First Quarter 2018

Economic and Market Commentary

Somewhere around six to eight million years ago, growing in Central Asia, the malus sieversii fruit trees stood, forebearers of our modern apple, malus pumila. These apple ancestors fed the wild horses of the Steppes some several million years later, and by 50,000 BCE, they were a mainstay to prehistoric man in Central Asia.

Now just to be clear, I'm not spouting Darwinism here and refuting the Bible's timetable as to when Adam and Eve took that fateful bite of apple. An apple wasn't used as the article of temptation until the Latin translation of the Bible. Originally, the Hebrew text stated that they ate a fruit, period. Now that's just an aside. What we do know is that by 2000 BCE, apples were a rage in Greece and Italy and eventually made their way to Western Europe. You see, one of the great things people realized about apples was they could be stored and used throughout the winter months when nothing else was growing. Remember, they could be sliced and dried or kept whole in underground cold bins. By the 1600s, French, English and Spanish explorers were bringing apples with them to the New World to make sure they had something hard to drink. Parenthetically, hard apple cider remained the most widely consumed alcoholic beverage worldwide until well into the 20th century. Today there are more than 7,500 varieties of apples grown around the world.

As American As...

Here in the US, we grow more than 2,500 varieties of apples, over 100 of them grown commercially. A guy named John Chapman has a lot to do with that. Now John was an early conservationist known for his kind and generous manner. Born in Leominster, Massachusetts, in 1774, John was a true child of the American Revolution. As a teen, he entered into an apprenticeship to a Mr. Crawford, a noted nursery man who happened also to run a commercial cider press.

Here's where truth and folklore part ways. The myth tells us this young man spent the next 50 plus years of his life walking through the wilderness barefoot spreading apple seeds wherever he went. We know him today as "Johnny Appleseed." The reality is actually quite different.

Here's what he did: John figured out that all those cider manufacturers were basically wasting the seeds that were in the apple pomace, what's left over after the press, and he proposed to buy them for a pittance. He didn't just randomly plant the seeds anywhere as folklore would tell you but mastered, in the most ethical way, "The Art of the Deal." He wound up going to established farmers to whom he would then propose a partnership. They would provide the land and he would plant an apple nursery. He made sure it was fenced in to protect it from the farmer's animals' munching into the profits, and every year or two he would return and tend the nursery to ensure it stayed healthy. In return, the farmers would sell shares to their neighbors so they could each make their own cider and have fruit throughout the year, and John and the farmers would then split the profits.

Talk About Connecting the Dots

John never married, and for the next 50 years, he developed and tended nurseries, befriended Native Americans, became an early advocate of vegetarianism, and lived a life of naturalistic simplicity in spite of his vast properties. Over the years, he developed nurseries from Ontario, Canada, to the Carolinas.

Today, apples are grown commercially in more than 30 states. We produce more than 240 million bushels a year grown on 322,000 acres of land. Apple production and its related by-products account for more than $20 billion of GDP per year. No small sum.

Out here in the West, our oldest apple grower, the Gebber Farm Company of Brewster, Washington, still runs as a family business. The company was started by old Dan Gamble who walked across the Continent from Nova Scotia in 1882, chasing the Okanogan Valley Silver Discovery. Talk about growing them tough. The business is family run to this day, growing everything from Fujis to Galas to Golden Delicious to Granny Smiths.

What On Earth Is A Bloomery?

Now right around the time apples became the rage of the Mediterranean about 4,000 years ago, the earliest known pieces of ironware were being produced in Anatolia. It didn't take long before iron and carbon started to be melded together, creating a much more useful alloy called carbon steel. Stronger than cast iron and more malleable, steel became the gold standard for bladed weapons in large part because of its strength and ability to hold an edge. So what's a bloomery? A bloomery is an ancient furnace that was used for thousands of years. Really, in one form or another, bloomeries continued to be used in various parts of the world until the invention of the blast furnace in the 17th century.

