John Dessauer Investments, Inc.

John Dessauer's Outlook

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A Fed Shocker…and the Outlook for Stocks and Bonds

While our Federal Reserve still expects a slight improvement in GDP growth next year, disappointing growth in productivity has raised doubts about the long term. Interest rates will likely remain at extreme lows far longer than most investors expect. Returns on cash and bonds will stay low. Stocks won't keep climbing at a 20% annual rate, but are still a better choice than cash or bonds.

Last summer, Fed chairman Bernanke talked about the possibility of "tapering" - reducing the monthly $85 billion bond buying program. Markets immediately overreacted, sending interest rates up. Fed Chairman Bernanke was surprised. He said the rise in rates was "unwanted and unwarranted." Since then, he has commented on QE, tapering, and interest rates several times. During one talk he went so far as to say that the Fed would keep the federal funds rate low even after the bond buying was reduced or even stopped.

Investors have been on interest rate alert for the last year or so, believing that economic growth would improve and push interest rates to higher levels. Bond buyers have shied away from long term maturities because their prices fall the most when interest rates rise. No one wants to reach for a 3% current return only to lose 10% or more on the principal value when interest rates rise. Cash in money market accounts has swollen to $2.71 trillion. Experts believe much of that cash is waiting to buy bonds after interest rates go up.

The underlying reason so many have been expecting higher interest rates is the popular assumption that the recovery is gaining strength. That assumption is now in question. As a result, the

investment landscape is likely to change in favor of stocks over bonds or cash.

The members of the Federal Reserve board met for two days at the end of October. The main topic was the sluggish rate of U.S. economic growth. In past meetings the chairman and others expressed confidence that slow growth was temporary. During the October meeting, chairman Bernanke changed his comments. He now is worried that the damage to the economy's long term potential may be permanent. The board members are still hopeful that the rate of growth will pick up next year, to 2.5%-3%. However, the long run of subpar growth in productivity could mean that next year's faster growth will not be sustainable and that the underlying, long term growth potential for the U.S. economy may be less than 2%.

Worker productivity has grown at an average annual rate of only 1% over the last four years. The long term average, since 1983, has been 2.2%. Until recently, Fed board members thought the slow growth was a temporary consequence of the 2008 financial crisis. However, in the minutes of the October meeting the Fed members wrote: "Slower growth in productivity might have become the norm."

This is a major change. In past meetings Chairman Bernanke commented that the deceleration in productivity growth probably was temporary and would end as the expansion continued. If slow growth in worker productivity is the new norm, it means the underlying long term growth potential for the U.S economy is far lower than in past economic cycles. The potential consequences are dramatic. It would mean great difficulty for governments to reduce debt and correct fiscal imbalances. It would mean lower returns for stockholders. And, it would also mean a greater challenge for central banks to stimulate growth without inflation.

There are lots of ways to look at an economy the size of the United States. However, when it comes to generating sustainable growth without inflation there are two basic factors: growth in the labor force and growth in productivity. The sum of those two factors determines the economy's long term growth potential. Fortunately, the U.S. labor force is still growing. However, that good news is being limited by the very slow growth in productivity.

There are two types of risks that follow from long term slow growth in worker productivity. The first is depressed returns for investors. Instead of the 20% annual returns investors have enjoyed on stock portfolios since 2009, the coming years may produce returns of 5% or less a year. Bad as that may seem, the greater risk is inflation. Wage inflation, without corresponding growth in productivity, would directly become overall inflation. That is basically what happened in the 1970s and early 1980s. A long period of very slow growth in productivity combined with government efforts to stimulate economic growth resulted in consumer price inflation of 14.8% in 1980. While that is the long term risk, we can take comfort in the fact that, at the moment there is no wage inflation and no sign of a rise in consumer price inflation. The opposite is the case in most job categories. Workers have to settle for wages far below what they enjoyed before the recession or take part-time jobs. However, the underlying inflation risk can be seen in the political thrusts to raise minimum wage levels and the protests demanding a "living wage" for every job. As one economist said recently, "Never turn your back on inflation." Even though there currently is little to no upward pressure on wages overall, we must pay close attention to developments on wages and not rely only on unemployment data.

