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Economic and Market Commentary

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In the words of Charles Dickens, “It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of incredulity, it was the season of light, it was the season of darkness, it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us ...” No, I’m not using perhaps the most famous opening line in literature from *A Tale of Two Cities* to describe how many view this past political season, but rather using it as an introduction to an earlier time in our country’s history. I want to bring you back to 1938.

A Most Unsettling Year

The year had started off with promise for many Americans. The country seemed to be pulling out of the Great Depression. The minimum wage was $.25 per hour, Social Security had been introduced two years earlier and the great Joe Louis knocked out Max Schmeling in the first round to become the heavyweight boxing champion of the world.

The average cost of an American home was less than $4,000, a new car cost less than $800 and Fannie Mae (FNMA) was established to aid many Americans in regaining home ownership. President Franklin Roosevelt championed the Fair Labor Standards Act, which eliminated oppressive child labor and reduced the maximum workweek to 44 hours. It was one of the most important pieces of legislation to come out of the Great Depression.

Hi Ho Hi Ho

On the cultural front, Disney Studios introduced their animated classic, “Snow White and the Seven Dwarfs,” Spencer Tracy and Mickey Rooney stole your hearts in “Boys Town,” and Kate Smith sang “God Bless America” on the radio for the first time. Ballpoint pens were introduced, Teflon was discovered and the March of Dimes was created to raise funds in the fight against polio. Seeing-eye dogs were used for the first time, and a young Orson Welles scared the pants off millions of Americans when he presented a radio adaptation of H. G. Wells’ “War of the Worlds” on his Mercury Theater Hour.

Regrettably, the year ended up being a real mixed bag. Things started turning for the worst. The economy started weakening, the country fell back into recession and unemployment was soon running close to 20% in a very short period of time. As bad as things were here, overseas they were worse.

China was in the midst of a Civil War, Imperial Japan already was occupying Manchuria and all of Korea. Jews were being persecuted in Europe, Nazi Germany had annexed Austria and now wanted Czechoslovakia. Fearing confrontation and another World War, British Prime Minister Neville Chamberlain went to Germany, and after agreeing to allow Hitler's Nazi Germany to occupy Czechoslovakia, shamefully returned to Britain declaring, "Peace for our time."
These were dark, dark days made none the lighter by the fact that the Madoff family from Queens, New York, gave birth that spring to a bouncing baby boy they affectionately called Bernie. The country needed a distraction from its troubles, and it proved to come from the most unlikely place.

The Horse Race That Stopped the Nation

Back in the 1930s, the three great sports in America were baseball, boxing and horse racing. Unlike today, horse racing back then was followed by millions, the sport had its own rock stars and followers, and in 1938, the rock stars were War Admiral and Seabiscuit. Think of the unbeatable Apollo Creed (War Admiral) versus the knobby-kneed underdog Rocky Balboa (SeaBiscuit) and you start to get the flavor of the match up that came to be called the Race of the Century.

The Triple Crown is run by three-year-olds exclusively every spring in the Kentucky Derby, Preakness and grueling mile and a half Belmont Stakes races. Only 12 horses in the history of thoroughbred racing have ever won the title. War Admiral, son of famed Man of War, was the fourth horse to win the Triple Crown and did so in convincing fashion. Considered part of East Coast racing nobility, War Admiral won the Kentucky Derby wire to wire, came back just one week later to win the Preakness and completed the 1937 Triple Crown by setting a track record at the Belmont. This performance not only earned War Admiral the Triple Crown but also the 1937 American Horse of the Year. Small of build at 15.3 hands, War Admiral sported a dark brown coat, and his fiery disposition earned him the title of "The Mighty Atom."

Seabiscuit's road to racing immortality and American legend took a more circuitous route than his privileged rival War Admiral. Foaled in 1933, Seabiscuit was actually a grandson of Man of War and was thought to have great potential while viewed as a yearling. Originally owned by the powerful Wheatley stable and trained by renowned "Sunny" Jim Fitzsimmons, the horse was thought to have great promise until it started demonstrating characteristics of laziness and gluttony (yes, it can strike horses too). Fitzsimmons soon lost interest in the horse and relegated it to an exhausting schedule of smaller races losing its first 17 in a row.

Over the next year and a half, Seabiscuit kept up a grueling schedule with occasional flashes of brilliance. In the summer of 1936, trainer Tom Smith watched Seabiscuit run in a cheap allowance race at Suffolk Downs and convinced his friend, automobile entrepreneur Charles Howard, to buy the horse for $8000. With a new owner, new trainer and a new one-eyed jockey from Canada named Red Pollard, Seabiscuit found himself on a train heading West.

The Tide Soon Turned

Once West, Seabiscuit started living up to his original potential. A huge crowd favorite at Bay Meadows in San Mateo County, Seabiscuit traveled up and down the West Coast, winning 11 of 15 races in 1937. Each time the horse ran, he kept having to carry more and more weight yet always found a way of being in contention.
In the winter of 1938 (February), jockey Red Pollard suffered a near fatal fall while racing on a horse named Fair Knightness. Lucky to be alive, Pollard was still heartbroken that he wouldn't be able to ride his beloved Seabiscuit in the match race the country was clamoring for, the match race of the century between Seabiscuit and War Admiral.

