Fourth Quarter 2018

Economic and Market Commentary

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Sitting at the foot of the Apeninne mountain range where the Savena and Reno River Valleys meet, the city of Bologna has evolved for more than 3,000 years. Originally founded by the Etruscans around 1000 B.C.E., the early settlement thrived because of its reliable water source, fertile soil and centrality to trade.

Nothing lasts forever, so after 500 years of Etruscan rule, the Celts took over, and a few centuries later, the Romans came in. That's when things started moving fast. The Roman colony was now named Bononia, a nod to the Boii people who had been living there for the past several hundred years. The Romans built roads and aqueducts and, most importantly, introduced the concept of canals which would play an important role in the city's future development as a trade center.

A City Grows

The Romans left Catholicism behind, the Benedictines built a monastery, and by 1088, the University of Bologna was founded, the oldest university in the world that has been in continuous operation. To put this in historical perspective for you, Dante was a student there. Students from all over Europe came there. The school became renowned for its medical studies and law school. Bologna flourished and grew into one of Europe's largest and most cultured cities, with a population of somewhere around 50,000 people by the end of the 13th century. Then in 1348, the Black Death arrived wiping out half the population of Europe. The city survived, and it lived through what seemed to be a countless number of occupations and annexations for several hundred years. Yet it grew with modern and cultural innovations the whole while. Clock towers were built, paper mills flourished, and the printing press rolled. By 1477, Ptolemy's *Geographia* was published there. Theaters were built, libraries opened along with public gardens, fountains, conservatories and art academies. It's fair to say that Bologna was one of the great cultural capitals of Europe throughout the late Middle Ages and Renaissance times.

What A Shame

Once again, nothing lasts forever. By the early 16th century, Bologna fell under papal rule. What was long a trade capital of the world started falling into deep decline. The culprit? The imposition of poor trade policies that imposed heavy customs dues and manufacturing concessions that were sold, not earned. This created monopolies. The environment lowered competition, depressed productivity and led to graft and corruption.

By the dawn of the 19th century, Napoleon's empire controlled Bologna. By then, with a population of fewer than 75,000 people, the city had shrunk to half its peak size. Talk about the

disparity. For the next 60 years, the city was the scene of failed uprisings and revolutions. Austrian troops controlled the city for the papal state. Ten percent of the population owned all the real estate, 50% lived in poverty and the official census of 1841 reported 10,000 permanent beggars.
It wasn't until French and Piedmontese troops expelled the Austrians in 1860 that things changed for the better. That was the year Bologna joined the Kingdom of Italy.

Now I guess that right around this time some readers are saying, "Oh, look at that, Ray's drawing parallels between the decline of a great city-state, Bologna, with what's going on here in America: gridlocked government, one percenters, disparity of wealth, a permanent and large homeless population, and don't forget protective trade policies. When you think about it, it's an easy connection to make. But alas, that's not where I'm going with this tale of two cities.

The Birth of Guglielmo

In 1874, Guglielmo, the second son of Giuseppe, an Italian aristocrat, and Annie, his Scottish/Irish wife, was born into a life of privilege and scholarship. He was educated at home and taught by the finest tutors in all of Italy. He had an inquisitive mind and excelled in his studies of chemistry, math and geography.

A teenage Guglielmo was taught the basics of physics and introduced to the new physical phenomena being studied in *electricity*. At age 18, some 800 years after its founding, our young protagonist entered the University of Bologna.

It was not long after entering the University that young Guglielmo started exploring the realm of "wireless telegraphy." In other words, was it possible to convey messages without connecting wires? He thought it was, and started building on the work of physicist Heinrich Hertz who had proved a few years earlier that it was possible both to produce and detect "electromagnetic radiation." When discovered, this phenomenon was termed, "Hertzian Waves." Today, we know them as radio waves.

Over the next several years, our young inventor moved his experiments outdoors at his father's estate. He started with a simple oscillator, or spark-producing radio transmitter, and was soon able to transmit morse code signals wirelessly over a distance of two miles.

Alright, You Guessed It

Yes, I've been talking about Guglielmo Marconi, inventor of the radio. It wasn't long before the British invited Marconi to continue his research in England. Before the century was out, Marconi had installed radio transmission equipment on the ocean liner St. Paul and had personally reported her position off the English coast at a distance of 66 Nautical miles to his Royal Needles Hotel radio station on shore.

In 1909, Marconi's vision and genius were recognized when he shared the Nobel Prize in physics with Karl Braun. By then Marconi had developed high powered stations on both sides of the Atlantic. His company, Marconi International Marine Communication Company, had been broadcasting transatlantically for more than 10 years when two of the company's best radio operators boarded a ship.

Talk About Heroic

Jack Phillips and Harold Bride were radio operators out of Marconi International. In April of 1912, their assignment was to serve as the radio operators for a ship making its maiden voyage on the 10th from Southampton. The ship's name? The RMS Titanic. Both men stayed courageously at their stations broadcasting their location until just before the ship went down. Only Bride survived. Luckily, for the 705 souls who were rescued by the RMS Carpathia, for it too had Marconi radio equipment and was led to the location of the sinking.

