

Third Quarter 2018

### **Economic and Market Commentary**

The Roman Empire lasted for more than 500 years. Historians mark its fall when emperor Romulus Augustus was deposed by the Germanic king Odoacer in 476 CE. Meanwhile, across the ocean, people were building a culture that would last a thousand years.

To many, these people are known as the “mound builders.” The center of the pre-Columbian Mississippian culture I’m talking about can be pinpointed to a spot called “Monk’s Mound,” a gigantic manmade earthen pyramid as tall as the Great Pyramid of Giza.

### **Carved Out of a Frontier**

The Cahokian people built their mounds to honor their dead. The urban center next to Monk’s Mound was where trade, commerce and congregation would occur amongst the largest population center in what one day would be called America.

To feed themselves, the Cahokian people cleared out forests and planted crops. Spoking out in all directions from Monk’s Mound, the city grew fields of corn and vegetables. The culture prospered for a thousand years and then it vanished. Did its chiefs fear the supernatural and declare that they should go? Was it a massive earthquake that drove them away, or did they outstrip their water supply? Historians couldn’t tell you because they simply don’t know, but by 1450, the Cahokians were gone for good. Monk’s Mound still stands today.

### **A Town Is Born**

It wasn’t until 1818 that fur trappers congregated there, close to the banks of the Sangamon River, not far from where the Cahokian center once thrived. At first they called their settlement “Calhoun,” but changed its name to Springfield in the early 1830s. Springfield, due to its fertile soil, abundance of water and trading opportunities became the county seat.

Now Illinois gained their statehood in 1818, the same year the trappers founded Calhoun. The first state capital was a frontier town called Kaskaskia. That town lasted little more than a year. The second state capital Vandalia fared better, lasting almost 20 years. But people found it remote, hard to get to and away from the centers of population and commerce.

By the late 1830s, a group of respected and influential leaders nicknamed the “Long Nine” (because of their combined height of 54 feet), convinced the Illinois State Senate to move the capital yet again, this time to Springfield. The group’s leader was a well liked, raw-boned six-foot-four inch country lawyer by the name of Abraham Lincoln.

### **A Great State Deserves a Great Capital Building**

Built by the town square of Springfield, “the old state capital” was actually the fifth state capital

building of Illinois. Built from locally-quarried limestone at a cost of \$240,000, it housed both houses of the Assembly, the Governor's office as well as the Illinois Supreme Court.

Fewer than 20 years after construction began, the old capital building made its way into American history when, on a humid June day in 1858, Lincoln declared his candidacy for the United States Senate while delivering his "House Divided" speech on the floor of the House Chamber, the same room in which his body would lie in state less than seven years later. In that 1858 election, Lincoln's opponent was none other than Stephen Arnold Douglas, the greatest orator of his time.

### **The Little Giant**

Standing not much more than five feet tall, Douglas was known for his oratory prowess and booming voice. Having supported Andrew Jackson and James Polk, he was a "whole hog" Democrat now running for his third term in the United States Senate and was a vocal proponent for having new states and territories decide for themselves if they would allow slavery or not.

The election is remembered for its series of debates between Lincoln and Douglas. In the end, Douglas would win his third term and face Lincoln again in the presidential election of 1860.

### **A House Divided**

It's said that Lincoln got his inspiration for his House Divided speech from a passage in the Book of Matthew. "Every kingdom divided against itself is brought to desolation; and every city or house divided against itself shall not stand."

The Supreme Court's Dred Scott Decision four years earlier (one of history's most glaring examples of the Supreme Court getting it wrong), sped the way for ultimate resolution through the American Civil War.

Lincoln's speech rallied Northern Republicans to stand firm against slavery. Among the most famous passages of the speech was Lincoln's declaration that:

"A House divided against itself cannot stand. I believe this government cannot endure permanently, half slave and half free. I do not expect the Union to be dissolved. I do not expect the House to fall, but I do expect it will cease to be divided..."

At the time, violence was everywhere, not limited to bloody Kansas or Harper's Ferry but found its way right down to the US Senate's floor, where South Carolina Representative, Preston Brooks, almost caned to death Massachusetts Senator, Charles Sumner. It was clear that the Union could no longer conduct business as usual.

### **Some Things Never Change**

To say we're a house divided today would be such a horrible understatement. Was it really all

that long ago that the topic of animal cloning was one of our most divisive issues? It's so much harder today to enjoy the little things in life like World Series baseball when today's headline tells us about the massacre at a Pittsburgh synagogue or pipe bombs being sent to our political leaders. Just last month, it was the Kavanaugh hearings that kept the country riveted. The need for movements like "Black Lives Matter," or the "#Me Too" movement are a constant and necessary reminder of how very far we still have to go.

At the time of this writing, the mid-term elections are a little more than a week away. By the time you get this piece, the results will be in. As a nation, we'll be voting for the 116<sup>th</sup> Congress. All 470 Congressional seats are up for grabs as well as one third of the Senate seats.

Usually, mid-term elections are viewed as a referendum on the incumbent president. Their party usually loses seats. In the last 21 mid-term elections, the President's party has lost seats 19 times and only twice have they gained.

One of the most thought provoking artists of the 20<sup>th</sup> century, Renee Magritte, once wrote, "We always want to see what's hidden to us." How timely a quote as we count the days to election.

### **Drum Roll Please**

It's been a couple of days since I've had a chance to come back to writing this commentary. The election is closer, the radio and television ads more constant and the rhetoric amplified even higher. But if you think about it, our democracy is set up so that only one of four things can happen:

- The Republican Party winds up holding on to both houses of Congress.
- The Republicans hold the Senate and lose the House.
- The Republicans lose the Senate but keep the House.
- The Republicans lose both the Senate and the House.

