October, 2016

COMMENTARY

We have three primary topics for his quarter's Commentary: a rehash of the Brexit, the Federal Reserve and interest rates, and the election. Uggh! Sometimes we wonder why we ever committed to writing these pieces. Nonetheless, let's get to it!

In our July 2016 Commentary, we devoted more than half the content to the Brexit - Britain's vote to leave the European Union (EU). Therefore, we'll minimize our discussion here. But as we write this, the British pound is plunging again. Why? Because Prime Minister Theresa May has made it clear that she would honor voters' wishes and proceed with separating Britain from the EU. It appears many are shocked by her failure to disregard the national referendum - which by the way, led to her becoming PM. It just goes to show, you never really know for certain what's discounted in the markets.

As we wrote three months ago, while the adjustment will be difficult, the "doom and gloomers" likely have it wrong. Of course, the British could make a mess of things themselves. It is likely that European negotiators won't take kindly to the Brits. What the British could do to help themselves is start working with other nations to establish free trading (or nearly free trading) agreements. Ideally, there would be an English speaking trading block (U.S., Canada, Australia, New Zealand, and Britain). Besides overcoming many of the negatives of going it alone, this might have the effect of making EU negotiators more practical in their future dealings with Britain. This idea only suffers from making sense. We'll have to wait to see what actually happens.

Now on to topic number two - interest rates. The Fed has failed at its latest meeting to raise its benchmark Fed Funds rate, but it says conditions are close to favoring an increase. Surprise, surprise! Quoting from our July 2016 Commentary, "[t]here is virtually no chance that the Fed will raise interest rates any time soon ... but you already knew that." Meanwhile, long rates have edged up since mid year, but are still below levels at the beginning of the year.

While we are, and have been, critical of the Fed, we do need to show a little charity towards the institution. They live in a world where other central bankers are determined to keep rates low, they face intense pressure in an election year, and the Federal government's failure to address fiscal and structural issues has left the Federal Reserve with more responsibility for economic growth than it should probably have. Still, they have a job to do. While many have attributed stock market success to the Fed, we attribute lower economic growth partially to their actions. On net, higher stock multiples have probably been offset by lower earnings as a result of that slower economic growth.

So when will the Fed recognize tha it needs to have a "normal" interest rate / monetary regime in place? We don't know when this will occur. There's always another reason not to take action. Our guess is that eventually markets will demand higher rates and sound monetary policy. At such a time, the Fed will have no choice. But, when this will happen, we don't know.

And now, on to our favorite topic. We've spoken very little of the presidential election to date. There have been several reasons for this. First, this is the most contentious election in our memory, though we understand that Jefferson vs. Adams and Jackson vs. J.Q. Adams races were pretty rough. So in writing about the election we're faced with the issues of how we can 1) minimize our own biases, 2) minimize the extent to which we offend some or all of our readers, and 3) draw conclusions that have real relevance with respect to investing. Believe it or not, the last issue is the most difficult.

So, to put this in perspective, there is a perceived range of outcomes associated with both Mrs. Clinton and Mr. Trump. Without stating which candidate's policies and actions would be better or worse, most can agree (though that doesn't make it necessarily so) that the expected range of policies, actions and outcomes associated with a Trump presidency are wider than those associated with a Clinton presidency. In other words, there is more perceived uncertainty associated with a President Trump than with a President Clinton. And what do the markets hate? It's uncertainty. So irrespective of the eventual actions of either Mr. Trump or Mrs. Clinton, if it becomes more likely that Mr. Trump will win, we would expect to see more market volatility - at least for a while.

Now, what happens if each candidate wins? Well, with a Trump presidency, we're just not sure. He has stated many different policies - some in definitive terms, some in vague terms. We're in favor of some, and others we believe are just wrong. But that doesn't matter. What does matter is whether a President Trump 1) could get any of his preferred policies enacted or 2) would veto any legislation initiated and enacted by Congress. We don't have answers, other than to say that some of the extreme fears are probably overblown. There are other branches of government that have a say.

But, there is one area where we see an impact. The next President will likely nominate at least three, if not more, Supreme Court justices. Therefore, the balance of power is in play. Mr. Trump has already issued a list of potential nominees. While we are not personally familiar with them, based on reviews we've read, they'd likely be able to pass muster in the confirmation process. They'd also be less likely to favor an expansive government than nominees of President Clinton.

Turning to Mrs. Clinton, we believe her presidency would serve as more of a continuation of the Obama presidency. Expect moves to further consolidate health care under the control of the Federal Government. Whether President Clinton is successful or not in such an attempt, it is impossible to say. Expect her to use the power of executive orders and departmental rule making to implement much of what might not pass congress. This approach may be challenged in court, and this is where Supreme Court nominations come into play. Mrs. Clinton's nominations would be highly likely to view an expansive role of government favorably.

So where does that leave us? Mr. Trump is likely to engender more fear, while Mrs. Clinton is likely to encourage more control of economic activity by the Federal government. One issue hampering the current economy is that fear and uncertainty have lead to low levels of business formation, risk taking, and hiring. A second, though not unrelated issue is that regulation and rule making are placing increasing burdens on business - especially small business.

So which President would be better for investment portfolios? As one news network might say, we've just reported. You decide.

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