John Dessauer Investments, Inc.

John Dessauer's Outlook

February 2014

In Defense of the Federal Reserve And Ben Bernanke

First: Do not let Dow Jones volatility cause you financial anxiety. Call it the January effect. Capital gains taxes have been raised significantly. Waiting to sell in 2014 pushes the tax payment day to April 2015. Economic fundamentals remain favorable. Emerging market fears are exaggerated. Interest rates are normalizing. Inflation is not a threat. Stock valuations are within a normal historical range. Earnings are growing. Dividends are attractive and also growing. If anything, a drop in the stock market is a buying opportunity for investors who have been sitting on the sidelines with too much cash.

Special note: The Fed is tapering because the U.S. banking system has been fixed. The tapering is measured and step-by-step because the U.S. economy, while better, is far from fixed.

Now: When economists look back at the 2008 financial crisis, I expect they will praise Ben Bernanke and his team for one of the most remarkable economic rescues in history. His policies not only prevented a plunge into depression; they stabilized the financial system and provided essential support for the economy. We can only imagine how much worse conditions would be today if the Fed had followed a different course. Meanwhile, he is feared by investors for having created too much of the liquidity that some believe makes high future inflation inevitable. He is attacked by politicians who want to rein in Fed powers. In a recent talk for the Brookings Institute, he expressed serious concern about the political attacks, saying that an independent central bank is essential for the American economy. The facts support the actions taken by the Bernanke Fed. The new chairperson, Janet Yellen,

will continue to follow the Bernanke policies. Economists, politicians and especially investors should be thanking and praising Ben Bernanke and his team for their remarkable achievements in dealing with the threat of another great depression.

Why Inflation hawks are wrong

During his talk at the Brookings Institute, Bernanke made a bold statement, saying the Fed could tighten monetary policy while the balance sheet stays the same or even grows larger. That must come as a puzzle for Fed critics and inflation hawks. The popular assumption is that sooner or later the Fed will have to shrink its balance sheet and take back the trillions in liquidity that has been added to prevent inflation from gaining traction. During the talk at the Brookings Institute, Bernanke did not provide details on how the Fed could tighten monetary policy. He has provided details before, although market and media pundits have largely chosen to ignore him on that question. One very effective tool the Fed has is control over bank reserves. By increasing bank reserve requirements, the Fed can severely limit banks' lending ability. A credit bubble is the classic cause of unwanted inflation. By raising bank reserves the Fed can prevent a credit bubble from forming and stop inflation in its tracks.

A year or so ago, China faced an inflation threat. The money supply grew rapidly. China critics, like the current Fed critics, confidently predicted an outbreak of high inflation in China. They were wrong. China stopped inflation by raising bank reserve requirements. As economist Arthur Laffer has said, economics knows no boundaries. Basic economic principles apply everywhere. No doubt U.S. market pundits like to think that China is not just far away geographically, but is subject to different economic laws. Yes there are differences, but Arthur Laffer is right: if raising bank reserve requirements kills inflation in China, it will also kill inflation in the United States.

Another related powerful anti-inflation tool is Fed Funds. The Federal Reserve controls the interest rate on Fed Funds. Banks buy and sell Fed Funds every day. Fed Funds are the deposits banks have with the Federal Reserve. The amount of Fed Funds a bank is required to have is determined by the reserve requirement. If a bank has more on deposit at the Federal Reserve than required, it can sell Fed Funds. A bank that has just made a lot of new loans may be short on its reserve requirements and will have to buy

Fed Funds. The interest rate on Fed Funds has a direct impact on bank interest costs. When the Fed Funds rate rises, bankers become more cautious. They make fewer loans because they don't want to be buyers of Fed Funds. Raising the Fed Funds rate is another powerful tool that can be used to choke off a developing credit bubble.