Wages can rise while unemployment remains high. The reason is that skills atrophy for workers who are unemployed for a long time. They become unemployable or suitable only for low wage, basic jobs. The size of the employable labor force can shrink even though population data show growth in the overall labor force. The law of supply and demand applies to labor as well as goods and services. With skilled workers in short supply, competition among employers could drive wages up to a level high enough to fuel a rise in consumer price inflation. That would leave central banks in a very uncomfortable position. Traditional efforts to cool inflation could result in recession and rising unemployment.

Signs of labor market pressures are already evident. When entrepreneurs are asked why there are so few start-ups, their first response is a shortage of human capital. They complain they can't find people with the right skills because universities are failing to keep pace with the fast-changing job market. Small companies do not have the resources to provide training to fill the education gap. So far this has not put upward pressure on wages. Small start-ups are making do with fewer people and working longer hours. But this is a warning sign, an example of a tightening in the market for people with employable skills.

Why has this recovery been so sluggish for so long?

That is the question being addressed by Fed board members and economists. There is no quick easy answer, and therefore no easy solution. However, economists offer several explanations. We know that business executives at companies large and small have been reluctant to hire, invest, expand and increase research and development spending. When asked, they have cited a higher than expected level of uncertainties. Increased federal government regulation is high on the list. Between 2009 and 2011 the Obama administration issued 106 new regulations, each expected to have an economic impact of at least $100 million a year. On top of the landslide of new regulations, business executives suffer from constant political uncertainty generated by a combination of ambitious new legislation - such as Obamacare - and ideological trench warfare. Add in the ever-changing tax laws and you can understand why so many business executives are so reluctant to invest in new ideas or expand existing facilities. Had some of the uncertainties been resolved early in the recovery, business executives might be more confident by now. However, that has not been the case. The long period of slow growth and recurrent political failures have chastened business executives. They are discouraged, disappointed that the often predicted improvement in the economy has not developed. Most would likely agree with Columbia University professor Edmund Phelps who says: "We're in a slow-growth period of unknown duration."

Start-ups have been a significant source of job creation in past economic cycles. Companies that are five years old or younger have accounted for all of the country's net job creation and the bulk of innovation. That has not been the case during this recovery. New, burdensome financial regulations - most notably the Dodd-Frank legislation - have made it very difficult for entrepreneurs to get the financing they need. Lenders have been cautious ever since the 2008 financial crisis. Now new regulations have increased bank capital requirements and changed risk asset definitions. As a result, banks have been shrinking their balance sheets, leaving start-ups competing for scarce risk capital. The result is fewer new jobs being created by start-ups.

Note: A little known reason why inflation hawks have been wrong:

The Fed has expanded its balance sheet at an unprecedented rate and is still adding $85 billion a month in new liquidity. Inflation hawks have been sounding the alarm, arguing that so much new money had to ignite a steep rise in consumer price inflation. They rely on history. In past economic cycles inflation ignited with far less than trillions of dollars in new money. What the inflation hawks are missing this time is that since the 2008 financial crisis there has been an equally significant tightening of monetary conditions through new bank regulation.

The tightening is a global phenomenon, triggered by the collapse of Lehman brothers more than five years ago. Lehman Brothers was an American company and largely regulated by U.S. authorities. However, when Lehman failed, the pain was felt around the world. For example, British authorities complained that Lehman was allowed to snatch $5 billion in cash from its London branch days before declaring bankruptcy. Germany was furious, because the Bundesbank - Germany's equivalent of our Federal Reserve - was stuck with $11 billion worth of loans to Lehman's German subsidiary. Pensioners in Singapore and Hong Kong lost life's savings. The result has been a regulatory rush to reduce the risks posed by big foreign banks. Rulemakers have been quietly carving up the global financial system, reducing its flexibility and effectiveness. Where capital once flowed easily from regions rich with savings to those with better opportunities for growth and expansion, it is now walled off, providing lower returns at home. In addition regulators are reducing risk at home by raising capital requirements and imposing new credit standards for domestic banks.

