

MARKET COMMENTARY – NOVEMBER 1, 2016

If men were angels, no government would be necessary.

If angels were to govern men, neither internal nor external controls on government would be necessary. ~James Madison

(This is the final commentary in a short series on regulation. An important and complete discussion of the current market may be found at the end. We resume our normal monthly remarks in December.)

To those of us who have attained a ripe age older than ten, it is clear that our fellow citizens are decidedly not angels and therefore require some type of government. But since governments are populated by these same fallen men and women, it is equally clear that there must exist protections from a bureaucracy run amuck. If perhaps the dear reader is not convinced that controls on government are essential, we urge you to log onto any news site to see the latest hubbub about our current slate of major party candidates. She's lacking wings. He's without a halo.

But enough politics. Two months ago we began a brief look into the paucity of small business formation in the U.S. That led into our October Commentary where we examined the burgeoning number of regulations in the Federal Register. Today, we delve a little deeper into the arcane world of Federal rules and what, if anything, can be done to reassert reasonable limitations.

As a refresher, Congress creates new Federal agencies (currently 440 of them). Each agency must pass rules and periodically update them. Once it has begun, the rulemaking doesn't stop. At issue here is that bureaucrats in the Executive Branch make these rules, not the elected Legislature. We fondly remember our wide-eyed innocence when we learned in elementary school that the Congress makes the laws and President carries them out. How gullible were we! Had we only read the following 250 year old quotation from Montesquieu, we would have known to dig a little deeper into the workings of the agencies.

When legislative power is united with executive power in a single...body...there is no liberty, because one can fear that the same monarch...that makes tyrannical laws will execute them tyrannically.

Ouch. That's a stern rebuke.

In theory the process of rulemaking is open to input from citizens, in practice it is exceptionally difficult to change its course. Agencies have wide latitude on how and when to promulgate the final rule. Once a rule is finalized it is nearly impossible to repeal. Consider a painful example. The Congressional Review Act grants Congress the authority to review regulations passed by Federal agencies. In the act's 20 year history and despite thousands of new regulations over that time, Congress has only disapproved of one rule. The volume of regulations is simply too large to effectively monitor. Finally, private parties who wish to challenge a Federal rule will quickly find they are in for a lengthy and costly battle in the courts, which have now established onerous precedents that favor the agencies over the citizenry.

So, what are we, as conscientious citizens with businesses and lives to lead, to do? Fear not! We aren't going to suggest that electing our favorite candidate for President, or Senator, or Auditor, or Town Constable is the solution. We acknowledge that even the best of politicians are in need of abundant grace. No, we humbly suggest that we merely peruse that marvelous contract that so starkly separated the powers of government at our nation's founding. The Constitution has a viable answer.

Article I grants all legislative powers to Congress. Since none of the three branches seem to care that our current system is in flagrant violation, we advocate the use of Article V, Section II. This little treasure, put in after vehement and well-thought arguments during the Constitutional Convention, allows amendments to be proposed by 2/3 of the state legislatures (which bypasses the Federal morass). Never in our country's history has this method been successfully employed. But given the scope of our current plight and the brazen manner in which elected Federal officials and bureaucrats churn out stifling rules, we believe it to be our best hope. The Founders allowed it for this very reason!

And more important, we further believe that it need not be a partisan issue. A convention of states carries with it the chance to unite us after a time of agonizing division. Democrats, Republicans, Independents, Constitutionals, Libertarians, et cetera can come together on a challenge such as this. The solution wouldn't eliminate regulation, merely rein it in.

A resolution to call a convention of the states has already been passed in 8 state legislatures. It is working its way through more than 15 others. Once it is successfully passed in 34, history will have been made, regardless of the ultimate outcome of the convention. Hope has gotten us this far. Perhaps relief is on the way.

Time for a quick shift in gears.

October saw a modest drop in overall equity and bond prices. Earnings reports for the 3Q have come in a little better than expected. Perhaps more important than 3Q earnings at this point, revenues have shown solid firming after several difficult quarters. Also, expectations for 4Q and 1Q earnings have improved. Earnings must remain strong to support higher price levels.

Global PMIs (Purchasing Managers Index) have come in with strength of late. These measure industrial activity within specific countries and indicate a resumption of activity, a rebuild of depleted inventories, and may portend continued growth.

We expect no announced change in interest rate policy from the Federal Reserve Open Market Committee following their November 2nd meeting. However, the metrics do support a slight increase this year. Barring an unforeseen or calamitous event, we anticipate a quarter point raise to come out of their December meeting.

Polls are predicting and the market is pricing in a Democrat White House, a Democrat Senate, and a Republican House. And remember, folks don't really like surprises. Anything appreciably different from this outcome could potentially lead to a sell-off beginning November 9th. But such weakness should be short-lived as the economy remains in fairly robust shape.

Finally, there is a growing credit expansion in China. We believe it is not in any immediate danger of popping. However, if it continues to grow at this rate over the coming years, it will burst, and like all credit-fueled expansions, come to a bumpy end. We keep our eyes focused and our ears attuned to the situation.

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Sincerely
Jason Born, CFA
President