No credit bubble - no high inflation

The popular definition of inflation is too much money chasing too few goods. Market pundits tend to focus on the too much money part of the definition. They see all the liquidity the Fed has added in recent years - roughly $3 trillion - and jump to the conclusion that there is too much money in the economy and that therefore high inflation is inevitable. They are ignoring the mechanism - how money gets into the economy. The mechanism is lending by the banks. The Fed bond buying increases cash in the hands of the banks. The banks do not have to use the money to make new loans. Bankers can elect to keep part or even all of the new cash on deposit with the Federal Reserve. If they do that, the liquidity supplied by the Fed does not end up in the economy. It remains bottled up in the Federal Reserve System. That is basically what has been happening the last few years. We have had the opposite of a credit bubble - deleveraging. A major reduction in overall borrowing was inevitable because of the 2008 crisis. The great threat to the U.S. and other economies was the sudden deleveraging that occurred as trillions of dollars in loans went bad. Overnight, after the collapse of Lehman Brothers, global liquidity dried up. Loans could not be rolled over. Prices of all sorts of collateral plunged, making the underlying loans partially or whole uncollectable. The world faced a credit implosion of unprecedented proportions.

Once you understand that a credit bubble is how inflation becomes a threat, and you also understand that in 2008 the U.S. and global economies suffered the exact opposite, you can then understand why inflation has not been nor is currently a risk. Of course inflation is always an underlying risk. Could there be another outbreak of unwanted inflation? The answer is yes, but only when conditions change and another credit bubble forms. Given the slow pace of growth here at home and in Europe, it will likely be at least several years before economic conditions favor a new credit bubble.

"QE (Quantitative Easing) works in practice but not in theory." Ben Bernanke

This is a remarkable statement. Former Fed chairman Bernanke said it at the Brookings Institute in response to a question about the Fed's monthly bond buying program.

According to economic theory the bond buying (QE) won't work because it is no more than a way for the Fed to temporarily and artificially manipulate interest rates. Market participants are not fooled by the low interest rates because they fear much higher interest rates are only one step away. We saw that last September when then Chairman Bernanke talked about tapering - cutting back on the size of the monthly bond buying program. Interest rates immediately spiked up while stocks and bonds fell sharply. Bernanke's reaction was to say that the interest rate spike was unnecessary and unwarranted. In the last few months, Bernanke and other Fed members have spent time talking about tapering, preparing markets for reductions in the monthly bond buying. Markets have behaved much better. Interest rates did not spike when the Fed actually announced the first step in tapering - a reduction from $85 to $75 billion a month in bond buying. Instead we have seen what is being called "normalization" in interest rates. Market participants are starting to act as if the Fed were not involved in the bond market. This is a healthy development. It means that normal forces such as supply and demand or the pace of economic activity are determining interest rates. Interest rates are no longer being manipulated by the Fed.

What does Bernanke mean when he says QE works in practice?

If the trillions of dollars in bond buying did no more than temporarily manipulate U.S. interest rates, then QE would be judged a failure, a bold step that inflated the Fed's balance sheet and introduced an unwanted inflation risk.

The mechanism is complex, but the results are clear, there for all to see. American banks are now in excellent shape. After announcing an outstanding fourth quarter of 2013, Bank of America's CEO said the bank's balance sheet is now stronger than it has been in decades. That is after the financial pain brought on by two major acquisitions - Countrywide and Merrill Lynch. Bank of America is not alone. Most American banks have worked through the mountains of bad mortgage and other loans. They are now profitable and well capitalized. Fannie Mae and Freddie Mac recently paid $40 billion to the U.S. Treasury. The Federal Reserve is the nation's

lender of last resort, the bank for banks. The Fed's bond buying included mortgage backed securities. One way to look at the program is to see the Fed as a market maker in mortgage backed securities, the most important market for banks after the 2008 financial crisis. Without the Fed and QE there might not have been a market for such securities. Banks would have been frozen in place, unable to do new mortgage business and unable to provide refinancing opportunities. If the banks had been frozen in place, the entire economy would have been stuck in recession or perhaps worse.

Researchers at the San Francisco Federal Reserve bank have concluded that Quantitative Easing (QE) has helped improve the U.S. labor market. They noticed that data on unemployment claims and new job creation began to improve after QE was implemented. They now have enough evidence to say that there is a connection between QE and the labor market. It is not a coincidence. QE has done more than improve bank balance sheets - it has helped the labor market as well.

