Second Quarter 2018

Economic and Market Commentary

On the west slopes of Little Mercy Mountain, high up in the Adirondacks, a brook begins that leads into Lake Tear of the Clouds. Flowing out of the lake is mile-long Feldspar Brook. Now Feldspar Brook soon comes to the confluence with Calamity Brook. Calamity Brook joins Indian Pass Brook flowing out of Henderson Lake. When the two converge, they form a river. The Iroquois called it Ca-ho-ha-ta-te-a, the Mohicans called it Muh-he-kun-ne-tuk (the river that flows two ways), and the early Dutch settlers called it the North River. We know it as the Hudson River.

A 1939 *Life Magazine* article referred to the Hudson River as "America's Rhine." This 315-mile long river runs north to south with its mouth ending up in the upper New York Bay, the finest harbor in the Western Hemisphere. Named for Captain Henry Hudson who first sailed up river in 1609 on behalf of the Dutch East India Company. About a dozen miles north of the mouth, straddling Manhattan's Washington Heights and the Jersey Palisades, sits the George Washington Bridge.

A Lot of Traffic

First conceived in 1906, construction on the "GW" as locals refer to it, began in 1925 and was completed six years later. When opened, it was the longest main bridge span in the world, and it held that record until the Golden Gate Bridge opened in 1937. One record the bridge still holds is the fact that it carries more motor vehicles per year than any other bridge in the world, with 105 million cars traversing its spans each year.

The Forts

The eastern entrance to the George Washington Bridge is in Manhattan at 179th Street, not far from the site of Fort Washington. Fort Washington was one of General George Washington's strongholds during the American Revolutionary War. In 1776, Washington and his troops had to abandon Fort Washington, evacuate Manhattan and cross the Hudson as a result of the Battle of Washington Heights.

Washington and his army retrenched themselves high on the bluffs of the Jersey Palisades at Fort Lee, named after General Charles Lee. It's here that patriot Thomas Paine wrote, "*These are the times that try men's souls*." It's here that the George Washington Bridge terminates at its western end.

Located in what became Bergen County, New Jersey, Fort Lee became America's first motion picture capital. Remember, Orange, New Jersey was just down the road and that's where the "moving pictures" were born at Thomas Edison's "Black Maria" motion picture studio. Stars like

Mary Pickford and Douglas Fairbanks Sr. got their start right there in Fort Lee. That's where my uncle Richard comes in.

Me and My Uncle

When I graduated from college it was early December. Graduation came at precisely the right time. I was done with Vermont winters. After a month or so of idleness at my folks' apartment in Manhattan, I awoke one morning and found my mom in the kitchen on the phone with my uncle Rich. The side of the conversation that I heard, my Mom's side, went something like this:

"Richard, this is Pearl."

"Fine, fine, and how are you?"

"Listen, Raymond graduated college last month, and I want to send him over to visit you."

This was actually code for, "I want you to give him a job."

"Yes, I love you too. Raymond will give you a call."

You see, Pearl was Richard's older sister by 10 years and she thought the world of him. Growing up, she loved his shy yet inquisitive mind and, as an adult, she was proud of his accomplishments. A straight A student who became a CPA, a CPA who became a Federal Bank Examiner, a Federal Bank Examiner who became President of a small and thriving community bank, the First Bank of Fort Lee, New Jersey. Pearl would tell me, "Your Uncle Richard, he's one smart cookie."

Now the First Bank of Fort Lee was local banking at its finest, the type of bank that would sponsor the local Little League Team, know its depositors by name and try to help its commercial customers be successful. Uncle Rich was always a good guy. Wiry in frame, with a marine-style crewcut, he smoked a briar pipe and played handball. I have to admit, he had a competitiveness to him and I took great pleasure in besting him regularly in ping pong which was usually followed by his plea for, "one more game, one more game."

Rich's wife, my aunt Bobbie, was always a favorite of mine. Think of an energetic blonde cheerleader type with a short permed bob and a slightly twisted sense of humor (when she came to my wedding last year, her white hair had a Mohawk streak of purple running through it). I dragged my heels and eventually called my uncle to set up a date to come shadow him. The date was set for late January.