All Very Interesting But...

Yes, I know, you have to be asking yourselves, "what's the relevance of all this, particularly in a commentary that's supposed to be dedicated to markets and finance?" To paraphrase Bill Clinton, "It's all about the tariffs, stupid." You see, back in early April, after much talk and posturing, the US government drew up a list of 1,300 Chinese products worth $50 billion in exports to be subject to tariffs. The next day China retaliated with a 25% tariff on US exports including soybeans, cars, aircraft and, yes, apples. What was at the top of our list subject to tariffs on Chinese goods? You guessed it— Chinese steel.

Since the mid-1800s, the world has grown dependent on steel for its construction of tools, appliances, weapons, vehicles and building materials. Last year, the world produced approximately 1,650 million tonnes (a tonne of steel is the equivalent of 1,000 kilograms) of crude steel production. That's about four times what was produced 50 years ago back in 1967. Back then, China was responsible for just over 2% of the world's production, and used just about all they made for things like railway tracks, plates, wire rod, etc.

Fast forward 50 years, and China now produces about one half of the world's steel, about 10 times what the US produces. Although it uses much of what it produces, it winds up exporting 10% to 15% of what it makes every year, which has many countries crying foul. It is said that the Chinese are dumping their surplus on the market which lowers prices but also winds up eliminating jobs. After all, who wants to run a company whose product has to compete in a market with over capacity to begin with, and then to have to try to sell their product at a price higher than their competitors? (Remember who we bought our steel from to rebuild the Bay Bridge? China.)

It's the current administration's thinking (hotly contested), even within the administration, that the playing field needs to be leveled so that a growing world GDP will raise all boats. There is much to be said about the importance of a level playing field, one where things like intellectual property right infringements and knock offs are not tolerated. Regrettably, though, tariffs just don't work. And that's the scary part.

A Brief History Of Tariffs And Why They Don't Work

Throughout the millennia, societies have felt that a nation's wealth was a reflection of how much gold, silver, land and natural resources it had. It was thought that if a country had to give up these resources to another country to "import" goods, it was the poorer for it, and if other countries had to pay in hard goods for things they produced, they'd be the richer for it. I just realized that what you're reading now is actually the segue to the birth of colonization, big with pre-modern European countries for centuries. Here's how it worked: Rather than countries openly trading with each other, they would impose taxes on goods coming into their countries. This would make foreign goods more expensive and supposedly protect domestic industries whose products would be made artificially cheaper, at the same time protecting jobs.

The problem was (and still is) that, over time, unintended consequences started to creep in. Examples: domestic industries get less competitive because they feel protected by the tax on foreign competitors (the tariffs); people in the countryside get hurt because they are principally agricultural producers who have to now purchase manufactured goods at higher costs from people in the cities, and eventually these countries enter into a tit for tat, commonly called a "trade war."

In the old days, the answer lay in the Seven Seas. "Colonization." Send your Navy out, claim a territory, make it a colony, which is sometimes affectionately called a "protectorate." Insist that the people of that colony only produce raw materials (no finished goods) and then further insist that they sell those raw goods to you only and not to other countries. You then being the benevolent "mother country" that you are will take those raw goods, produce them into finished products and insist that your colonies only buy the finished products they need from you at non-competitive prices. Sweet!

That is until a Scottish philosopher and economist named Adam Smith wrote his *Wealth of Nations* in 1776, and then it was game on. Now don't get me wrong. The English don't have a monopoly on enlightened thinking. But a generation after Adam Smith published his *Wealth of Nations* a young Sephardic Jewish Englishman named David Ricardo put forth his hypothesis of, "The Theory of Comparative Advantage." Simply put, the theory says do what you're good at and the world will benefit. He felt that countries should specialize in producing goods that they have an absolute advantage at to promote trade with companies that enjoy an absolute advantage in something else. Ricardo was not just a thinker. Disinherited by his family for marrying outside his religion, he earned his own fortune in trading government securities, retired at age 40 and became an influential member of Parliament. Today he is viewed as the most influential adversary of protectionist policies and the founder of the concept of comparative advantage.