Ironically, the White Star Line had offered free passage to Marconi on the Titanic, but he chose to take an earlier crossing on another luxury liner, the RMS Lusitania, which departed three days prior to the Titanic's sailing. Just three years later, she herself would sink after being torpedoed by a German U-Boat, U-20, with a loss of 1198 lives.

Radio Fever

With the innovation of the oscillating vacuum tube, radio technology took off. The first entertainment broadcast was transmitted from Chelmsford, England in 1920. Around the same time, Station 8MK in Detroit, Michigan broadcast the first news program (the station is still in existence today).

The early radio sets were quite simple, and crystal sets could be assembled by almost anyone who was the least bit handy. I'm not sure if they still do it, but for many years, the Boy Scouts of America would use the building of a crystal set as a way of teaching scouts basic electronics.

Once amplitude modulation was figured out (AM), multi-stations could send simultaneous broadcasts from the same region—a huge leap forward. Users of these early sets now had the opportunity of choosing between stations. What they didn't have, though, was a way to modulate the volume. You see, these early sets didn't have a volume knob. So the question that begs to be asked is, "What's the significance of the radio and its volume knob to the economy and the markets?"

It's time to turn down the noise.

Let Me Bring it Home

At the time of this writing, the government has been shut down for more than 35 days with no compromise currently in sight. By the time you receive this commentary, maybe the government will be open and maybe not. In spite of this embarrassment and disruption, equity markets are up dramatically from their Christmas lows. Counter-intuitive, isn't it?

The Fourth Quarter 2018 proved to be the worst quarter for the stock market indices since the early 1930s, with December being the worst December since the start of modern indices. Today, you can't turn the television on without some banner or another flashing, "Breaking News" across the screen. So how do you sift through it all? How do you navigate such turbulence in the markets in order to make thoughtful investment decisions? Start by turning down the static and paying attention to the fundamentals.

Pause to Reflect

In my life, I've seen two presidential impeachments, 22 government shutdowns, five or six recessions and close to 10 Bear markets, including "Black Monday," when the Dow dropped 22% in one day on October19, 1987.

Now I won't recount for you all 22 government shutdowns because it would make your blood boil, but here's a sampling for your consideration:

$ In 1980, President Carter was in the throes of a re-election campaign. Wearing a cardigan sweater, he would speak to the American people from the Oval Office about how greed and excess were causing our double-digit inflation, interest and unemployment rates (critics called it the "Misery Index"). Meanwhile, the Federal Trade Commission closed for lack of funding. This was the first government agency to close in modern times.

  Remember, the Constitution gives the "sole power of the purse" to Congress. They write the appropriations bills that both houses of Congress have to pass, and the president then has to sign them. If the president vetoes the bill, it goes back to Congress where the veto can be overridden with a two-thirds majority of both houses. (In a parliamentary system like the one England has, if the veto was overridden, this would be comparable to a vote of no confidence, and a new election would be held.)

$ President Reagan wound up winning the 1980 election by asking the American people "if they were better off then from how they were four years ago." The answer was a resounding no, and he won the election in a landslide. During his two terms in office, the government saw eight different shutdowns over issues as far ranging as budget cuts, Nicaraguan Contra funding and XM missiles.

$ Do you remember George H. W. Bush's pledge, "Read my lips, no new taxes?" When the budget was submitted in 1990, it did contain new taxes negotiated by President Bush and both parties in Congress. This resulted in a Republican uprising led by House Minority Whip Newt Gingrich, and lo and behold, we had another government shutdown, the shutdown of national parks and the Smithsonian being the most visible evidence of Washington's season of discontent.

$ The broken promise of "no new taxes" doomed President Bush's re-election, and former Arkansas governor Bill Clinton won the presidency easily in 1992. As we know, his tenure in office led to impeachment proceedings and two government shutdowns over Medicare, health care, the environment and education.

By now you get the picture: Life goes on, and we as a people and as a nation have weathered the storms of sometimes childish politicians and conflicted policy decisions and moved forward.

Back to the Basics

Fundamentally speaking, our economy is relatively strong in spite of the distractions that often affect investor sentiment. December job numbers were incredibly robust, and unemployment is at 40-year lows. The Federal Reserve Board has clearly signaled a tempering in their policy, leaving businesses with a clear indication that interest rates will stay predictable and within quite a low range band. Parenthetically, back in late 1995, the Federal Reserve boosted interest rates by one half of one percent. That was the seventh rate increase in a 12-month period. The economy survived, and equity markets flourished for another four years. As I said, life goes on.

In addition to our low unemployment and low interest rates, we are seeing real wage growth for the first time in 20+ years. Couple this with low energy costs and low inflation and you have a combination that creates an excellent environment for good companies to continue to make money. The operative word here is "good companies." These are companies that are making money consistently and re-investing in their businesses are enjoying healthy free cash flows and, most importantly, have reasonable and well-structured debt. Keep in mind that there are a lot of companies out there that don't fit this description. To analysts, they're known as "zombie companies," the walking dead of the corporate world.

