Ray's Corner

Ray L. Lent *Chairman, Portsmouth Financial Services*

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Economic and Market Commentary

Physician and naturalist, Sir Hans Sloane, lived a most remarkable life. Born six years before the Great London Fire, Sloane grew to be inquisitive, scholarly and generous, but his most unique characteristic was his passion for collecting. He collected books, manuscripts, antiquities and "curiosities," which were basically everything else. As I said, Sloane was a generous man, and he decided he wanted his collection to stay intact. So he bequeathed it to the nation. At the time of his death in 1753, his collection consisted of over 71,000 pieces that filled Montagu House in Bloomsbury, London, and so the British Museum was born, the first national public museum in the world.

Over the years, the British Museum's collection has grown to over eight million pieces spanning the history of the world's cultures. Somewhere along the way, the Museum acquired a small crystal globe six centimeters in diameter. For many years, this piece sat unnoticed, nestled in a mahogany and glass display case amongst the mineral collection. It wasn't until the mid-19th century, when the natural history material of the Museum was moved to a separate building in South Kensington, that the museum's curators realized what this small crystal globe really was. It turned out that this was no mere mineral specimen but the prized "shew stone" of John Dee, astrologer, mathematician, alchemist and "scryer." Yes, that's right, what the curators realized was that this was the crystal ball that helped define Elizabethan England in the 16th century.

Contemporary reports described Dee as tall and slender. "He wore a gown like an artist's gown, with hanging sleeves and a slit ... a very fair, clear, sanguine complexion ... a long beard as white as milk ... a very handsome man." Think of a real life Albus Dumbledore, Hogwart's headmaster in *Harry Potter*. Dee was the real deal, with one foot firmly planted in science and the other in the occult. His widely influential work, "Mathematical Preface" to Henry Billingsley's English translation of Euclid's elements in 1570, argued the central importance of mathematics in the arts and sciences. It was reprinted for more than 150 years after Dee's death. But its his role as a seer, one who can give information on future events, that fascinates us to this day.

It is said that Dee would not actually see events unfold in the depths of the crystal but rather would clear his mind by staring into its featureless interior that would enable him to portend future events. From the time Elizabeth I came to power, she relied on Dee's ability to see the future so completely that he picked the date of her coronation by gazing into the crystal. Some would say that with the help of his powers, the Roanoke colony was established, Mary Queen of Scots was executed and the Spanish Armada defeated. And so it went for almost 50 years.

All Right, Ray, So What's the Point?

When you manage other people's money, you're frequently asked, "What do you see in your crystal ball, and what are you going to do about it to protect me?" Now I don't profess to have a crystal ball, but I do use lenses, the 3000-year-old invention of the Assyrians used to bend light and bring things into clearer focus

The balance of this quarter's commentary will be dedicated to four global macroeconomic topics, along with the lenses through which I view them and what strategies we're employing based upon our perspective.

Towers of Steel

Originally powered by men or beasts of burden, construction cranes were invented by the ancient Greeks for the construction of tall buildings. When early engineers figured out how to employ human powered treadmills to these cranes, their lifting power improved dramatically. By the late Middle Ages, harbor cranes came into use to load and unload ships as well as step masts into larger and larger sailing ships. By the 1700s, steam engines, the darling of the Industrial Revolution, were harnessed to the new cast iron and steel cranes being manufactured at the time, again providing much greater lifting capacity. Today's modern tower cranes can stand as tall as a 20-story building and lift 40,000 pounds. If you've looked across the city's landscape recently, you'll see 48 of these modern marvels redefining San Francisco's skyline. San Francisco is on fire with social media and technology money creating millions of square feet of new office space, giving moot testimony to the health and vitality of the Bay Area's economy. Are we alone? Absolutely not. New York City right now has over 200 tower cranes in operation.

Now on the surface the tower crane count is pretty good empirical evidence that our economy is strong and moving in the right direction. And that's understandable. Alas, it's not the full story, however.