One Small Step For Ray

When the day arrived that I was to drive to Fort Lee, a cold rain pelted the metropolitan area, and to make matters worse, we had had six inches of snow two days before. With the snow melting

and the rain coming down, I made my way cross town, got on the West Side Highway and over the George Washington Bridge. By the time I got to my uncle's Main Branch, it was mid morning.

My uncle's assistant greeted me and let me know Richard was on a call and would be out in a minute. Sure enough, two minutes later, out came Uncle Rich, who then took me around to the dozen or so employees at the branch. Each time we stopped at either a banker's desk or a teller's window, Rich would introduce me. Each introduction was pretty much the same: "Sally this is my nephew, Raymond, Pearl's son. Raymond here just got out of college..." And so it went. After twenty minutes or so during which all the introductions were made, Rich told me to grab my coat and we'd take off. I asked him where we were going to which he said, "Come on, I'll show you what I do for a living."

My uncle's car was parked behind the bank. Foreign cars for American bankers were not yet in vogue, so we got into a mile-long American-made sedan that probably got about six miles to the gallon.

Wiper blades slapping, a cold rain falling, Rich began to tell me that much of what he did was to look after the bank's larger commercial accounts. He wasn't talking about their commercial checking but lines of credit, term loans and helping these clients with their business plans. He did it all. He said our first stop would be at one of the bank's best client's business, a dry cleaning plant that looked like a low-slung factory out of 1950s Russia. He pulled up as close as he could to the main entrance, stopped the car, and told me, "Put on your galoshes before we go in. It's nasty out there." Now, I was in a raincoat with shirt and tie. I was used to wearing Dunham hunting boots for the last three years up there in Vermont and had my one pair of dress shoes on—a pair of Beef Roll penny loafers from Florsheim. I had no galoshes.

After telling Uncle Richard that I had no galoshes, he said, "Never mind, jump out, the owner is looking forward to meeting you." So with that in mind, I opened the door and went to get out. Planting my right foot on the ground, I was hit with the rudest shock: I had just stepped into six inches of freezing slush. Immediately, the slush flooded the top of my shoe and saturated my wool sock. It was precisely at that moment that I decided I was going to head out West to sunny California and enroll in law school.

Had I known to borrow a pair of my dad's galoshes that fateful day, I could easily have become a banker. But in this case, it really doesn't matter. Whether you're a banker, economist or wealth advisor like me, the next topic is one we're all following closely. And I want you to become familiar with it. It's one of the key indicators I follow which has been very active of late and you may not have even noticed. So, let's get started.

The World Is Made From Debt

Think about it. Take your average new home buyer. How much do they put down when they buy a house? Typically, 20%. That means 80% of the house is bought through debt financing, a.k.a. mortgages. Corporations function the same way. There is roughly three times the amount of debt

for every dollar of equity. In this case, debt would be referred to as fixed income securities (bonds), and equity would be referred to as stock. Governments function the same way, with most operating on borrowed money.

If you were to take the total amount of federal debt in the U.S. right now and tried to pay it off, it would take approximately 15 months of time where every dime Americans made would have to go to pay down the debt. That means no money for food, shelter, clothing— nothing. Every dime would have to go to pay down debt. If that's not bad enough, much of the outside world is in worse shape. Emerging markets on average would take more than two and a half years to pay off their debt, with some taking much longer. In fact, as a form of callous humor, I've heard bond managers referred to recently as "grief counselors."

Normalization

The government refers to it as "normalization." Mathematicians refer to it as, "reversion to the mean." The rest of us recognize it as rising interest rates. Just two years ago, I was writing about 10-year Treasuries hitting a low of 1.4% interest. Today, they are more than double that amount. Barring any type of "Black Swan" event, the Feds are poised for at least one more interest rate hike in the federal funds rate this year and probably several more in 2019. This would put the federal fund rate somewhere around 4% by the end of next year and everything else higher from there.