Let Me Bring It Home

You don't need me to tell you the world is an unpredictable place. Let me give you just one example of this. Four or five months ago the world was fixated on public exchanges between President Trump and North Korean leader Kim Jong Un as to who had the "bigger button." The talking heads on TV went wild. Two days before this writing, the airways were bombarded with images of Kim Jong Un and South Korean President Moon Jae-In literally walking hand in hand, helping each other over a broken cobblestone curb dividing North and South Korea. Now honestly, which one of you out there in your wildest imagination saw that coming? I sure didn't.

The point is: there are things you can plan for and there are things you can't. During the first quarter of 2018 alone, we have seen a heightened volatility that we haven't seen for years with 23 market days either up 1% or down 1%. We didn't see that all of last year. And you know what? That's not the exception; that's much closer to the general rule. It's the past year of market complacency that is the exception. Day after day, equity markets were shirking off any negative news, marching to a higher drum beat. At least for a while, those days are over.

Does That Mean We Should Hold Up Our Hands And Hope For the Best?

Absolutely not! There's never any place to hide. If you invest in the equities market, you have the risk of ownership, if you invest in fixed income securities, you've got the risk of rising interest rates known as interest risk or credit risk, in essence the risk of not getting paid back on a loan you made. If you invest in real estate, just remember 2008's market meltdown. (I still see modern day ghost towns when I take my boat up the San Joaquin, heading toward Stockton.) You have inflation risk. In other words, when you get your money back after that 2% CD matures in six years, what will prices be like? Likely higher. That's known as losing purchasing power.

Conclusion

There's an old truism on Wall Street that the average investor "greeds in and panics out." Boy, is that ever true. Successful money management requires discipline and flexibility. Are there cross winds out there? You bet. You get low interest rates, low wage costs, low energy and the advancements of technology all working in your favor. Couple that with fiscal stimulus, government tax cuts and spending and you can make a strong case for sustainable growth in the equity markets.

But how Pollyanna would it be if one didn't consider the depth of the dark side. For example, will the Feds raise rates too fast, or even worse, unpredictably raise them? What happens when Central Bank liquidity stimulus is gone, creating greater vulnerability? Can we really count on "growing our way out" of the incredible debt burden that is currently in place? (That's not just government debt either, but it includes plenty of personal household debt as well.)

But what do you expect? Goldilocks-perfect all the time? Certainly not, it's not going to happen. What one strives for instead is a principled approach based on a balanced risk reward continuum unique to the individual investor. And above all, observe and don't discount the fundamentals, then apply common sense and don't be afraid to modify as needed. Here are three examples we're using right now that we think are sound and have more than short-term legs to them:

- Tariffs are in place. Has a trade war started yet? We hope not, but we realize the climate calls for less reliance on companies that export a great deal and find quality small and mid-cap companies that focus their sales locally. Companies like that can be found both here and abroad. Companies that have strong local markets. That means we continue to build our small and mid-cap representation as we have been doing this past year.

- Accept what mother nature throws your way— floods, hurricanes and fires. We've sure had our share of them recently. It is our firm belief that over the next five years or so, we will see Puerto Rico, Florida and Houston rebuilt as well as fire ravaged California. And when we do, paint and dry wall will be needed. Heavy equipment to move the debris along with building foundations will certainly be needed. And elevators and roofing will all be needed as well. This is an area where we are looking for the best in breed. In other words, who makes good paint, who sells the most drywall, who can deliver on time? These are the companies we are seeking out and adding to our portfolios. Don't think of this as opportunistic bloodsucking because it's not! It's tactical allocation, and that's what good money management should always strive for.