These zombie companies are up to their eyeballs in debt, and when lending tightens (bond buyers become more selective) and interest rates rise (raising the cost of servicing their debt), their cash flows will be stretched to the limit, and in some cases, they will snap. This is not a market where rising tides lift all boats but this is a market where good companies will be rewarded, smart companies will innovate and bad companies will fold.

Remember, I Grew Up A Math Geek

Without a doubt, I do enjoy my literary forays, but deep down I remain the same Ray who was captain of the audiovisual (AV) squad in junior high and a member of the math team. In other words, numbers remain important, and ratios count. When I look out and see that pulled back earnings forecasts are projecting a future price-earnings multiple in the 12½ to 13½ range, that's pretty darn strong (consider that the average P/E these past 60 years has been north of 15). Is it all rosy? Certainly not. Putting government ineptitude aside for the moment, you still have to deal with the overhang of a considerable amount of shaky corporate debt, underfunded pension plans, an underfunded social security system and a debt-ladened national budget. The glass is always half full as well as half empty. It's only reasonable that one should consistently process both halves and not fixate on one.

A Sad Tale

It was almost 20 years ago that I remember listening sympathetically to new clients who had just told me how they had been “snake bit” with their investments. When asked to elaborate, they proceeded to tell me how they had sold their entire portfolio back on 10/22/87 (the first day the market was open after “Black Friday”). They waited more than three years to get back in and did so just as the market was in a euphoric state.

That’s right, “snake bit.” It was just months later that the savings and loan debacle hit. Remember the “Keating 5" and the Resolution Trust Corporation? In 1991, the market tanked and the economy went into a tailspin. It gets worse. Now in shock after taking two huge beatings by buying high and selling low, they sat on the sidelines through much of the 90s. But were they through with the market and their timing strategies? Unfortunately, not. Drawn like the moth to the flame, they got the “dot.com fever” and got back in the market in late 1997. They enjoyed two giddy years of rising share values before the dot.com bubble burst leaving them staggered once again. They sold all their positions. By the time they came to me, markets had recovered, and they gave up trying to do it themselves. Were they “snake bit?” Hardly. They were simply responding to their intuitive feelings of fear and greed and not deploying reason and knowledge.

Conclusion

The effects of stock market volatility on human emotions are not that difficult to graph. Think of the stock market with people on the sidelines watching the market go up. They start getting excited and take an interest. The market continues to go up, exhilaration sets in and pretty soon your Uber driver is giving you stock tips. People get euphoric and overcome with FOMO (fear of missing out). This marks the time when many buy in.

But as we discussed earlier, life goes on and markets don’t rise forever. When markets do start to decline, apprehension sets in. If the markets continue to decline, apprehension turns to fear. Around the bottom of the market, fear turns into panic and panic leads to selling. Analysts call it “capitulation.” It’s human nature.

Sitting in the conference room filling out new account forms for that “snake bit” couple, I realized how important it was that my clients understand the perils of knee jerk financial decisions. If I couldn’t get them to control their emotional reaction to market volatility, they’d have me selling for them at the worst time as well as plunging back in during market run-ups. Again, at the worst possible time.

Always a firm believer in “a picture’s worth a thousand words,” I remembered an Ibbotson Associate’s packet I had received a few days earlier. (They are a Chicago-based financial research firm that has provided data to analysts for more than 40 years.) In it was a laminated graph titled, “Dangers of Market Timing.” It used the hypothetical case of one dollar being invested in the broad based market at year end 1980, and seeing what you had 20 years later.

If the dollar had been invested in a ladder of Treasury bills, you would have had $3.61 at the end. If it had been invested in the broad-based US equities market, you'd have had $18.41. Here's the kicker: If you had invested in the broad-based US equities market and missed just the best 15 months, you would have had $4.73. Not much more than you would have had just invested in Treasuries (probably less if you factored in the cost of all the antacid tablets you would have consumed along the way). Seeing that graph for themselves was like a light switch being flicked on for the clients. They got it. Not only did they get it, but they recognized what a common mistake they had been making and no longer felt embarrassed or "snake bit."

If you were to ask me where that chart is today, I would tell you it's in the top center drawer of my office desk. There, for whenever words might fail me and I need a picture. Next time you're in, remind me about it and I'll show it to you.

It's a good bet that over the years I've probably shared with you my personal philosophy of being a mentor to others and always having good mentors oneself. Many years ago, a wise broker and market maker friend shared six words of wisdom with me that have never left me: "Sell in haste, repent in leisure."

This coming year will no doubt be filled with continued volatility and significant market swings. It is my firm conviction that the discipline and methodology any serious long time investor needs to possess will be rewarded. Smart, well run companies will profit, as will the investors who have sought them out. I look forward to our next periodic review.

Best Regards,

Ray Lent
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Enclosures