It almost goes without saying that, regardless of the election results, all Americans should hope to their cores that civility and equal justice for all will always be the American standard. If we manage to avoid annihilating ourselves, business and commerce will continue just as they have since the earliest days of the Phoenicians.

As hard as it might appear right now, economic analysts are completely putting aside social, ethical and moral issues, and are trying to forecast what might happen to the capital markets when one of the four possible outcomes just mentioned comes to fruition.

### **Here's What the Talking Heads Are Saying**

Many Democratic candidates have framed this mid-term elections as the "Party vs Trump." If they don't take at least one of the houses of the Legislative Branch, it will embolden Republicans who will treat the election as a referendum on their aggressive approach to national security, judicial picks as well as trade. Goldman Sachs strategic group thinks the stock market will

resume its rise (at least through 2019). They believe this would encourage greater deregulation, further tax cuts and a hawkish Fed policy. This would reinforce a strong dollar. (Remember a strong dollar makes it tough on emerging markets, since their currency would then buy fewer goods and services of ours and net them less for theirs.)

The pundits say that should the Democrats take the House (their best shot), look for Treasury yields slowing along with a freeze in fiscal policy. They further predict no major market moves (barring a Black Swan event), with attention then focusing on the upcoming Presidential election of 2020.

It's in the unlikely event that Democrats take both houses that analysts feel the markets would be most sensitive to "news headline risk," resulting in heightened volatility. In all likelihood, Democrats would view their election victory as a mandate to try and impeach the President while opening up additional investigations. In the very least, they would look at legislation designed to restrain Trump. We would also see a slowdown in deregulation.

### **Political Uncertainty Aside**

When you separate politics, the economy and the markets, you are left with fundamentals. Fundamentals like corporate earnings, growth, Federal Reserve policy, changes in bond yields, inflation, labor markets and economic data. That's not even mentioning the most important of them all—Mother Nature.

Although we wish we could "see what is hidden to us," we can see what is available, i.e., the fundamentals, and use those fundamentals to help us make good decisions.

What matters most in capital structure (how the world is financed, including governments, businesses and families is:

1. The cost of money, think *interest rates*
2. How much debt you have and can you handle it, think *free cash flow*
3. Is what you are spending money on going to help modernize, innovate and produce a desirable and competitive product, *think capital spending*

Will people have the money to buy your product? Think *consumer spending*  
Can your earnings exceed your cost of money? Think *growth and profitability*

### **Let Me Bring It Home**

Fundamentals keep changing but their importance does not. A year ago, I was writing about volatility rising and an unhealthy complacency in the market. Although complacency has quickly vanished these early weeks of fall, volatility, on the other hand, hasn't and won't.

One must always stay vigilant and focus on companies (or funds that focus on companies) that are well capitalized with soundly structured debt. Companies with good free cash flow and strong margins are always looked for in building solid equity portfolios.

On the debt side, I would point to a chart of the 30-year US Treasury Bond. Now being a history buff, I'm going to point to one that goes all the way back to 1900. Over that period of time, 30-year Treasury Bonds have been down as low as roughly 2% a couple of times (most recently as 2010). Back in the early 1980s, they have gone as high as almost 16%. So with them hovering down there today in the high 3s, that's still really low.

Bond yields could go up significantly, and stock prices could go up and have gone up, usually depending on two things:

1. A stock maintains the sound fundamentals of earnings servicing debt and producing a net profit worth the equity risk  
and
2. Bond rates (read that interest rates) rise in a predictable and reasonable manner

If both things were to occur, both the stock and bond markets could each offer inviting opportunities. Erratic interest rate behavior, on the other hand, would have a negative effect on both markets.

A significant rise in interest rates, particularly if it is seen at the long end of the curve, could create real opportunities in the bond market. Higher interest rates would bring an out of favor asset class (bonds) back into consideration. They could become something we would want to own.

Whether you're looking into the second half of a Presidential cycle or not, when you're managing wealth, complacency is bad and vigilance is good.

It would be remiss of me not to thank my editor, friend and long-time colleague, Denise O'Toole, for suggesting the upcoming conclusion to this commentary. You couldn't script a more thoughtful addition.

### **Conclusion**

November 23, 1963. Tucked in the inside breast pocket of his Brooks Brothers suit, John F. Kennedy, 35<sup>th</sup> President of the United States, carried a copy of a speech he was to deliver on the night of his assassination. Back then, like many other times in our history, our country felt like a "House Divided." The closing paragraph of that speech read as follows:

**"Let us not be petty when our**

**Cause is so great**

**Let us not quarrel amongst**

**Ourselves when our nation's  
Future is at stake  
Let us stand together with  
Renewed confidence in our cause  
United in our heritage of the  
Past and our hopes for the future  
And determine  
That this land we love shall  
Lead all mankind into  
New frontiers of peace  
And abundance.”**

*John Fitzgerald Kennedy*

Looking forward to our next meeting. With...

Best Regards,

Ray Lent  
RLL/dot  
Enclosures

P.S. By now, many of you have had the pleasure of meeting Putney's newest associate, Kelly S. Lawson. Kelly has been a personal friend and peer for many years. She brings a wealth of talent and experience to the firm, with more years of experience than any gentleman would get her to admit to. She's an experienced financial planner and wealth manager with great energy and common sense. Never one to beat her own drum, I'm quite proud of the fact that in 2014 she was named by *San Francisco Magazine* as one of San Francisco's few five-star wealth managers. As if that wasn't enough (show off), *Barron's Magazine* named Kelly to their list of Top Independent Financial Advisors in California the following year. Can't wait for you to meet her.  
Regards, Ray