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INSIDE STORY

Worst of BOTH Worlds?

★ ELECTION 2016 ★

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Worst of BOTH Worlds?

Every four years in our country we have a presidential race, which means every four years we get at least some real discussion on government policy. At least that is the normal course of action; this year most rules don't seem to apply. But, since the current state of our politics has the vast majority of us disgusted, we will pretend this is a normal year and there are policies to discuss. Iron Capital is honored to serve a diverse group of clients and it is our role to make investment decisions, not to weigh in on politics. Policy, unlike politics, affects the economy, which impacts your investments.

There are two myths regarding policy that I take pleasure in dispelling, the first being that our two political parties are somehow wedded to certain policies that they own. Such as Republicans cut taxes and Democrats raise them; Democrats increase welfare programs and Republicans decrease them; Democrats regulate and Republicans de-regulate. These are all myths. John F. Kennedy cut taxes while Richard Nixon expanded welfare programs and George W. Bush created the first new entitlement program since LBJ's Great Society. Jimmy Carter began the de-regulatory movement of the 1980s and 1990s. I could go on and on. Part of this phenomenon is because economic philosophy and political philosophy are not as tied together as many are led to believe, and part of it is that Congress, not the president, actually controls policy.

The second myth is that different areas of policy are unrelated to one another. This, I believe, is because of the presidential debate system. Granted this year's version looks more like mud wrestling, but in more normal election cycles we get a debate about this policy, then a separate debate about that policy. The problem is that all policies actually relate to one another in the real world. For example, let's take two policies we have heard a lot about in this election: international trade and regulation of corporate America.

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Let's begin with trade. Free trade between countries is under attack this year, but before we go into those details we need to understand why trade exists in the first place. To make things simple we will use two countries, both of which make only two products: they grow wheat and raise cattle. Country A is very good at growing wheat and not so good at raising cattle, while Country B is really good at raising cattle but not so good at growing wheat. In Country A they have really good bread, but the meat isn't very good. In Country B they have great meat but the bread leaves a lot to be desired. They could go on living like this, separate from each other, but then none of the citizens of either country could have a great meal with both great meat and great bread. To do that, the two countries would need to trade with one another. Country A should sell its superior wheat to Country B in return for some of Country B's superior meat.

In fact, if every person in each country is going to get to enjoy the superior product, then Country A should stop producing cattle altogether and only produce wheat. Country B should do the opposite and concentrate on raising cattle. If both countries did this, then everyone's lives would be improved. Except for one problem: Half of the people in Country A work to raise cattle, and half of the people in Country B work to grow wheat. Both countries need to keep these people employed.

So what happens if everyone in Country A can now buy the better meat from Country B? Their lives have been improved, but the local cattle industry will be hurt. In a perfect world the cattle ranchers, or at least most of them, in Country A would simply convert to growing wheat. Likewise, the wheat farmers in Country B would start raising cattle. Both countries would concentrate on what they were good at, and everyone would stay employed and enjoy a better life.

However, real life is seldom perfect. Both countries have rules and regulations. The wheat farmers in Country A enjoy the benefit of being able to sell their product to the citizens of Country B. This has greatly increased the demand for their product and as a result profits have increased. They have a vested interest in protecting those profits – profits which would likely disappear if the displaced cattle ranchers start growing wheat. They will lobby their government to create rules which make it harder for cattle ranchers to convert to wheat farms. This will be done as a "protection" for consumers. After all, what do cattle ranchers know about growing wheat?

If the wheat farmers are successful in using their new-found wealth to make it harder for people to compete with them, then Country A will have an employment problem. The cattle ranchers can't compete with Country B cattle ranchers and now, because of regulation, they can't convert to producing wheat. Most will go out of business and their employees will be unemployed. Those that survive will likely do so by cutting prices and that will mean they must pay their employees less. Country A will now be separated into two classes - those in the wheat business who are doing wonderfully, and those who have been left behind in the new "global" world. Inequality will grow. The unemployed and under-employed cattle workers will be upset, and the most obvious target will be trade. They want a job and the only job they have known has been in the cattle industry. They will demand protection from the competition of Country B.

Trade barriers will be raised and Country B will retaliate. Before long everyone is back where they started, except now they have hurt feelings (but that is foreign policy, which is another subject entirely, right?). This less-than-ideal reality comes from a misunderstanding of what the original problem was in Country A. Humans have a tendency to focus on symptoms instead of problems. Country A did not like their cattle ranchers going out of business while the wheat farmers got rich; but the real problem is that regulation made it impossible for the cattle ranchers to convert to growing wheat. A policy of free trade does make everyone better off, if it is paired with a regulatory policy that promotes new business instead of preventing it.

Joseph Schumpeter was a mid-twentieth century economist who coined the phrase "creative destruction" to describe the process of the death of an old industry making way for the new. In our example the cattle farmers in Country A that were forced out of business, aka destruction, could then start farming wheat, or in a more realistic example with more than two products perhaps grow grapes (after all, what good is good meat and good bread without some wine?). This is what happens in real life as long as the rules allow, or better yet encourage, the creative renewal.