Think about it. What a match-up: the regal king of the Eastern racing establishment and a Triple Crown winner against an undersized upstart from the West who couldn't do anything but run his heart out and win races. From his bedside, Pollard called upon his old friend and world-class jockey, George Woolf, to race Seabiscuit in his stead.

Throughout the spring and well into the summer of 1938, the two camps parried back and forth on the terms and venue for the race the entire country wanted to see. Eventually the deal was struck. The race would take place on November 1, 1938, at Pimlico racetrack in Baltimore, Maryland. The two horses would race over a 1-3/16th mile course without the use of a starting gate. They would use a bell to signal the start of the race, a mandatory condition for War Admiral's owner Sam Riddle, since War Admiral had a history of getting skittish at starting gates and had previously sliced a hoof in the starting gate on his way to winning the Belmont Stakes and the Triple Crown the previous year.

Off To the Races

With the terms set, both camps started training in earnest. Never one to let the grass grow on him, Tom Smith immediately started preparing for the "Walk Up Start" of the match race by using a whip and starting bell to give his horse a Pavlovian burst of speed from the start.

At the time, Pimlico race track was designed to accommodate 15,000 spectators. On the day of the race, 40,000 spectators were in attendance, with 40 million people glued to their radio including the 32nd president of the United States, Franklin Delano Roosevelt.

Mysteriously, just an hour before the race, the racetrack officials were unable to find the starter's bell. They eventually went to Tom Smith, Seabiscuit's trainer, and asked if they could borrow his. He graciously offered to lend it to them. I told you, no grass grew on Tom Smith.

It had been raining in Baltimore for several days before the race. Seabiscuit did not like a muddy track. The night before the race, Woolf walked the track by flaslight and found one particular track that was harder than the rest. A few feet from the rail, that's where he would lead Seabiscuit.

When the race was run, Seabiscuit took the start and won, running away by more than four lengths. He set a new track record, and the great sports writer Grantland Rice summed it up for a most grateful nation when he wrote: “A little horse with the heart of a lion and the flying feet of a gazelle yesterday proved his place as the gamest thoroughbred that ever raced over an American track.”

Deservedly, Seabiscuit was named 1938 American Horse of the Year.

I’ll Admit It, I Love the Ponies

Most of my life, I’ve loved horse racing. As a young man, it was my good fortune to be at the finish line at Belmont when Secretariat became the first Triple Crown winner since the great Citation 25 years earlier. Two years ago, I was at the finish line at Churchill Downs when American Pharaoh won the Kentucky Derby on his way to being the first Triple Crown winner in 37 years.

My purpose in telling you the story of Seabiscuit and War Admiral is to use it as a prologue to another story about a different kind of race. Although perhaps not as entertaining, it’s a race of Herculean proportion when it comes to the future well-being of our country. No, I’m not talking about the presidential race concluded this past November 8th. That was resolved on election day and, like it or not, we’re witnessing democracy in action, the peaceful transfer of power that has occurred in our country since 1797, when John Adams took over the office of president from George Washington.

Let’s Call It: Race To 20

Now I’m not talking about some form of discounted blackjack. What I’m talking about is the unhealthy attention the public and pundits (read that talking TV heads) are giving to the Dow Jones Industrial Average breaking 20,000, and the noticeable lack of attention these same people are paying to the much more significant fact that our national debt will soon exceed $20 trillion dollars. That’s approximately $43,000 dollars for every man, woman and child living in America today.

This is not new ground. I’ve written and spoken about it many times and will again. Please rest easy, the story is way too big and its understanding of it way too important for me to try to tell it in one part using this venue. (I know as a writer not to overstay my welcome or tax my readers’ patience.) With that said, let’s continue.

Don’t read too much into the “Trump Bump.” In the weeks just following the election, the Dow increased (before falling back) six or seven percentage points, making it the biggest post-election jump since Milton and Ager copyrighted their hit song, “Happy Days Are Here Again.” As I said, don’t read too much into the bump. Happy Days was written in 1929, just months before Herbert Hoover took office and the bottom fell out of the market. By no means am I forecasting that type of future. By nature, I am generally an optimistic person, and I do believe right now that we have the healthiest developed economy on the planet. But vast chasms exist between those that are prospering and tens of millions of hard-working Americans that are barely scraping by.

Here in the Bay Area, like New York, Boston and LA, we are shrouded from the anemic nature of our recovery since the Great Recession. If you want to see for yourself, just take a drive down Highway 99 South and see the condition of towns like Modesto, Merced, Fresno and Bakersfield.

Refresh My Memory

So why is the Dow not a good indicator of the market or economic health? Because it's a price weighted index famous for its longevity and name recognition as opposed to being an accurate indicator of the broad-based health of either the equity markets or the overall economy. Let me remind you how it works.

