John Dessauer Investments, Inc.

John Dessauer's Outlook

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Stocks are up and the Outlook is Better than you Think

The bad news is so well known that it is already priced into everything, including gold. According to polling firm Gallup, Americans are more pessimistic about their country's future than at any time since the start of the poll in 1959. The World Economic Forum says the United States is now down to seventh place among the world's fittest economies. The only place where we are still number one is in market size, but we will soon lose that position to fast growing China. U. S. economic growth is sluggish - well below past recovery averages and below our current potential. Unemployment is too high and our national debt is approaching $17 trillion - more than100% of GDP. Our infrastructure is old and crumbling. When it comes to education rankings, American students do poorly. In an OECD study, our children finished 17th out of 65 countries in reading, 23rd in science and 31st in math.

Speaking of math, if Medicare, Medicaid, and Social Security stay on their current trajectories, these entitlement programs will consume 100% of the federal government's revenue within the next generation, leaving no money for everything else. Obviously, entitlements must be reformed, but voters do not like that idea, and politicians are quick to use the entitlement weapon against any opponent courageous enough to make suggestions on how best to accomplish reform. Politicians are not normally visionary. Their horizon is the next election. At the federal level that means two years for all members of the House of Representatives. The pessimists are right: if nothing is done to address the rising costs of entitlements, Americans will suffer a loss of competitiveness and a decline in standards of living. However, Americans are well known for both procrastination and strong reactions to crisis. For example, we reformed our banks and made them raise capital quickly after the 2008 financial crisis. As can be seen in the Cyprus

crisis, Europe did not act soon enough and many banks in the euro region are now under pressure to raise capital. We are resisting entitlement reform for now, but as the sense of crisis grows, odds are we will tackle the issue and make the tough decisions.

When it comes to our personal finances, it is essential that we keep the long term pessimism in the right perspective. Dysfunctional federal politics has not inflicted any crippling economic damage yet. The economy is growing and we are creating jobs. We can still borrow all we need at low interest rates. A European-style fiscal crunch is still years away. We have time, and believe it or not, the country beyond the Washington DC beltway is making real progress, developing a foundation for stronger competiveness and faster growth. *The Economist* recently published an issue with the title: "The America that Works." (3/16-3/22/2103) Here is part of their conclusion:

"Yet there is also another America, where things work. One hint comes from what those bosses like to call the real economy. Recent numbers from the jobs market and the housing sector have been quite healthy. Consumer balance-sheets are being repaired. The stock market has just hit a record high. Some of this is cyclical: the private sector is rebounding from the crunch. But it also reflects the fact that, beyond the District of Columbia, the rest of the country is starting to tackle some of its deeper competitive problems. Business and politicians are not waiting for the federal government to ride to their rescue. Instead, as our special report this week shows, they are getting to grips with the failings Congress is ignoring."

There is yet another reason to be optimistic. Economist A. Gary Shilling has published articles for Bloomberg making a compelling case that deflation, rather than inflation, will be the greater challenge for years to come. Inflation and high interest rates have been stock market killers in the past. What if neither surfaces for the next five years, and "The America That Works" keeps gaining strength? If that happens, Wharton professor Jeremy Siegel's forecast of Dow 18,000 in 2014 could be too conservative.

"The important thing is that America's 50 states are vigorously competing to find the best formula for regulation and taxes." *The Economist*

Conservatives pound the table criticizing their Congressional colleagues for excessive regulation and job inhibiting uncertainty about taxes and health care costs. Complex regulation does in fact infuriate American businessmen. Small firms often rate regulation as their biggest concern, right aside the cost of fuel and health insurance. State governments have found that while these are certainly major issues they are not what companies focus on when deciding where to invest. The number one issue for investment is available, suitable labor. In response states have focused on reforming and improving education. Not all, but most states permit charter schools, link teacher evaluation to students' performance and have "common core" teaching standards. *The Economist* concludes: "America's schools are getting their biggest overhaul in living memory."