The main tool in dealing with banks is capital. Regulators now require banks to hold far more capital. That limits the amount they have available to lend. In addition, capital requirements are higher for loans that are considered to have above average risk. And, the definition of what constitute risk assets has been changing. Loans that once were considered ordinary are now in the high risk, high capital category. Combine all the new regulations with bankers still frightened by the 2008 financial crisis, and the bottom line is that banks at home and abroad are no longer going to be the source of economic stimulus they were before the 2008 crisis. The good news is that inflation is being held in check. The bad news is that slow growth is likely to be the norm for quite a while.

Technology to the rescue?

Northwestern University professor Robert Gordon argues that the spurt in productivity associated with the computer and Internet revolution is over, and as a result, the U.S. will be consigned to a long period of "dismal" growth. Last year he predicted that for twenty years from 2007-2027, gross domestic product per capita would rise at the slowest pace of any 20-year period in U.S. history, going back to George Washington.

The stock market seems to agree. Technology stocks used to sell at a premium to the broad market. According to professor, Jeremy Siegel, they now sell at 13 times current earnings, a significant discount to the 19 times for the stocks in the S&P 500 index. Investors have long worried about the death of the PC, and about markets that are fully saturated with smartphones and other mobile devices. However, if there is one lesson from history, it is that Malthusian predictions, no matter how logical they may seem, always come up wrong thanks to human ingenuity and new technologies.

The idea that businesses have exhausted all the benefits from the Internet, computers and current technology is patently wrong. Banking is one small example. Thanks to the Internet and cameras in mobile devices, you no longer need to see a bank teller to deposit a check. Endorse the check, take a picture of both sides; send the picture to the bank via an appropriate app and the check will be deposited in your account. This one small step enhances worker productivity at banks. Inside bank branches we are seeing a variety of new devices. For example, there is a cash-dispensing machine connected to a computer that will issue cash in any denominations you want, quickly.

In manufacturing, the numbers continue to show that computer assisted machines such as robots are increasing worker productivity. In recent quarterly earnings reports companies such as Cisco Systems and Intel said that they were in product transitions, as new, faster, more energy efficient devices begin to replace products that were considered state of the art just a few years ago.

Professor Gordon could be right in one respect: per capita GDP. We normally look only at economic data for the whole economy. The usual quarterly reports do not include a calculation of GDP per capita. If the economy keeps growing at a subpar rate and the population keeps expanding, it is possible that GDP per capita will grow very slowly, below historic rates. That would be bad news for the millions of Americans who do

not have the skills needed for employment. It would mean the wealth gap would grow even wider. However, slow per capita GDP growth would not mean dismal stock market performance. Businesses will continue to use technology to improve efficiency and profits. They will also expand wherever there is opportunity for growth. Sluggish per capita GDP growth in the United States would not mean the same for every region of the globe.

Last fall there was a meeting for mangers of major institutions, pension funds and mutual funds. They were asked this question: if you could own only one asset class what would it be? The overwhelming winner was: emerging markets. The mangers believe the long term growth opportunities in emerging markets are significantly better than in the developed world. At the moment some emerging markets are struggling. China is dealing with bad debts from a real estate development boom. India is battling double digit inflation. Brazil is suffering political turbulence that has spilled over into the private sector. Russia's growth rate has slipped below 2%. However, none of these current issues discourage the professionals that mange the big funds. They understand that it is not easy for a country like China to go from unbelievable poverty to prosperity without significant challenges along the way. However, we now have twenty years of experience with China and other emerging markets. The record is outstanding. Not every emerging market will go from bust to boom, but the largest - China, India and Russia - are on the right track. Other smaller countries are also making the right choices. The institutional pros are likely to be right. The emerging markets asset class will be a source of profits for investors for many years to come.

Conclusions:

Stocks have been the best choice for the last several years. They remain the best choice for dividends and potential capital gains. The greatest risk is a melt-up, which has not happened so far. As investors digest the new Fed slow growth concerns they will see that stocks remain a better choice than cash or bonds. Our best strategy is to hold on to our stocks positions.

NEWS AND VIEWS ON OUR COMPANIES

Cisco Systems is a world class technology company with a truly global business. The recent quarter tells a tale of current difficult market conditions, but long run opportunity.

