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Economic and Market Commentary

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Today China is recognized as the second largest economy in the world. The country is grounded in a civilization that dates back more than 5000 years. By the fifth century B.C.E., China was dominated by seven warring states all vying for supremacy and locked in constant conflict. This lasted almost 300 years and came to be known as "The Warring States Period."

Toward the end of the Warring States Period, the State of QIN became the dominant influence, and under the leadership of Ying Zheng unified the other six states becoming China's first Emperor. History knows him as Qin Shi Huang.

Throughout the ensuing centuries, China introduced to the world countless inventions and innovations. They included gunpowder, paper, cannonballs, movable type, woodblock printing, and the compass to name a few.

By the 13th century, one of Genghis Khan's grandsons, Kublai Khan proclaimed himself Emperor of China after years of bloody fighting with the Jin Dynasty. The "Great Khan" and his successors formed the Yuan Dynasty. This was a period when much of the Asian Continent was controlled by Mongols who promoted commerce and exploration. They hosted Venetian adventurer Marco Polo for years, but ultimately were always viewed by ethnic Chinese as outsiders.

The Yuan Dynasty lasted less than 100 years. Ultimately, it was displaced by the Ming Dynasty that ruled for almost 300 years. They reconfigured the Great Wall of China to resemble in large part how we know it today. They promoted peace with tribes on the Northern Frontier. They supported the arts through court poets and musicians and created precious porcelain that is highly prized to this day.

Yet One More Invention

For roughly 2000 years prior to the emergence of the Ming Dynasty, money was based on the intrinsic value of the material it was made from. Typically, gold, silver, copper, and bronze. Chinese coins were called "cash" or Qian, round coins with a square hole in the center so they could be strung together for easy transport. This type of currency money, whose value is based on its intrinsic content, came to be known as “specie” currency.

It was early in the Ming Dynasty that the concept and production of paper money came into existence. The premise was simple: The government would produce paper money backed by their specie currency. If a merchant wanted a 1000 (cash) note, they would hand in 1000 cash coins to receive it.

The opposite was true as well: A merchant who wanted 1000 cash coins would simply hand in a 1000 cash note which was printed on mulberry paper. How fitting when one considers that up until this time, much of China’s silver and gold came from its trade with the Portugese. The Portugese would trade their precious metals for silk. What do silkworms eat? They live off mulberry leaves. Synchronistic, wouldn’t you say?

In Italy, the government was fearful of counterfeiters, and printed right on the note itself that counterfeiters would be executed by beheading (no halfway measures here). Furthermore, anyone who turned in a counterfeiter would be entitled to all of the counterfeiters’ property after execution. For years, this system worked quite efficiently.

Merchants now created greater commerce by not having to lug around hundreds of pounds of cash coins to conclude a transaction. Instead, they could carry in a small pouch an equal value of hundreds of pounds of cash coins in the form of paper money.

Temptation

After 20 years or so of this system working quite well, the government had a brainstorm. Rarely do government brainstorms work out, and this one was no exception. Up to this point, the Ming Treasury never issued more paper money than they had “cash money” in their vaults to cover the possible redemption of all the paper money that they had issued. This is the critical point in time when a good idea turns south.

The Ming officials theorized that people holding paper money would never turn the paper money in all at the same time for redemption to “cash coin.” So, what did they do? They started printing more and more paper money. After all, mulberry trees were quite abundant. They continued to print so much paper money that, if everyone were to turn their paper money in at once, the government wouldn’t have enough “cash coin” to pay people what their paper money said it was worth.

So, this went on for a while, pretty much unnoticed, but eventually people started to recognize that the government did not have enough “cash coin” to redeem all the paper money they had printed. So, what happened? Devaluation. No longer would a 1000 “cash coin” note buy the equivalent of 1000 cash coins. Soon, a 1000 cash note would only buy you 750 coins worth of goods, then it would only buy 500 “cash coin” worth of goods. By the time it reached the point where a 1000 coin note would only buy 250 "cash coin" value of goods, the government gave up on paper currency. It would be more than 300 years before paper currency, or basically sovereign IOUs, would be tried again.

Wars and Paper Money

Governments have a nasty tendency to finance their wars by issuing paper. Our own Founding Fathers issued "Continental Dollars" to finance our fight for independence. After the war, desperate veterans sold those dollars to speculators for an average of 10% of their face value because the government didn't have the specie currency to redeem them for their stated value.