Remember, it wasn't all that long ago that Detroit, Michigan, was in all the headlines for having filed for Chapter 9 bankruptcy protection. Even though Detroit represents the largest municipal bankruptcy in US history, the city is certainly not alone. Across the country, cities like Stockton, Vallejo, Boise and Harrisburg have joined the ranks of the insolvent. Keep in mind that with only 19 of our 50 states allowing assistance to local governments facing insolvency, many more are sure to follow. Although city and municipal bankruptcies are not new, what seems most troubling to knowledgeable observers this time is that larger economic conditions seem to be the cause in a way that we haven't seen since the Great Depression.

So what's at the core of these municipal bankruptcies, the Yin to the Yang of New York and San Francisco's forest of tower cranes? Unfortunately, it's seldom the result of one unlucky event. More often than not, insolvency comes about in a pattern shared by many poorly managed cities. Typically, the problems emerge following many years of financial mismanagement usually accompanying no growth policies, underfunded retiree health benefits, underfunded pension benefits, poorly constructed debt and too much of it along with a declining tax base.

Don't think for a moment this only happens in cow towns and rust belt enclaves of dying industries. Just remember, we here in marvelous Marin have managed to run up two billion dollars in underfunded county pension benefits. The question begs to be asked, is the glass half empty or half full? I'm generally an optimistic person who does think our recovery has gained traction, but I nonetheless apply self-imposed guidelines in what I choose to own in our portfolios.

That's why you'll see us more often than not getting our portfolios' heavy equipment representation in large part by owning companies that lease out the equipment, as opposed to owning the equipment manufacturers themselves (an example of our "tollkeeper" strategy). Another means by which we hedge our portfolios' risk is buying our real estate in areas that demonstrate resiliency

The Guns of August

In early June, 1914, the world cheered as man's greatest achievement to date in terms of modifying his landscape to forward human progress and trade, the Panama Canal, opened. At a cost of thousands of lives to yellow fever, what was once thought of as impossible came to fruition, the two mightiest of oceans joined as one. Many thought the world would never be the same. How right they were when, less than three weeks later, Prince Archduke Franz Ferdinand, heir to the Austro-Hungarian Empire, was assassinated in Sarajevo.

By late July, the "war to end all wars" was joined. First, Austria declared war on Serbia. Next, Germany declared war on Russia to defend its Serbian allies, and on August 3, the Germans invaded Belgium to get at France. Then Great Britain declared war on Germany to defend its ally, Belgium. Before long, the Belgian provinces of West and East Flanders came to be known the world over as, "The Western Front."

In Flanders Fields the poppies blow

Between the crosses, row on row

That mark our place; and in the sky

The larks, still bravely singing, fly,

Scarce heard amid the guns below

We are the dead. Short days ago

We lived, felt dawn, saw sunset glow,

Loved and were loved, and now we lie

In Flanders fields

Lt. Col. John McCrae

The East Baltimore Veterans of Foreign Wars Post Number 1858 is named the Henry Nicholas Gunther post. Henry had the distinction of being the last soldier killed in World War I. At 10:59 AM, one minute before the signed armistice was to take effect, Gunther was cut down by German machine gun fire outside of the village of Chaumont-devant-Damvillers. In a little over four years, a total of 17 million people, both military and civilian, had lost their lives in the war to end all wars.

Fast Forward

One has to ask oneself just what has changed these past 100 years. Based on a recent sampling of newspaper headlines I collected in researching this column, I'd say not much. The world is still a bubbling cauldron of hostilities, only now we find out about bloodshed and violence in real time. Whether it's the downing of Malaysia Airlines flight 17, shot out of the skies above eastern Ukraine, or the fighting in Gaza, Syria, or Iraq, there are constant reminders all-around of just how dangerous the world we live in is.

If you accept the basic fact that danger and hostility are all around us, have you given any thought to why the equity markets have behaved in such a blasé fashion? Every time China and Japan play a game of chicken in the skies over the Diaoyu Senkaku Islands, you'd think the equity markets would have taken a beating. But no, they shirk it off. So why the lack of volatility? My suspicion is that US oil and energy self-sufficiency has a lot to do with it.