Cisco Systems, NASDAQ, CSCO, $21.36, reported first fiscal quarter results that beat expectations, but sales missed, and guidance for the second quarter was disappointing. In the opening quarter of this fiscal year Cisco's adjusted earnings were $0.53 a share - 10% better than last year and better than the $0.51 analysts expected. Revenue grew only 2% in the first quarter and CEO Chambers said that the last two weeks of the quarter were "really tough." For this quarter Chambers said revenues would be down 8%-10% and that adjusted earnings would be $0.45-$0.47 a share. Analysts had expected revenue growth and earnings of $0.52 a share. The stock fell sharply after the report. What should we do? Here is Morningstar's advice: "We think long-term oriented investors seeking dividend yield with income growth potential should consider buying into price weakness." I agree and here is why: Cisco is financially very strong. First quarter operating cash flow was $2.6 billion. An additional $15 billion stock buyback program has been announced. That will reduce the shares outstanding by about 12%, boost per share earnings, and reduce cash required for dividends. According to Synergy Research, Cisco is the leading provider of cloud infrastructure. Cloud is growing fast. In the first quarter Cisco introduced a game changing core routing and core switching platform. Emerging markets account for about 20% of Cisco's product business. Those markets offer excellent long term growth potential, but are currently soft. That will change as the cycle returns to stronger demand for technology. Even with the current soft market, Cisco will be able to report adjusted earnings of more than $2.00 a share this fiscal year. The current dividend is $0.68 a share, for a yield of 3.1%. At about 10 times earnings Cisco is a buy.

Walt Disney, NYSE, DIS, $68.50, reported a strong fourth fiscal quarter. Earnings per share were $0.77, up 12% from last year. For the full fiscal year that ended September 30, Disney earned $3.51 a share - up 14% from fiscal 2012. After the announcement of the fourth quarter results, the stock went down because some analysts were concerned that the pay TV networks, including ESPN, rose only 1% and profits from that division were down 7% from last year. Disney's chief financial officer explained that a big chunk of fees came in during last year's fourth quarter and that excluding fee-timing issues, revenue and profit would have been up 6%. Disney has become an entertainment giant with a global reach. There will always be some issues in any given quarter with an enterprise the size of Disney. The remarkable thing is that – overall - Disney just keeps growing year after year. Fiscal 2013 diluted earnings per share were $3.38, up 8% from 2012.

For the year that began last month, the current estimate is $3.90 a share. Both Argus Research and Standard & Poor's rate Disney a buy with a stock price target of $75. I agree.

Wal-Mart, NYSE, WMT, $79.20, reported third fiscal quarter profits up 2.8% to $1.14 a share. That was $0.02 better than Standard & Poor's research expected, but otherwise in line with most analysts' forecasts. Sales rose 1.7%, but same store sales in the United States were down 0.3%. Wal-Mart is struggling with the payroll tax hike in the United States, the ongoing subpar economic recovery, and the recent government shutdown. On a constant currency basis international sales rose 4.1%. Management reduced full year earnings guidance to $5.11-$5.21 a share. Argus Research rates Wal-Mart a hold at the recent stock price. Standard & Poor's says buy and has stock price target of $85. Wal-Mart is the world's largest retailer. The global economy is growing at a 3%-4% annual rate. Emerging markets represent a huge long term growth opportunity for Wal-Mart. However, as we can see right now, there will be volatility rather than never ending straight line growth in those markets. I see Wal-Mart as a low risk investment with above average long term growth in income and capital gain potential. Buy Wal-Mart below $75.

Housing is another source of growth for the U.S. economy. The recovery in housing has been stronger than the overall economy. As foreclosure numbers decline and the inventory of existing homes for sale shrinks, the number of homes bought will settle down. However, there is more to housing than home sales. The U.S. economy and companies like **Home Depot** and **Lowe's** will continue to benefit as new home construction improves, and consumers spend on home improvements.

Home Depot, NYSE, HD, $79.15, said that sales were up 7.4% in the third quarter. Same-store sales in the U.S., a key metric, rose 8.2% in the quarter. Earnings per share were $0.97, up 28.4% from last year and well ahead of the $0.89 analysts expected. Management now expects full year earnings to be $3.72 a share, up 24% from last year. In addition management expects to buy back $2.1 billion worth of common stock during the fourth quarter. Clearly, Home Depot is exceeding all expectations. The only question is the stock's valuation. The stock is currently trading at 21.3 times management's most recent 2013 earnings guidance. That is not so high as to be worrisome, just too high to buy more. I would buy more if the stock pulled back to $70 or less.

