. Historians argued that this slowed down the formation of the actual union by some 20 years. During the 70s and 80s, membership in the EEC grew, with Denmark, Ireland and the UK joining in 1973; Greece in 1981; and Portugal and Spain in 1986. (Parenthetically speaking, the Brits now wanted to join because they had seen their economic growth lag behind the other EEC member nations.) Initially, Britain's entry into the EEC was vetoed by France, not once, but twice.

To reinforce the fact that referendums are not new concepts (think Brexit), Norway had applied for membership in the EEC at the same time as Britain and then withdrew their application when a national referendum (vote) was taken confirming that the majority of Norwegians did not want to join.
By the mid-80s, it had become apparent to member nations that an effective European integration of European countries served as an excellent way to balance not only the power of Russia but that of the United States as well.

The Maastricht Treaty

Straddling the Meuse River in Western Europe, the Romans built a fort some 2000 years ago that, over the centuries, grew into a medieval religious center and then a cultural center. The Dutch ultimately named it Maastricht, and on February 7, 1992, 12 members of the European Council gathered there to sign what came to be known as the Treaty of Maastricht. This instrument later became known as the European Union (EU), the entity the British so surprisingly exited with the Brexit referendum vote on Thursday, June 23, 2016.

At the signing, the main purposes of the European Union were spelled out and agreed to. The organization's fundamental purposes were designed to promote greater social, political and economic cooperation amongst the nations of Western Europe. The thinking here was that countries whose economies are interdependent on each other are less likely to engage in conflict. (On the surface, certainly sound enough.) Key to the goals of the unification of European markets was the use of a single currency, the Euro. In addition to the common currency came a set of legal standards to which all prospective and member nations are held to. These included no tariffs between members, open borders to their citizenship, the elimination of passport use amongst members to name a few. Supernational institutions worked with national governments to oversee the implementation of these standards and help the EU to act as a unified body on the world stage. Think of the ECB, the European Central Bank, as an institutional example.

Nothing's Perfect

It was clear from the beginning that, as attractive as the formation of a new powerhouse was, offering access to foreign and direct investment along with membership into the largest single marketplace in the world came with serious disadvantages and challenges. Some drawbacks

included regulations on immigration. For instance, member countries cannot turn away large numbers of refugees no matter what strain that might place on the country's economy. The use of a common currency affects some members by eliminating their control over their own currency. (Many a country has avoided debt crises by being able to devalue their currency, a strategy Greece and Spain would've employed years ago were they able to.

The EU's policy on immigration oftentimes results in the loss of experienced staff. Additionally, all companies in member countries must reevaluate all contracts rather than doing business with a specific firm or organization, raising the cost of doing business. Finally, membership costs are very high, making it hard for poor economies to participate and wealthy countries to justify their membership relative to what they get in return.

Over the years, the EU's charter has been modified many times. One such modification, which you will be reading about a lot due to the significance of Britain's vote to exit, was voted on and put into force on December 1, 2009. It's the closest thing the EU has to a constitution and has come to be known as the "Lisbon Treaty." In the treaty, the office of president was created and committees were consolidated to create a more robust and unified foreign policy. Additionally, changes occurred in voting policy, and the document spelled out a host of civil, political, economic and social rights guarantees to all citizens of the EU, incidentally creating almost unlimited border crossings amongst members, with little or no security restrictions. With the current state of global terrorism alone—think Paris, Nice, London—this has placed a great strain on the commitment of many countries and their continued resolve to maintain their membership in the EU.
Buried deep within this complex document sits "Article 50," the language which outlines the provisions under which a country once in the EU can leave. Remember, this Article was enacted around the time that the economies of Portugal, Ireland, Greece and Spain were spiraling out of control. (The talking heads on television referred to them as the "pigs." Austerity measures were failing to slow the dissent, and EU leaders seriously began to address the possibility of a "Grexit" Greek exit, now you know where "Brexit" comes from). Greece wound up reaching agreements with its creditors that averted the immediate crisis, but a host of challenges such as Russia's forcible annexation of the autonomous Ukrainian Republic continued. This was a bellwether to the incredible refugee crisis that certainly was a large contributing factor in the United Kingdom's vote on June 23, 2016, when some 52% of British voters chose to leave the EU leading to Prime Minister David Cameron's resignation a few days later.

