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Market Observations

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Growth is never by mere chance; it is the result of forces working together.
James Cash (J.C.) Penny (1875-1971)

As we look into the maw of this upcoming election, there are many items we could choose to address. Since the United States has two candidates running for President that roughly 60% of the electorate finds dishonest and untrustworthy, I have decided to leave the candidates themselves out of this commentary. Rather, I would like to focus on the legislation I believe we need to see from the eventual winner; policy enactments that will drive growth in the US from the 1% we have averaged over the past eight years to something approaching the 2+% we experienced for most of our lives. The difference between 1% growth and 2% growth is not simply 1%; it is a doubling of growth that would be additive to corporate profits, earnings, employment and wages, while leading to a lessening of the inequality pressures evident in our country.

Let's start with how we found ourselves in this current environment. The slow growth we are experiencing in the U.S. is not a new phenomenon, but rather what we have endured for the past 15 years. In the US, per-capita gross domestic product rose by an average of 2.2% a year from 1947 through 2000. Starting in 2001, it has averaged only 0.9%. Productivity itself has declined for the past three quarters, the longest such streak since 1979. Since 2007, productivity has increased at a pace of 1.3%, half the pace seen from 2000 through 2007.

Over long periods of time, these shifts in GDP and productivity portend a radically slower improvement in our living standards and a potentially angrier electorate. Let's drill down a bit into some of the reasons why these trends need to change. Fewer people are seeing the benefits of this modest growth. To be more precise, 81% of the population in the US is in an income bracket that had flat or declining income over the last decade. The policy of the Federal Reserve in pursuing quantitative easing (QE) has been beneficial to asset owners (people who own equities and bonds) not to the average wage earner. The upshot is that income inequality is real but has been greatly driven and exacerbated by Government policies themselves. When Government says they can solve a problem they have, in part, created, we should all take a pause. It will not be surprising if the electorate become increasingly polarized, divisive and angry, since more people feel left behind and the Government suggests that people should be happy with the current rate of growth.

In the end, it appears that something is clearly broken when Central Banks spend over $12 trillion driving asset prices higher and interest rates to zero or below, and that policy mix is insufficient to drive growth back to the levels we have enjoyed for decades. The issue is complicated and contentious, but I would argue that the primary focus should be on the lack of demand by consumers. In other words, despite how low interest rates have fallen, over-leveraged consumers are simply not interested in borrowing or spending down their savings to consume more. This is the classic definition of a "balance sheet" recession, similar to that experienced by Japan over the past 30 years, where no amount of Government interference in the economy has been successful in forcing consumers to borrow and spend.

If my thought process is correct, then one logical step for the Government to take is to increase fiscal spending to help generate economic growth. Spending on infrastructure, for example, is one way to potentially generate growth. This approach may increase employment in high paying jobs, thereby pushing wages up and driving increased demand and hence economic growth. The virtuous cycle may begin anew.

Why hasn't the Government already undertaken such an approach? Partly because the White House has had difficulty getting legislation through Congress and has resorted instead to Executive orders. While that approach may work in generating new regulations, it does not work in areas that require spending, because Congress still largely controls the purse strings. Furthermore, the Federal debt in the US has exploded under the current administration from $9 billion to over $19 billion. As a result, there is little Congressional appetite for new spending.

An additional headwind to economic growth has been the regulatory environment. Over the past 8 years, regulations introduced by Executive order have exploded. Businesses must now comply with over 600 major rules. Government considers a major rule one that imposes a cost of $100 million or more on businesses. *600 major rules equate to 81 per year, or 1 every 3 days the Government is open.* Since Government usually underestimates the cost and overestimates the benefit of regulations, the $100 million figure is probably low. In all, the economic cost of these rules is estimated to add up to more than $750 billion. This cost eventually shows up in some combination of higher prices, fewer jobs, lower profits or reduced wages.

Finally, according Fed Chairwoman, Janet Yellen, a "key uncertainty for the US economy" is how to increase productivity. She states that the economics profession is divided on the issue. "Some are relatively optimistic, pointing to the continuing pace of innovations that promise revolutionary technologies, from genetically tailored medical therapies to self-driving cars; while others believe that the low-hanging fruit of innovation largely has been picked and that there is simply less scope for further gains."

What would be nice to see as a result of this election? Let's put aside the subject of increased productivity for this letter and look at possible Government initiatives.

An **increase in fiscal spending** seems inevitable. We must hope that it is paid for in a responsible way; either through spending cuts or through thoughtful long-term (50 - 100 year) debt issuance on the part of the US Treasury; not through higher taxes. Increased fiscal spending will likely target **infrastructure investment,** which should lead to spending on capital goods, education and research and development. Investment in these areas has a direct impact on the economy, boosting commerce, skill development, and innovation.

Lowering corporate taxes could encourage companies to invest in the United States. Many believe that, because the US has the highest statutory corporate tax rate (39%) among advanced countries, it is a serious deterrent to foreign investment.

Immigration reform might bring more immigrants into the workforce and allow them to take jobs better aligned to their skills. This could both boost growth, by increasing the size of the labor force, and enhance productivity, as many of these immigrants are likely to be entrepreneurs and innovators.

For years, the number of start- up companies has been declining. **Encouraging competition** and creating a hospitable environment for start-up companies would benefit the economy. Large firms seem to be "blocking out" start-up companies. This may, in part, be a result of the regulatory burden imposed on corporate America. Large firms can better afford to deal with a thicket of compliance issues mandated by the Federal Government. Continuing with this idea, the patent system may also need reform to lessen the hammer-lock some firms have on innovation and to allow smaller companies to compete more quickly.

Decreasing regulation would allow new businesses to break through the United States' labyrinthine and multi-layered regulatory system. As a simple example, a quarter of our workers are required to have a license to do their jobs. This has increased five-fold since the 1950's. This rule alone likely prevents people from moving to another state and taking up new, more profitable professions. I admit this is a tax revenue driver for states, but given the choice, I favor growth over taxes.

In the end, regardless of who our next President is, we hope to see intelligent infrastructure spending, lower corporate and potentially individual tax rates, immigration reform, greater competition and less regulatory burden. A focused policy approach that encourages these outcomes will have the best chance of doubling our growth trajectory, thereby allowing both profits and wages to increase, while lessening income inequality. Finally, these policies may lessen the anger in our country and allow us to move forward in a cooperative spirit rather than continuing the divisive attitude of the past 16 years. If we fail in the next four years to achieve this outcome, I fear the next election cycle will produce political personalities angrier and more populist than what we are experiencing today. Let us hope that is not the case.

As always, we remain grateful for your ongoing support and confidence in us. We will continue to work to deserve it. If you have any questions or concerns, please let us know.