My wife and I recently had a rare evening where we could sit together and just watch a movie. We watched "The Intern," in which Robert DeNiro plays a retiree who signs up for a senior citizen internship at an online retailer run by a young entrepreneur (Anne Hathaway). DeNiro's character had produced phone books, and now the business in which he had spent his career was obsolete. In a neat twist, Hathaway's Internet business occupies the same building in which DeNiro spent his entire career. I can't imagine a more poignant example of creative destruction. The phone book company was gone, but in its place was a new company the existence of which would be beyond

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REVIEW *of* ECONOMY

Yes it is the same old story. Second quarter GDP was up 1.4 percent. We expect the third quarter number to be higher but still in our new-normal range. We are still stuck in this new normal sluggish growth mode.

The official unemployment rate is 5 percent in September. Jobs growth has slowed and there has been little change in the work-force since last quarter.

Inflation has been flat with CPI coming in at 0.2 percent in August. The Fed remains on hold after their first interest rate hike last year. The Fed has prepared the market for a move late this year. We shall see if it actually happens. They may have waited too long. +

REVIEW *of* MARKET

We bounced back and the market finally moved away from the FANG and Dividend trends to a broad based rally. The question is will it continue? The S&P 500 finished up 3.9% but Small Company stocks were up 9% as represented by the Russell 2000 index.

Bonds were flat for the quarter up 0.46 percent. High yield bonds ended the quarter up 5.50 percent. The search for yield and a more stable economic mood translated to big returns for the high yield market which is now up 15.21 percent year to date.

International stocks also rallied. The EAFE index finished up 6.50 percent and the MSCI Emerging Markets index ended the quarter up 9.15 percent. +

MARKET *forecast*

The long-awaited rotation to beaten down areas of the market arrived in the third quarter. The question now is will it continue. We are hopeful that it will.

Emerging markets look attractive as do small company stocks. Large company stocks look expensive to many but that is skewed due to the FANG outliers. Overall stocks are attractive.

Bonds remain our biggest concern over the long term, but they are still a shelter in the storm when the market does go down. The run in high yield bonds will likely slow down. +

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the imagination of DeNiro's character when he was beginning his career. This is how free economies are supposed to work.

We look a lot like Country A today. Economists know that trade protectionism was a major cause of the Great Depression. This led ultimately to strained international relations and the rise of Nazi Germany and World War II. Because of this knowledge trade relations, until very recently, have been improving to the benefit of many industries. Approximately half of the earnings of the S&P 500 companies, roughly the largest 500 companies in the U.S., come from overseas. Many people have been like the wheat farmers that benefited from free (or at least freer) trade. Others have been left behind as some industries have had trouble competing and factories have shut down.

Our problem is that while trade policies have become increasingly liberal, we have simultaneously been growing the regulatory leviathan which has made it more and more difficult to create the new. This puts us in a place with the worst of both worlds: We have the destruction that can come from free trade, but without the creation that comes from free markets. The Wall Street Journal recently pointed out that the number of initial public offerings (IPOs) on Wall Street is the lowest it has been in 20 years. This means we are not creating new businesses to take over the old. Harvard professor Robert Barro wrote an op-ed published in The Wall Street Journal on September 20, 2016, in which he outlined why the recovery from the 2008 financial crisis has been so slow. He blamed it on a lack of growth in productivity and went on to say, "Variables that encourage economic growth include strong rule of law and property rights, free trade, rolling back inefficient regulations and other constraints on market activity…". In other words, our problem isn't trade; our problem is regulation.

This is a policy issue which should not be a political issue. Former Senators Bill Bradley (D-N.J.) and Alan Simpson (R-Wyo.) both sit on the advisory board of an organization called the Common Good, whose mission is to overhaul government and legal systems to allow people to make sensible choices. They speak of restoring common sense. They claim polls show that huge, bipartisan majorities of America's voters support their initiatives. I believe them.

Wouldn't be nice to hear two intelligent, thoughtful, maybe even dignified Americans debate the details of restoring our creative economic engine? Instead we get crude sexism and illegal emails. One candidate promises protectionism and the other promises to double down on the regulatory explosion of the last 16 years. Sometimes it looks like the worst of both worlds.

This brings me back to the beginning. One of the reasons that the economic policies of different presidents did not always jive with our perception of party identity is because Congress, not the president, creates policy. One of my personal political pet peeves is that I have to wait in a long line to vote for the president, but two years later get to walk right in to vote for my congressman. Iron Capital has never endorsed a candidate or suggested to our clients how they should vote, but this year I will say this: Please vote. Especially to those clients who are among the majority of Americans who would select "none of the above" were it an option. Vote for your congressman, your senator, all of your local open seats and any ballot initiatives. Vote for all those things that don't get the national attention of the presidential race, and do it again in two years. It is these things that create the direction of government policy, and policy matters.

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