Lowe's, NYSE, LOW, $47.90, said sales rose 7.3% in the third quarter. Same-store sales rose 6.2%. Earnings per share were up 34% over last year to $0.47 a share - a penny less than analysts expected. Lowe's is also buying back shares - $761 million during the third quarter. For all of 2013 management says Lowe's will earn $2.15 a share. The excellent third quarter results say that Lowe's, like Home Depot, is benefiting from the housing recovery. Again the question is the stock's valuation. Lowe's is currently trading at 22.3 times management's full year 2013 guidance. Like Home Depot, that is not so high as to trigger a major decline, but too high to be attractive to new buyers. My advice is to buy Lowe's on a pull back to $40 or less.

CLOSING THOUGHTS

Bashing the U.S. dollar seems to be a sport that is always popular among some Americans. However, they pay no attention to the facts - such as the huge demand for U.S. dollar denominated Treasury securities. For the last few years, even during times when the dollar was declining versus a basket of trade weighted currencies, demand for U.S. Treasury securities rose to record high levels. Last month Bank of America reported that the U.S. dollar is attracting the biggest wagers by money managers in almost five years. While the Bank does not cite actual volumes, they did say that pension funds and institutions bought the most dollar-denominated assets in late October since at least January 2009.

Barry Ritholtz, writing for Bloomberg, says Google the phrase "falling purchasing power of the U.S. dollar" and you will be rewarded with more than 91 million results. Drop the U.S. and the results double to 187 million. All of the millions of arguments against the dollar ignore facts such as the record demand for U.S. treasury securities and the enormous inflows to buy U.S. assets. Barry Ritholtz looked at the dollar bashing arguments and said this: "The problem is, nearly all of these arguments are wrong." The core flaw among all the dollar bashers is that they look at the dollar as cash buried in the ground or left under a mattress. That is a misleading metric. If you invested in stocks your dollars would have grown and compounded. Barry Ritholtz says, "Let us ignore for the moment the compounding benefits of putting those dollars to work in stocks or real estate. Let us make the most conservative, liquid, riskless investment possible for cash: 3 month T bills."

The result is that buying and rolling over 3 month T bills since the 1950s or 1960s preserved purchasing power. The total dollars today would be pretty much even with inflation over those decades. That is a nice exercise and helps to put the dollar bashers in their place. But, the most important measure is the purchasing power of an hour of labor.

"What matters more is the purchasing power of an hour of labor to acquire a need good – food, shelter, clothing, iPhones. How many hours of labor required to make those purchases is a much more important than the currency used as an intermediary between the labor/wage earner and the consumer." Barry Ritholtz

Professor Mark J. Perry on his blog site Carpe Diem recently published data on the cost of a classic Thanksgiving dinner for ten people. The cost this year is $49.04, according the American Farm Bureau Federation. That is down 2.2% from last year. It is also down 20% in real terms from 1986. The nominal cost in 1986 was $28.74. In 1986 dollars the cost today is $23.11. Dollar bashers, of course look only at the change in nominal costs. They see the price rising from $28.74 in 1986 to $49.04 today and argue that those who buried dollars in a jar in their back yard in 1986 have suffered a loss of purchasing power. Most Americans did not bury their dollars - they spent or invested them.

A realistic look at the dollar means asking how real Americans have fared over the last decades. When it comes to Thanksgiving dinner they have done quite well. At the average wage an American worked 3.22 hours to buy Thanksgiving dinner in 1986. This year it took only 2.42 hours to buy dinner for ten. And, if they went to Wal-Mart the time cost was 1.74 hours. That is an amazing fact. I wonder how many other countries have produced such outstanding results. Where else can you work two hours and provide a feast for ten people? Maybe living in a U.S. dollar based economy is not so bad after all.

Next weekly Hotline: Wednesday December 11, 2013

All the best,

John Dessauer
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