The United States is well on its way to becoming largely self-sufficient in oil and gas and soon will overtake Saudi Arabia as the world's biggest supplier of hydrocarbons. Although US energy independence is still several years off, it's still a stunning reversal from 40 years of US dependence on imported energy sources, and all the attendant geopolitical and economic concerns that dependence brought. Driven by innovative methods in both exploration and extraction of fossil fuels such as shale gas from hydraulic fracturing, natural gas supplies in the US have soared and prices have plummeted, a situation unthought-of just five years ago.

This newfound energy bonanza has resulted in cheaper and cleaner electric production, since we're burning more and more natural gas and exporting more and more coal to energy-starved Europe. I do believe these developments have resulted in a significant decline in market volatility in recent years. Now, does that mean I want to own a lot of US oil and gas companies? No, not necessarily. But staying true to our *tollkeeper* strategy of owning companies that have to get paid regardless of the cycle by how they're positioned in the delivery chain, we definitely like owning tanker rail car manufacturers, refineries and pipeline companies to name just a few.

What's Up With Fixed Income?

A naïve perspective that the average investor might hold is that the bond market can be a benign investment universe, stable and void of big swings. Unfortunately, that view couldn't be further from the truth. Investing in the bond market is subject to a myriad of risks, including credit and inflation risk and issuer and market risk.

To me, the bond market today is a particularly inhospitable fishing hole in which to drop your line. Yes, we all recognize the interest rate risk with 10-year Treasuries hovering around 2½%; there's certainly not much in the way of yield to justify the risk. But what I find particularly disturbing is the mispriced credit risk.

Think about it. It wasn't that long ago when everyone was talking about the demise of the "PIGS" (Portugal, Italy, Greece and Spain). Their economies were on the brink of collapse fueled by excessive debt, no growth, along with unsustainable public health and welfare safety nets. Fear of the PIGS brought into question the very viability of the Euro and the European Union.

Here we are, some three years later, and Italy's 10-year-Treasury is paying 2.75%, Portugal's 3.69% and Spain's 2.56%. Literally the same yields as US treasuries. To me, that's mispriced credit risk (meaning the yields should be higher, given the risk a lender is taking).

Without a doubt, I will gladly trade very low yield for the chance of a reasonable total return potential by continuing our strategy of tactically trading our preferreds and convertibles. This strategy produces very modest interest risk because of our short maturities but excellent upside equity growth potential because of the convertibility features of the securities. This has been an effective strategy that has dampened portfolio volatility while avoiding in large part significant market risk.

So Where Does That Leave Us?

We are now in the fifth year of the recovery. Stocks have soared since April, 2009, yet the country is still plagued with persistent and high long-term unemployment. Today, we have 3.5 million fewer full-time jobs (and I emphasize full-time) than we had at the beginning of the recession. With that said, equity markets are trading at a reasonable P/E multiple of 16 (meaning corporate profits have gone up with stock prices).

This year represents an important mid-term presidential cycle. In the 13 mid-term off-presidential cycles in the last 50 years, the market has seen an average decline of 12%. In every instance, a significant stock market rally has followed the completion of the mid-term bottoming process.

Given how far the market has come in the past five years, coupled with investors' expectations of increases in interest rates slowing the economy (although this is usually not the case if interest rate increases are slow and measured), I believe a temporary pullback can certainly be expected and perhaps even welcomed by some.

By whom, you might ask? By those with capital to deploy I would answer. With that in mind, I would remind you of my commentary a few months back that told the story of Andrew Ure, the Scotsman who invented the thermostat and how we're applying that concept to our portfolio management.
By setting equity targets, in other words, lowering the amount of common stock we want to own as the market gets higher and higher, we are effectively taking profits off the table. At the same time, we are positioning the capital in lower volatility instruments like preferreds and convertibles, pending future deployment back into common stock when attractive entry points present themselves. At that point in the market cycle, the forces that bring about higher interest rates, including a stronger economy and higher inflation, will also push up corporate revenues and profits, supporting higher stock prices and the next leg up in the market rally.

Best Regards,

Ray Lent

Ray

RayLent@portsmouthfinancial.com
www.portsmouthfinancial.com

Toll Free:
800.443.2227
Phone: 415.543.8500
Fax: 415.764.1064

250 Montgomery St
Ste 200
San Francisco
CA 94104

PORTSMOUTH
FINANCIAL SERVICES