Now smart money managers are employing various strategies to deal with this reality. After all, most of us can't afford or stomach the volatilities of an all equities portfolio. So many of us are sticking with high grade issues (minimizing credit risk). We're keeping our maturities short term. We're using floating rate corporate loans, even "unconstrained" funds, where the manager can take both long and short positions. In this case, the long does not refer to the length of the maturity, but to the fact that the manager thinks the asset will go up in value and the short refers to the fact that they think it will go down.

The Bull market in Treasuries that started in 1982 is over. The same way that 1982 is not coming back, it's an extraordinarily remote possibility that we'll see the 14.6% 10-year Treasury rate again the way we did that August.

So, as Pearl would often like to say, "Some things bear repeating." The point now is not how high interest rates get, but where they settle on the yield curve.

Okay, Smart Guy: Tell Us About Yield Curves

The range of rates between the two-year Treasury and the 10-year Treasury is critical. It works like this: If you are a lender and make a loan, a.k.a. buy a bond, the longer you have to wait to get paid back, the more risk you take (both interest and credit risk). The more risk you take, the more you should be paid for taking on that risk. In other words, you should receive a higher interest rate.

The point where the Feds stop raising rates and the yield curve flattens out is called the "terminal point." The phenomenon that's happening right now is the yield curve has already flattened out in spite of the fact that rates are still rising. In fact, the curve is at the flattest it has been for 12 years. Only 28 basis points (100 basis points equals 1%) separate the two-year from the 10-year Treasury rate. So the question begs to be asked: Why is this so important? Because...

A Flat Yield Curve Can Sometimes Signal Danger Ahead

Why would investors risk going long term with their bonds when they are not rewarded for it? They can get the same yield with less interest risk by keeping their maturities short term. And, yes, let me remind you, there will be a whole lot of borrowing going on in the future.

Strategists argue that rates will continue to go up. After all, the Treasury will be doubling their borrowing by surpassing the one trillion dollar a year level by 2020. That's less than two years from now. Couple that with the possibility that countries like China could dump our Treasuries in response to trade wars and the stage could be set for...

An Inverted Yield Curve

An inverted yield curve occurs when long-term rates are lower than short-term rates. Over the past 50 years, we've had seven different recessions (recessions are technically defined as successive quarters of shrinking GDP). Each one of these recessions was preceded by an inverted yield curve, usually occurring four to six quarters prior to the recession. During this period or prologue to recession, we will typically see corporate balance sheets weaken, higher default rates among junk bond issuers and tightening of credit.

Bond analysts will tell you what they are watching most closely, and parenthetically, what we're watching most closely, is the interest risk as measured by what is called duration. Duration is stated in years and reflects how much a bond's price will fall as interest rates rise. The longer the duration, the more the bond price will fall. So a bond with a six-year duration would drop 6% for each 1% rise in interest rates. Let me put it another way. It would take roughly two years of interest earning just to offset the decline in the bond's value. I heard one clever wag describe it as:

> "Risk-free return
> Has turned into
> Return-free risk."

It's Not All Doom and Gloom

The fact of the matter is that measured and predictable interest rate increases frequently result in up stock markets following the year the increases begin. At least that's what has happened approximately three quarters of the time over the past 65 years.

On the corporate side, American companies continue to show solid earnings. Labor costs have been rising modestly. This is a good thing if it can put a dent in the income divide we have here in America without triggering inflation.
Then we have the multiplier effect. Remember how many times a dollar changes hands with new business happening each and every time. Keep in mind there is a whole lot of stimulus coming into the economy from the one and a half trillion dollar tax cut. Most overseas economies on the other hand are hurting. Their equity markets are down, and Brexit is just eight months away. That's not to say value can't be found internationally, but one has to be select.

Let Me Bring It Home

Ever hear the term, "poker face?" It refers to deliberately inducing a blank expression on your face so as not to give away your emotional state. The ability to do this consistently gives a poker player a major advantage over his or her opponents.