When it comes to higher education, America is still number one. We are home to 27 out of the 30 universities that put out the most cited scientific research. And we are still good at developing the ideas. Investment in research and development recently reached 2.9% of GDP, matching the previous peak at the height of the space race.

The battles among states focus on a range of policies, such as right to work versus union, and high income taxes versus low or no income taxes. The facts on the ground so far do not clearly support either side on any of the major issues. For example, jobless rates are lower in right to work states, but so are average wages. Surveys by leading universities indicate that labor issues such as skills and costs outweigh tax rates when companies decide where to locate their next new factory. The important thing for us as investors is not to take sides, but to welcome the competition. After all, it will be what works best that prevails and that will be good for corporate profits and our portfolios.

"The only way Washington's dueling politicians could kill off the budding improvements to America's competitiveness would be by deliberate sabotage." *The Economist*

"The shale gas and oil bonanza is transforming America's energy outlook and boosting its economy." *The Economist*

Remember the rallying cry, "Drill Baby Drill"? It was directed at federal government reluctance to drill offshore, in the arctic or anywhere else. Our government has not changed its attitude toward drilling; federal

lands are still essentially off limits to drillers. However, states, hungry for new revenue, have been issuing permits to drill on private lands. Last year, for example, Pennsylvania alone issued 2,484 permits and 1,365 were activated and drilled. Pennsylvania is not alone. Arkansas, Louisiana, Oklahoma and Texas are also drilling “unconventional” wells for natural gas. The drilling is successful and profitable because of new technologies, including fracking and directional drilling. The huge success in finding natural gas has pushed the price down from $13 per BTU to $1-$2 per BTU. That is a huge benefit to consumers of natural gas, electric power generators, chemical producers and homeowners who heat with natural gas. But, the steep price decline reduces the profits from producing gas and reduces the incentive for drilling. The number of drilling rigs looking for natural gas in the United States has fallen sharply, but is now stabilizing. Compared with oil, natural gas is not easy to move from country to country. There is a huge fleet of oil tankers and plenty of oil terminals, but few ships or terminals capable of handling large quantities of natural gas. Therefore, the price for natural gas can be significantly different from one market to another.

In response to low natural gas prices, drillers turned to oil, using the same technologies. As we know from the oil boom in North Dakota, that too has been enormously successful. Over the past four years, U.S. domestic oil production has increased by a third, to 7 million barrels a day. While that is a small drop in the world’s ocean of oil, it has sliced $70 billion off our oil import bill.

IHS, a supplier of all sorts of information, - including statistics on energy - says that in 2012, unconventional oil and gas contributed $238 billion in economic activity, 1.7 million jobs and $62 billion in taxes. That counts only the exploration and extraction activity. It does not count the benefits to the consumers of oil and natural gas. Economists at Citigroup and UBS calculate that the shale gas activity alone will increase our GDP growth by one half of one percent per year for the next few years.

Inflation: Facts & Fiction

I suppose we could blame Milton Friedman. He was the one who declared: “Inflation is always and everywhere a monetary phenomenon.” Put that together with the classic understanding that inflation is too much money chasing too few goods and the current popular fear is understandable.

Our Federal Reserve, under the direction of chairman Ben Bernanke, has pursued a very aggressive easy money policy for the last four years. The Federal Reserve's balance sheet has grown to more than $3 trillion, an all time record. Clearly that is a whole lot of money. It is enough to fulfill the first part of the inflation story - too much money. It also seems to fit the Milton Friedman definition of a monetary phenomenon. Even supporters of Bernanke's policy are asking about the eventual exit. How in the world can the Fed unwind enough of the $3 trillion in time to avoid a burst of unwanted inflation?