When faced with the cost of fighting the Civil War, the U.S. government started issuing "Greenbacks," paper money to finance the war. By the time of the Great Depression, Franklin Roosevelt encouraged Congress to pass the Gold Reserve Act of 1934. This required the Federal Reserve banks to turn over their gold supply to the United States Treasury. The Federal Reserve received gold certificates (paper) to back their reserve notes. Simultaneously, the president changed the value of the U.S. dollar from equaling almost $21 per troy ounce of gold to $35 per ounce. In one bold move, he raised the U.S. gold reserve value by 40% while devaluing the dollar. Remember, this was in harmony with the "Executive Order 6102," which basically made individual ownership of gold illegal. Britain had already taken itself off the gold standard in 1931. As a result, you had a mass concentration of wealth at the very top, what we refer to today as the "one per centers," and a massive explosion of credit in the 1920s, which eventually led to an avalanche of defaults and the financial downfall of the 1930s.

Toward the end of World War II, 10 developed nations representing the allies met at Bretton Woods, New Hampshire, to craft a monetary agreement that established the international monetary fund. A new "gold exchange standard" was established, and these countries pegged their own currencies to the U.S. dollar. Over the next 30-odd years, various tweaks were made, but by the time of the Nixon presidency in the late 1960s-early 1970s, the writing was on the wall. Commodity-backed currency was a thing of the past. By 1976, the government officially changed the definition of the dollar, and it no longer had any connection to gold or silver. It was worth what the paper said it was worth because of the full faith and credit of the government (a sacred promise between those that hold the currency and the U.S. government). Our monetary system was now comprised of pure "fiat" currency.

Some Transitions Are Tougher Than Others

Between the Watergate scandal, a presidential resignation, the Arab oil embargo, along with a mass of decaying cities and the debt hangover from the Vietnam War, the U.S. had hit some very hard times by the late 1970s.

Enter the "Great Communicator," Ronald Reagan, who began his presidential bid by asking Americans, "Are you better off today than you were four years ago?" The American electorate responded with an overwhelming "No" and swept Ronald Reagan into office as America's 40th

president. At the time, the total of all U.S. debt was approximately $995 billion, roughly 45% of American GDP.

Fast forward some 40-odd years, and where are we now? Last month we narrowly avoided a national catastrophe by raising the national debt ceiling so that the government could pay its bills. National debt now tops $32 trillion and represents approximately 110% of GDP. That works out to almost $250,000 per American household. It's estimated that, at current spending levels. The national debt will top 225% of GDP within the next 20-odd years.

Now, does borrowing money lead to inflation? You bet it does! The cheaper the money, the more people, companies and countries borrow and spend.

"You Can Run But You Cannot Hide"

Joe Louis

In June of 1937, Joe Louis became the heavyweight boxing champion of the world, a title he held for 12 years, making him the longest heavyweight title holder in boxing history. Over the years, Louis had many memorable fights, Braddock, Baer, Schmeling to name a few. But perhaps his most memorable in many boxing historians' minds was his 1941 match with Billy Conn in front of almost 55,000 people at the New York Polo Grounds. Billy was a superb boxer and the Light Heavyweight Champion of the world. Weighing considerably less than Joe, he was asked, "Do you intend to put some weight on when you fight Joe?" Billy responded, "Naw, I plan to hit and run," to which Joe responded, "You can run, but you cannot hide."

The fight was a classic. After 12 rounds, Conn was ahead on points on two of the three judges' scorecards. With only three rounds to go, Conn ignored his corner's advice to stick and move and instead engaged Joe in close quarters. Bad move. Conn was knocked out with two seconds left in the 13th round, leaving Louis the undisputed Heavyweight Champion of the World.

Billy Conn Was Not the Only Example of "Not Being Able To Hide"

Over the years, I've written extensively about the "national debt clock." Originally ensconced in New York City's Times Square in 1989, the clock was the brainchild of real estate developer Seymour Durst who wanted to highlight America's rising debt and the financial "legacy" we were leaving our children. By 2004, the clock was moved from its 42nd St. location to 1133 Avenue of the Americas, near the Southeast corner of W. 44th Street. This is a corner I know well since on my visits to the City, I typically stay at 37 West 44th Street, just one block away. I remember distinctly how back in 2007 the clock and all those that followed it faced a dilemma. The clock display ran out of digits as the national debt approached $10 trillion. Not to worry, said the clock engineers, will just replace the $ sign that took up a space so that we can add another digit. An elegant solution for the clock. But not one for the economy.

In 2017, the clock was moved yet again, only this time, not to a prominent location, but to the west side of Bryant Park, facing an alley between Sixth Avenue and Broadway. Back in 2017, I remember being in New York and walking west on 44th Street. I was surprised when I looked up to where the clock should be, but the clock was gone. Did that mean the debt had been paid off? Hardly. To paraphrase Joe Louis, it can run but it cannot hide. If you hunt around a bit, you will find and recognize that, at the current rate the country is going, we will soon need a wider clock to accommodate yet one more digit.