Now most people can't keep a good poker face and actually develop a "tell," which good players are on the lookout for. Think of a tell as a nervous tick that demonstrates your mood. Here are a couple of examples: The guy that plays with his chips when he has a good hand, the woman who pushes back her glasses when she has a poor hand, or what about the chatty guy who goes silent when he tries to buy a pot. Now if you're a good player, you look for the tells, and that way have a better chance of walking home a winner.

Economics and markets have their own tells that an astute observer will watch for. One of the best known tells is following the price of copper. Copper is often referred to as a thermometer that measures the health of manufacturing. Think about it: Copper is used in just about everything. If copper prices are up, business is building things. If prices are down, things have slowed down. I've long believed that copper prices are a good tell and something a seasoned poker player (investor) would look for.

So if copper prices are a thermometer and a tell for manufacturing momentum, I believe just as firmly that the yield curve is a tell that works like a barometer. When long-term rates fall below short-term rates, it can be likened to the needle dropping on a barometer signaling heavy weather ahead, and forewarning is always a real good thing. It gives us a chance to plan and position.

It's important for an investor to avoid overreacting to headline news and daily market gyrations. Staying focused on the indicators and positions appropriate to one's time horizon and risk tolerance is a must. This is one time you don't try to be the "smart cookie" and time the market. (Now there's a tell for sure because the players that try to do that usually go home losers.) As the old axiom reminds us, "Market action always trumps opinion."

As always, I look forward to our next review.

Best Regards,

Ray Lent
RLL/dot
Enclosures

P. S. It's with gratitude and appreciation that I'd like to thank those many clients and friends for their good wishes these past couple of months with respect to my recovery. I'm happy to report that my back surgery was most successful. I'm now walking around with a whole lot more spring in my step, and getting back to a New Yorker's pace in my walk. Because I am feeling so good, my biggest challenge, in the words of my doctors, is "not to over do it, and to get the full beneficial effect by following the tortoise's example of slow and steady."

It would be so remiss of me not to share with you my appreciation for my colleagues at Putney for their attention to detail and for caring so well for our clients during my absence. A special thanks to my friend and colleague Mike Mosher who was so helpful during these past couple of months, handling those issues that require years of experience because they don't land within the nine dots. Things like researching and advising on Reg 453 installment sales for a tax savvy client trying to minimize taxes on the sale of investment property. We hope to be seeing a lot more of Mike at the office later in the year.

Now for the envelope please. You'll recall that last quarter I invited clients to put forth their suggestions, along with the rationale behind them, for an upcoming quarterly commentary. Let me tell you that we received some very thought-provoking submissions, so picking one was just too hard. So, the $500 prize will be equally shared by:

John Sh: For his suggestion on exploring the Gini Index, a long-held measure of income equality or inequality.

David S: For his suggestion of the metaphorical use of sailing principles as they relate to markets and economies. (I have to be careful with this one because it would be way too easy to over use the metaphors and really *sink* the commentary.)

John Sa: For his suggestion on the changing effects brought on by technology: "Better, faster, cheaper." Ironically, my cousin, Dr. Robert Lent, is coming to town in another two weeks to present two papers on related topics.

The above ideas will be melded into upcoming commentaries throughout the next year.

It was actually hard to narrow the contest down to three winners. To all of you who provided such thoughtful suggestions, there will be an extra wheel of cheddar coming your way this Thanksgiving. That should keep those Vermont cows busy.

Let me close by way of an update. The last of the boxes are now being unpacked at our new location. Smith Ranch Road is proving to be more than a tasteful office. More importantly, it's

fertile space that fosters the collaborative effort like few others. The city boy in me takes great pleasure in watching the wild turkeys darting around the greenery right outside my office window. We can't wait to share it with you.

It's my hope that you can join us this coming year as we host some casual dinners and show and tells at the new office. Come see some of Ray's curiosities never before viewed in public. Okay, I'll admit it, a bit P. T. Barnum-esque, but seriously, come join us. There's a terrific little Japanese restaurant right in our building, and you know we always try to honor any special requests, dietary or otherwise. Ray