Let Me Bring it Home

The results of the Brexit vote turned out to be a big surprise. The day before the vote, the talking heads in finance and media were so sure the referendum would be defeated that the U. S. stock market surged up. The vote was tallied, the pundits were proved wrong, and for the next two days the markets plunged, with the Dow Jones Industrial Average dropping more than one thousand points. Doom and gloom were in the air. All this was playing out against the backdrop of global drama and tragedy: On Bastille Day, the terrorist attack in Nice, a failed coup d'état in Turkey, innocent police officers gunned down in Dallas and Baton Rouge.

If anything, you would think the equity markets would be in turmoil. But what happened? The thousand point drop in the Dow Jones was recouped in a matter of days. The Federal Reserve intimated that, in light of world events, thought of interest rate increases would probably be deferred at least until 2017 or maybe even 2018. U. S. jobs reports came in strong, and then

earnings season began (when companies report on profitability every quarter.) So far earnings have been relatively strong and the market has gained new highs.(Remember, the new highs are found in the cap weighted and price weighted indexes, not in the broader based equal weighted indexes, a far more reliable indicator on the strength of the economy. For a more detailed explanation of the difference between price weighted, cap weighted and equal weighted indexes, go back to my quarterly commentary from Fourth Quarter 2014. If you can't find it and would like a copy, call Denise, and she'll be glad to send you one.)

Don't Get Me Wrong

There will be consequences from Brexit that people haven't even thought of yet. Just because British voters voted to exit, it will take years, in part due to Article 50, for them to truly leave. In the meantime, I believe:

- We will see a decline in mergers and acquisitions with British companies as the climate of uncertainty continues
- Changes to the UK's interaction with the EU related to capital markets will likely take place.
- Weakness will continue in both the pound and the Euro.
- Regulatory hurdles for countries in Europe will increase dramatically.
- Perhaps most significantly of all, the very makeup of the United Kingdom may change drastically.

It was only a couple of years ago that Scotland voted on their own referendum to stay in the United Kingdom or not. They narrowly voted to stay. Scotland voted overwhelmingly in the Brexit vote for the UK to stay as part of the EU. Now that the UK is out, I believe strongly that you'll see a call for a new referendum vote in Scotland, and this time they will vote to leave the UK.

Same story in Northern Ireland. For more than 100 years the Sinn Fein have worked for a United Irish Republic with the right of Irish people as a whole to determine their own self-interest. Like Scotland, Northern Ireland voted overwhelmingly to stay in the EU. I believe referendums for Irish unification will come back to the forefront.

Conclusion

For the past year or so, there has been an acronym popular on Wall Street called T I NA, which stands for "there is no alternative." That's why many feel the equity markets, although modestly overpriced, continued to be so resilient. Volatile, but resilient. Gone for now are the days in which a retiree could live a comfortable retirement off a 6% or 7% CD yield. The bond market is perhaps the biggest bubble of all, with some countries like Japan, Germany and England paying little or even negative returns on their government bonds. (To many foreign investors, America's 1 ½% 10-year Treasury seems downright decadent.)

So what's left, real estate? Sure no guarantees there either. Here in the Bay Area, many communities are just crawling back to price levels of 10 years ago. If you go to other parts of the country, even our own Central Valley, you'll see modern-day ghost towns of foreclosed houses. (It's estimated that 40% of Americans are upside down on their mortgage balance versus their property value.)

Now we're poised for 100 days of very nasty politics between two presidential candidates whose combined disapproval rating is the highest perhaps in history, but certainly in my lifetime. Whoever is elected will have their work cut out for them. In addition to dealing with the global recession that's going on (you'll notice very few international holdings in your portfolio), they must deal with the 20- trillion dollar deficit, underfunded Social Security and Medicare, deteriorating infrastructure, bloated government and a very hostile and ineffective regulatory environment toward business. It doesn't matter if they're pumps or oxfords, it's going to take some big shoes to forge a collaborative Congress to address these issues.

Never individuals to stick our heads in the sand, we will continue to work with our clients, populating their portfolios with sound investment instruments backed by leading companies capable of bringing dependability of income stream, (in many cases, backed by some of the world's leading insurers). Solid yield without reliance on the bond market or correlation to the equities market remains an important component in our portfolios.

(Thank you for reading this quarter's prologue entitled, "Anomaly" for an explanation and update on the new required pricing for non-publicly traded products. Next quarter, I will provide a similar prologue designed to help you better understand the changes occurring in banking that is either affecting or will affect everything from mortgages, credit cards, car loans and student loans. In the meantime, we anticipate continued volatility in a relatively range-bound market punctuated by the uncertainties of the upcoming presidential and congressional elections. As always, we will endeavor to do our best, seeking out opportunity without undue risk.

As always, thank you for listening.

Best Regards,

Ray

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