Let Me Bring It Home

Our budget imbalance has long been kept in a most visual way by the National Debt Clock, a digital reminder of just how much the country is in debt. Think of it as a national credit card statement. So, why is it that the amount of U.S. sovereign debt is so important? Simple, it directly affects how much of our annual budget needs to be allocated toward interest payments on our debt. Think about it. Even if the debt level remains the same, the higher interest rates go, the more of the national budget has to go toward debt servicing. That means less money is available for education, medical services, defense, veterans' benefits and infrastructure, to name a few. These are critical areas that would be adversely affected. Think of it in this way: When people are buying a house and count on using a mortgage. The more expensive each $100,000 of borrowing is (due to rising interest rates) the less house they can afford.

Sometimes it's referred to as the "Waterfall Effect." Renters can't afford to become homeowners, homeowners (in their first home) can't afford to become move up buyers. People who are already in their move up buyer home can't move because there are no buyers. It doesn't stop there. Everything is affected. No home is perfect, and people who buy want to personalize their home with items such as new appliances, window coverings, landscaping and new furniture. None of this happens if people are stuck in place. Bottom line, less goods are made, less goods are sold, less jobs are needed.

Balancing the Books

If we are to make the investment in our future that I believe most Americans want to do, we need to free up cash. How can that happen? It can happen in a variety of ways, just the way it can in budgeting a family's monthly expenses. Here are several simple yet relevant analogies. Pay down debt by not living beyond your means. Whether it's a family or a government, spend less than what you make and use the difference to chip away at your debt.

Lower your cost of borrowing. For a family, if you have debt, refinance at a lower rate. (This presumes that you've kept your credit rating up.) For government, lower your interest cost, and don't scare the world (much of which is comprised of your lenders, buyers of U.S. Bonds and notes) with the partisan political threat of defaulting on your debt by not raising your debt ceiling.

Earn more money as a family without spending more. As a country, grow your GDP without spending more.

Conclusion

You see, the only difference between family finance and government finance comes down to consequences. If a family overspends, they could lose access to credit, lose their home and even go bankrupt. If a government responds, they have to pay more to borrow, limit what help they can provide their citizenry and get voted out of office. If they are voted out, there's no guarantee those voted in will improve the situation. What's called for is non-partisan politics. A rare commodity in American history.

Now, from a glass half-full perspective, my favorite kind, much is going on surprisingly well, as evidenced by the 2023 market returns year to date. The market analysts are no longer talking about a "hard landing," or a "soft landing," referring to either a deep or shallow recession. Today's nomenclature references various market sectors going into and then exiting from severe market declines, what has come to be known as a "Rolling Recession."

First, it was Large Cap Tech that just got hammered during the first half of 2022, which has now provided much of the driving force upwards in the markets during the first half of 2023. Energy companies have proved another prime example of this type of market rotation. They were the safe haven of 2022, along with utility companies, and have now been the laggards of 2023's market recovery.

Bottom line, markets have proven far more resilient than the macroeconomic hangover of a post-Covid environment coupled with a war in Ukraine, along with 10 interest rate increases and counting would ever have led one to suspect. Why, one would ask? Because we are seeing inflation come down substantially, along with historically low unemployment and dramatic improvements in productivity, some of which is driven by generative artificial intelligence. It's no coincidence that we are just now seeing the first drug, Leqembi, approved by the FDA, for slowing down the effects of Alzheimer's disease.

It is my belief that we will continue to see sector rotation in the months ahead. What does that mean? It means well-run companies with sound capital structure will come into favor. These companies should start trading far closer to their historic mean. I believe we will continue to take our medicine from the Feds and expect two more rate increases, maybe one, depending on when this commentary goes out between now and year's end. I don't foresee any rate decreases until deep into 2024.

With that said, both the economy and the markets can prosper in a 5 ½ - 6% interest rate environment as they have many times in the past 100 years. What is a deal killer to an economy is runaway inflation. I believe we've seen the Federal Reserve Board's commitment to see that not happen. Granted they were behind the curb in late 2021 and early 2022 in recognizing inflationary trends and are now completely committed to correcting that shortsightedness, the same shortsightedness that led to the 2022 market meltdown.

As the summer unfolds and political rhetoric ramps up, listen for constructive recommendations centering around fiscal and monetary policy. Granted it's not as headline grabbing as proposed social policy debates, but it will be key in telling what the next several years hold in store for us from a market perspective.

It's my hope that you all enjoy a happy, healthy, and safe summer. As always, with...

Very Best Regards,

Ray Lent
RLL/dot
Enclosures