My running analysis has been that there is no current danger of an outbreak of high inflation. Yes, the Federal Reserve has pumped a lot of liquidity into the banking system, but very little has found its way into the broader economy. Excess bank reserves - deposits at the Federal Reserve - are $1.7 trillion. In other words, of the $3 trillion expansion of the Fed's balance sheet, $1.7 trillion came right back to the Fed. And this look at one piece of monetary data understates the situation. Banks have raised credit standards and loan demand is subdued. Just before the collapse of Lehman Brothers, bank outstanding loans were $205 billion more than deposits. Back then, banks were leveraged and loan demand was strong. Today the opposite is the case. Banks are holding $2.03 trillion more in deposits than they have in outstanding loans. Banks have deleveraged themselves and loan demand is weak. In other words, there is no upward pressure on inflation in the United States at this time. In addition, it will take time - at least several years - for the situation to change. Americans are saving, not borrowing and investing in securities they feel are safe. Bankers are born again conservatives and not likely to reduce credit requirements any time soon.

My analysis leaves open the question of what is likely to happen in the future. I have not ruled out the possibility of a repeat of the 1970s type inflation. I also have not ruled out the possibilities of deflation or a decade of very low inflation. A. Gary Shilling, a columnist for *Forbes* and a well respected economist, has been writing a series of articles for Bloomberg. The first is titled: **"Why Global Economies Face an Age of Deflation."** He believes deflation is a much greater risk than inflation. He also makes the case for a long period of what he calls, "good deflation," where people, governments and financial institutions successfully reduce debts and restore savings. After the deleveraging is finished, he sees real growth increasing to its long term average at 3.5%. His work is a wakeup call for all who worry

about all the liquidity that central banks, including our Federal Reserve, have pumped into the world's economies.

"The liquidity created by central banks is tiny compared with the destruction wrought by deleveraging financial sectors. The decline in securitizations is just one aspect of this contraction. Banks are eliminating or writing down off-balance sheet vehicles substantially. Governments are increasing capital requirements even as banks dump assets to raise capital ratios." (A. Gary Shilling writing for Bloomberg, 3/21/2013)

He is correct. Frankly, like so many others, I looked at the expansion of central bank balance sheets and never made the connection with the deleveraging of financial institutions. Cyprus is too small to impact the global economy in any meaningful way. However, Cyprus is an example of what A. Gary Shilling is writing about. In Cyprus we can see the consequences of a huge expansion of the banking sector. We can see just how difficult it is to reverse course and deleverage bloated bank balance sheets. Cyprus is clearly headed for a long period of nasty deflation with high unemployment. No one familiar with present conditions in Cyprus is worried about inflation. While the U.S. is not anywhere near a Cyprus, we have suffered from years of indulgence in excess credit. Remember the Home Equity Loan binge? Both banks and borrowers are suffering and struggling to recover after the collapse in home prices.

We worry about inflation because that is what most of us have experienced. The last time there was serious deflation in the United States was in the 1930s. A. Gary Shilling points out that periods of inflation have come along with wars - social wars, such as those against poverty, as well as shooting wars. The reason is that vast government overspending on the wars coincided with a strong private economy. He says that in the 95 wartime years since 1749, wholesale price increases averaged 5.7%. In the 168 peacetime years they fell 1.2%. The U.S. is withdrawing from Iraq and Afghanistan. Government spending on war is sharply down from years ago. Private sector growth is below average in recoveries. Government stimulus spending has not offset private-sector weakness.

There is downward pressure from labor and wages. After being unemployed for six months, about a third of those who finally find a new job accept pay that is less than that of their previous job. We know that government wages outpaced private-sector wages during the previous

economic expansion. Labor costs account for roughly half of state and local government spending. Under pressure from the recession and sluggish recovery, they are reducing their payrolls. Because they are paid 44% more than a private-sector worker is, their job loss takes a bigger toll on the economy. The loss of two state and local government jobs is equivalent to three jobs lost in the private-sector. With millions still unemployed and looking for work, wages are not likely to become a source of inflation pressure. They may not push our economy into full blown deflation, but they definitely act as a barrier to wage-push inflation.