Charles Dow and Edward Jones started the Index back in 1896. In 1928, it was expanded to 30 companies. Of the 30 companies in the Index today, only General Electric was in the Index in 1896. Let's start then with GE. Today, General Electric has a market cap (total value of the company) of approximately $277 billion dollars. Its stock is trading at about $31 dollars per share. About three years ago, the financial firm of Goldman Sachs was added to the Dow.

Goldman Sachs has a market cap (total value) of approximately $97 billion dollars and trades at about $244 dollars per share. The way the Dow formula works is: because Goldman's stock trades for eight times what GE's stock trades for, it counts eight times as much in the formula, even though it's only one third the size. The thought of reduced regulation gave Goldman's a big bump after Trump's election and accounted for almost 30% of the increase the Dow saw over that brief honeymoon period. Certainly not the type of fundamentals one wants to use in building a long-term financial plan. That's why Dow 20,000 is more about entertainment than an indicator of economic growth.

The Times They Are A-Changin

Penned by Nobel Laureate Bob Dylan in 963, the words could not be more prophetic today.

> "Come senators, congressmen, please heed the call
> don't stand in the doorway, don't back up the hall
> for he that gets hurt will be he who has stalled
> there's a battle outside and it's raging
> It'll soon shake your windows and rattle your walls
> for the times they are a-changin."

So this is where the race for the other 20 ($20 trillion of national debt) comes in. The one that I think really counts. The one focused on keeping our debt in check and working toward a balanced budget. This is not about finger-pointing, this is about understanding the difference between monetary stimulus versus fiscal stimulus.

For the last 10 years, the government has focused on the cost of money. By keeping interest rates at historic lows, they have helped us recover from the Great Recession, one brought on by poor lending practices, cheap money and lack of oversight. And recover we did. But our recovery has been the most anemic in the last hundred years, and our level of national debt has more than doubled. Stocks have rebounded from the morbid days of 2008/2009, but not as a result of many companies showing increased growth or increased profitability but because of TINA (there is no alternative). Think of money market rates, savings account rates, CD rates and US Treasuries. They've been next to nothing, so investor capital stayed in the equities market. This has been a period of monetary stimulus.

But just as Dylan reminded us, "The Times They Are A-Changin," last December (2015), the Federal Reserve raised rates for the first time in 10 years. They raised them again in the fall and are expecting to raise rates an average of three times a year until the end of 2019. Please don't think this can only be bad. That's not the case. Fixed income investors and retirees have had no place to go. Here's an example: In a 0% return environment like German or Japanese bonds are currently paying, a person age 60 who wants to retire in 10 years, with a life expectancy of 20 years after that, would have to save almost double the money to retire as compared to how much they would need to save if they averaged just a 5% annual return on their investments.

In the end, monetary policy can't change the growth rate. The feds have stabilized the economy and now need to adopt a neutral policy. Not too high, not too low. The stage is set for Congress and the White House, not the Federal Reserve, to boost the economy through policies like tax reform and infrastructure spending. It's time to turn our attentions to longer-term issues to change our growth rate which will help all Americans.

What needs to come to the forefront is genuine tax reform, effective but not punitive regulations, education, job training, research and development, along with infrastructure spending—the things that can have an effect in the long run on productivity.

The shift was underway well before the election for fiscal stimulus and not more monetary stimulus. Whoever had been elected as our president would have inherited the same challenges and the same advantages. It's where we go from here that counts.

Transizione Armoniosa (*smooth transition*)

A few months back, it was my great fortune to spend several nights sleeping in a room down in the desert where Albert Einstein would sleep on a regular basis for the better part of 20 years. The room took on such a mystique that a book was written about it entitled, *Einstein Dreamt Here.*

As you well know, I'm no Einstein. But I was hoping that perhaps a few good ideas would come to me as I slumbered away in this most remarkable setting.

So, in part two of this series, I will lay out to you the 10 most positive policy recommendations that I have whittled down from dozens of economists and elected leaders from both sides of the aisle. Those policy recommendations could lead to both market growth and economic expansion, thereby creating a case of "Rising Tides Lifting All Boats," a situation which regrettably has not been present in American economic development for quite some time.

Conclusion

Whether you're of the "anyone but Trump" persuasion or a "Hillary Hater," the die has been cast and the country moves on just as it has done through countless recessions, civil war, two World Wars, Korea, Vietnam and 9/11. The Republic is bigger than any one person, and that's why we will continue to be the shining city upon a hill.

We here at Putney will continue to apply discipline to our money management that places capital preservation ahead of speculative growth. We will continue to dampen volatility by the judicious use of insured and strong yielding instruments where appropriate while continuing our constant efforts to make sure each client's stated financial goals and objectives are both realistic and attainable. At the same time, these goals and objectives will be subject to periodic review and course modification as market and economic circumstances dictate. As always, with...

Best Regards,

Ray Lent
RLL/dot
Enclosures