- Develop a core holding in emerging market debt, a market that accounts for 18% of the world's debt, and is currently substantially undervalued as an asset class. Here we would use a fund manager who keeps a close eye on a country's "foreign exchange reserve." In other words, if the country's Central Bank starts holding far more currency, that's good, foreigners are buying their products. On the other hand, if foreign reserves go down, they are importing more than they are exporting, and in emerging market debt, that's not good. A smart manager will look for small improvements in corporate-run companies which can equate to outsized gains in their capacity and profitability. Here we can seek yield without having to go out very far, resulting in minimized interest risk. We're doing our due diligence on several such fund managers at the time of this writing.

For years I would read the weekly column in *Barron's* written by long-time analyst Steven Sears. He retired recently after a long and distinguished career. It was always his position that the average investor, left to their own devices, defeat themselves, losing more than they should. Why? Because they would fall victim to fear, not accepting the fact that investors have few friends in the market but fear should be one of them. Recognizing fear creates opportunities, and when embracing core investment principles, you will often find yourself on "the right side of the events." So how does that work? Let me give you an example that will complete the circle of this quarter's commentary. We started talking about apples and China and tariffs. (Incidentally, wherever you see the word apple, you could replace it with soybean or pork or wine.) We recognized that with China putting a tax on US apples coming into their country, it becomes that much harder for US growers to sell to China. So does that mean we should stop exporting apples? Absolutely not. China will simply buy them from another source, in this case, Australia, one of their leading trading partners. Australia happens to have more than 600 commercial apple growers and are looking to increase exports dramatically. It's just like the old adage: "Where there's change, there's opportunity." One just needs to keep their eyes open to it.

Should we expect more volatility ahead? That's almost a sure thing. Will good business continue to thrive over time? Most definitely. Will all businesses prosper? Absolutely not. They play taps across the world every single day for poorly run businesses. It's our job to distinguish between them. As my dear mentor Marvin Starr, Dean of California real estate law, has often reminded me, "Sometimes you don't want the whole forest; what you're looking for are a few good trees." Now there's a lesson I've taken to heart.

Truly, I'm excited about the year or two ahead and the opportunities that will be created in a volatile market that still enjoys many sound fundamentals. As always, I look forward to catching up at our periodic review, and if you need anything at all in the meantime, just pick up the phone and give us a shout. As always with...

Very Best Regards,

Ray Lent
RLL/dot
Enclosures

P. S. Just a couple of quick updates. Our new spacious quarters at 100 Smith Ranch Road could not be working out better. Beautiful green surroundings with room to grow, what more could one ask for?

On a personal note, I've shared with a couple of you that I've been dealing with back issues for a number of years. The way you can tell is I'm back to wearing my big boy suits. After physical therapy, chiropractic therapy, acupuncture with instruments the size of knitting needles and not much in the way of relief, I will be having back surgery in late June. You know I'm thorough in my due diligence, so it has taken me quite a while to find the right surgeon (thank you, Joan, for the most wonderful referral). Although I'm told the surgery is "relatively" non-invasive (isn't it always?), I do expect that there will be a few weeks when I'll be healing and out of the office.

My colleagues have all geared up for my operation and will all be there at the ready to assist you with any and all of your needs. With that said, I do recognize that there are times when a client needs a sounding board and the advice and counsel of someone who is not only extremely competent but has also been around the block when it comes to helping clients navigate difficult situations. Considering that need, I've arranged with a most trusted colleague who works in my Montgomery Street office in the city to be available should something out of the ordinary arise. His name is Mike Mosher. Mike has 25 plus years experience in the securities business and a stellar reputation of integrity, flexibility and extreme competency. His low key, unruffled manner has always been a delight to work with.

Also, since I'll have plenty of time for research while recovering from my surgery, I'd welcome some theme suggestions from you for my next quarterly commentary which comes due during that time. In fact, I'm posting a $500 prize and commentary recognition for the theme that's chosen. I invite you to send your suggestions to Denise O'Toole (Denise@putneyfinancial.com), who will collate them for me. Please, no more than three suggestions per household. I can only read so fast. Regards, Ray