We have a sluggish recovery with plenty of excess capacity, downward pressure on wages, a natural gas glut that is making energy cheaper for individuals and businesses, banks that are reluctant to lend, businesses that are flush with cash, and individuals who would rather save or pay down debt than borrow. There is pressure on governments to cut costs and streamline operations. A. Gary Shilling will most likely be right when he says: "Nonetheless, expectations for inflation over the next ten years are for a continued drop."

Combine *The Economist's* "**The America That Works"** with A. Gary Shilling's inflation-deflation analysis and you will feel very comfortable owning a portfolio of quality stocks. It is way too soon to be thinking about hedging against possible future inflation. This is a time to own stocks and enjoy the rewards.

The current economic outlook

Morningstar's Bob Johnson sums up the consensus view of what lies ahead for the next several months: "The big four economic indicators show a stable U.S. economy growing at a 2%-2.5% rate with minimal inflation." His big four indicators are: Private Payrolls, Retail Sales ex Autos & Gas, Manufacturing Industrial Production and Real Disposable Income less Transfers. All four have shown positive growth over the last twelve months.

Have stocks at record highs already priced in the good economic and inflation news?

Like A. Gary Shilling, Wharton professor Jeremy Siegel likes to include historical data in his stock market analysis. Together with a former student, Jeremy Schwartz, he looked back as far as possible, to 1871. When

all the data was broken down, they found definite patterns. After five years of underperformance, stocks usually delivered two years of better than average performance. Two major U.S. stock indices, the Dow Jones Industrial Average and the Standard & Poor's 500 stock index, have finally achieved new record highs. However, that means they are flat since reaching those levels back in 2007. In other words U.S. stocks have been underachievers for more than the last five years. History, according to professor Siegel, says we are headed for two good years. Using his historical data, the Dow Jones Industrial Average should reach 18,000 next year.

Corporate profits have been growing the last four years. Flat stock prices combined with higher earnings means stocks are cheaper today than they were in 2007. But, can profits keep growing? The best answer is yes, thanks to low interest rates, moderate U.S. economic growth and impressive growth in emerging markets. No one expects a surge in corporate profits. However, profit growth in the high single digits seems a very reasonable expectation.

Individual investors have taken hundreds of billions of dollars out of stocks since 2008. That cash is still sitting in low- to no-income safe investments. In fact individuals are still frightened, and while there was a respectable net inflow to stocks in January, that looks like a one-time event. The risk is that all that cash will come rushing back into stocks pushing prices to unsustainable highs like in 2000. However, that is not likely to happen this year and probably not next year either. Thanks to all the popular fears, individuals may stay on the sidelines for a long time. That would be excellent for our portfolios. We have had a very good first quarter of 2013. Don't expect a repeat this quarter. By year end, however, we could see Dow 16,000.

NEWS AND VIEWS ON OUR COMPANIES

What to do when a stock reaches a new 52 week high: Aetna, NYSE, AET, $50.59.

Aetna has pulled back slightly from its recent rise to a new 52 week high at $51.73. Aetna, like most Health Insurance stocks, is marked as a hold by major research organizations. They are concerned about the changes coming with Obamacare. On an earnings basis Aetna is still cheap, even after the recent rise. Argus Research, for example, expects earnings of $5.63

a share this year and $5.85 in 2014. That is a P/E of slightly less than 9 on 2013 earnings estimates. Of course being cheaper than most other stocks is a plus, but does not guarantee a future capital gain. Another plus is that Aetna's top and bottom lines will benefit from the improving economy and job creation. However, what best explains the rise to a new 52 week high is Atena's bold moves to anticipate and adapt to coming changes in health care, and health insurance in particular. Joseph Zubretsky, Senior EVP: "We have invested more than $1 billion to acquire and build a comprehensive collection of health management and health IT solutions to empower consumers and enable clinical integration and population health management."

I find Aetna an attractive long term investment. I rate the stock a buy below $48.

BP, NYSE, BP, $42.13, has announced plans for an $8 billion share repurchase program. That is about 6% of all shares outstanding. The program is the result of the sale of the Russian joint venture TNK-BP. BP is still embroiled in a trial in New Orleans over the Gulf oil spill. The case against some contractors has been dismissed by the judge. The trial is now in the defense phase. If not settled, the judge (there is no jury) will determine the outcome. The risk of a large fine is already included in BP's stock price. I am keeping a buy rating on BP.

Halliburton, NYSE, HAL, $39.16, has been under pressure from the natural gas glut in the United States, stable, but lower oil prices, the trial over the Gulf oil spill and lingering criticism of the company's mistake in buying high priced guar gum. The guar gum issue is now in the past and the market is both overreacting to the issues and underestimating Halliburton's long term growth potential. Halliburton is a leader in unconventional resources for exploration, maintenance and recovery for gas and oil. The company's fracking technology has now been proven effective here in the United States. North Dakota and other U.S. newly developed energy states are the envy of the world. Halliburton has a huge long term opportunity to take its proven technologies and apply them outside the United States. Here at home the benefits from natural gas are now obvious and more states are moving toward energy development. Argus Research has a $3.20 per share earnings estimate for this year and $4.15 for 2014. At just over 12 times this year's estimate, Halliburton is a buy. My twelve month stock price target is $50.

Mondelez, NASDAQ, MDLZ, $30.00 and Pepsico, NYSE, PEP, $78.93, rose nicely last Friday on rumors the two companies might be pushed to merge. A British newspaper reported that activist shareholder Nelson Peltz has taken a major stake in both companies. The report said he has invested $2 billion in the shares. That large amount will certainly give him clout in talking to both company managements. A spokesman for Pepsico responded by saying "We do not see the need for any large scale M&A." There is no way of knowing if Peltz really will try to force a merger and no way of knowing if the two companies will respond favorably. Both stocks are attractive long term investments. However, wait for a pullback before adding to positions.

Texas Instruments, NYSE, TXN, $34.30, provided investors with a positive mid-quarter update.

The Dow Jones Industrial Average has reached a new record high. The Standard & Poor's 500 stock index is close, but the technology-heavy NASDAQ is still almost 30% below its 2000 high. Over the last thirteen years, technology stocks have gone from crowd favorites to skeptics' delight. How many times have we recently heard or read sharp criticism of Microsoft, Cisco, Intel and Texas Instruments? Technology stocks may have fallen out of investor favor, but that looks like an opportunity to me. As the U.S. and global economies recover, there will be increased demand for technology by both governments and the private sector. It isn't just that new versions of hardware and software are better; there are quantum leaps in technology now in production. The recession retarded the normal demand for new technologies. The recovery will unleash the pent-up demand. The mid-quarter update from Texas Instruments says we are getting close to the day that demand is unleashed. The Texas Instruments update indicates that many of the company's customers, who carried significantly lower chip inventory levels because of a shaky global economy, have become more positive about their end market demand and started to place higher chip orders. Texas Instruments is a buy below $34.

CLOSING THOUGHTS

"Tax the rich" has been a popular American political theme for the past few decades. The George Bush tax rates gave some temporary relief,

but did not broaden the tax base. Relying on a tiny minority to support a huge government was bound to reach its limits sooner or later. The recession of 2008 and the slow-growth recovery have exposed the faults in the narrow American tax base. Federal tax collections fell more sharply than in past recessions. And they have recovered more slowly. Beltway politicians debate tax hikes versus spending cuts. Neither will do much good and either or both could further dampen economic activity. There is only one way out of the federal fiscal mess… faster - much faster - economic growth.

Washington politicians, especially the President and his congressional colleagues, are fond of using the word "revenue" when it comes to taxes. They argue that the federal government needs more "revenue." They have a point. Over the last four years federal tax collections have averaged only 15.3% of GDP. That is the lowest ratio in 60 years. The average since World War II has been 18.1%. In 2000 the ratio climbed to 20.6% of GDP. The federal deficit would shrink, if not melt away, if tax collections increased to the long term average. Republicans and Democrats agree about the benefits that would follow from increased cash from tax collections. The President and many Democrats think the way to increase tax collections is to increase tax rates on the high earners. When they use the word "revenue" they mean higher tax rates. Republicans believe cutting federal spending is the way to slash the deficit. They worry that raising tax rates will slow growth and hurt tax collections. Michael Solon, a former policy advisor to Senate Republican Leader McConnell, recently wrote an article for the Wall Street Journal titled: "The Revenue Deficit From Progressive Tax Rates."

His basic point is this: "The government now relies far more on fewer and wealthier taxpayers. No wonder revenues are lower." Michael Solon is correct, and the 3.8% tax on unearned income in Obamacare, plus the higher tax rates in the fiscal cliff deal make the situation worse. By worse, I mean more difficult to actually raise the ratio of tax collections to GDP.

In 2008 the top 1% paid 41.8% of all federal tax collections, up from 17.4% in 1980. Almost two-thirds of the top 1%'s income comes from capital gains, dividends and proprietors' profits, not from wages. We know all about stock market volatility. It doesn't take much thought to understand that the income for the top 1% is sensitive to the stock market, changes in corporate profits and underlying economic activity. By relying so heavily on this narrow tax base the federal government has created a problem. Uncle

Sam is now dependent on the financial health of a small group of Americans.

Tax collections did not fall to 15.3% of GDP because tax rates are too low. Collections declined because the rate of economic growth is too slow. Following past post-World War II recessions, tax collections recovered quickly, along with the economy. Not so in this recovery. The number of people employed is 2.9 million fewer than in 2007 and 12.7 million below what a normal recovery would have produced. The average real income of individual Americans is $702 less than five years ago, and $4,837 short of what an average post World War II recovery would have generated.

Republicans blame the federal deficits on too much government spending. They insist on spending cuts while Democrats insist on higher tax rates. What both should be talking about are policies that foster faster economic growth. Spending cuts - called austerity in Europe - can hurt economic growth. Consider this: every $1 billion spent on infrastructure projects creates 18,000 jobs. That is almost 30% more than the number of jobs that would be created through lower personal income taxes. The U.S. has lots of worn out roads and bridges. They need to be repaired for the health of the economy. There is room for government spending in any pro-growth plan.

Michael Solon puts it this way: “The country’s fiscal condition thus poses a choice for Democrats. They can harvest a great deal of revenue by making peace with a profitable and growing economy and with those productive individuals who create such an economy. Or they can embrace new taxes on both upper-and middle-class earners that will restrain economic growth. The latter course will make it harder and harder to raise the revenue that Democrats demand to fund the government they love.”

While I basically agree with Michael’s analysis, I do not think Republicans should be left out of the criticism. Rather than trumpeting long term risks from our debt and deficits they should be broadcasting ideas that will get the economy growing faster right now. For example, they could be more supportive of government spending on infrastructure and research and development. The only real solution to our federal government’s debt and deficit problem is faster economic growth. Tinkering with tax rates or spending cuts does not help. Get the U.S. economy growing faster, and the

deficit will shrink, and it will become easier to find solutions to the long term challenges from Medicare and Social Security.

Fortunately, there is real progress being made by politicians outside the D.C. Beltway. That gives us hope that those inside the Beltway will get the wakeup call that having eliminated taxes for so many at the bottom means they have no choice. They must stop attacking those on whom they depend, and instead encourage them to keep up the good work.

Next issue: The May issue of John Dessauer's Outlook will be ready on Wednesday May 1, 2013.

Next weekly hotline: Wednesday April 10, 2013

All the best,

John Dessauer
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