Banks can be described as custodians for the economy. The economy cannot prosper and grow unless there are strong banks able to act as financial intermediaries. Knowing that, it is no surprise that Fed efforts to help banks have also helped the labor market. I am sure there will be lots of research done by the Fed and private sector economists on QE and its effects. It may take a decade or more before theory can be amended to explain how and why QE worked in practice. That will help in future financial crises. For now, we can be thankful that Ben Bernanke and his fellow Fed board members were courageous enough to try something new. And when they saw that QE worked in practice, they continued until our nation's banks had a chance to repair and recover.

The Fed has begun tapering. The question is: why now and not later?

The economy is the number one priority for the Fed. Therefore it is clear that the Fed members believe the economy is now strong enough to continue growing with less support from the monthly bond buying program. However, I think there is another reason the Fed has cut back on the bond buying. The banks are now so healthy, with very strong balance sheets, that there is a new risk. If the Fed were to provide more financial help than the banks need, the risk is that bankers might start taking advantage of the situation. The might take on risky loans and package them knowing they

could be sold thanks to the Fed. The last thing the Fed wants is a new credit bubble.

Look for tapering to continue.

If the economy were stronger I am sure the Fed would do more than taper. Instead of slowly reducing the monthly bond buying, the Fed would abruptly stop QE altogether. The banks are now strong enough that QE could be stopped. The problem is that Washington's fiscal policies have not worked. There are too few good jobs, too many on food stamps and too many long term unemployed. Businesses are still hoarding cash and not investing and hiring as they did in the past.

Think about my story last week about the abandoned hotels in Papeete. Their labor costs were too high for the hotels to survive a slump. The slump came in the form of a global recession and the hotels went out of business. That was no ordinary slump. It was truly frightening. Banks and many other types of businesses failed as a result of the 2008 financial crisis. As one market commentator explained, after a shock like 2008, business managers will prepare for the worst for a very long time. Better to hoard cash and miss an opportunity than to invest, hire and fail when the economy turns sour again. What does it take for businesses to invest and hire again? It takes a return of confidence in the future. Restoring confidence after a near depression requires an almost ideal pro-business atmosphere at all levels of government. Anything less and business managers will remain cautious, fearful and prepared for the next economic slump. The Fed can do only so much. After that it is up to State, local and the federal governments to do their part. As we know, government initiatives such as affordable health care have introduced uncertainties about labor costs. Labor is the largest cost for many businesses. The last thing the economy needed in the wake of the 2008 crisis was labor cost uncertainty.

When asked about the future, Bernanke chooses his words very carefully. When listening, I sense he is frustrated, almost angry at what has been happening in the White House and Congress. He talks about the risk of slowing productivity gains, slower pace of innovation and less capital investment, without pinning down the causes and solutions. He clearly sees long term risks for the economy that are beyond the power of the Fed to solve. The Fed has achieved about all that can be expected from QE. The banking system is back in good condition and the economy has achieved a

rate of sustainable growth. The Fed has taken step two in tapering by trimming another $10 billion off the monthly buying program. The Fed will continue to taper until there is no more monthly bond buying - unless some unexpected adverse development slows the pace of the recovery. Given the strengthening U.S. economy, that is unlikely. The consumer is two-thirds of the economy. In the final quarter of last year U.S. consumer spending climbed the most in three years. That plus a strong performance from exports produced a solid 3.2% rate of growth in the fourth quarter.

The IMF's chief economist says: "The recovery is indeed strengthening…"

Last year started off slowly, but gained enough strength to lift full year growth to 3%. This year the IMF expects 3.7% growth for the global economy. Their forecast for the U.S. is 2.8% and for the euro region 1%. The data on the fourth quarter indicate that the IMF's U.S. forecast may be too conservative. Skeptics worry about a real estate credit bubble in China, and capital outflows from emerging markets. On Friday January 24, the U.S. Dow Jones Industrial Average fell 318 points because of fear that China and other emerging markets would drag down the U.S. economy. Those fears are based on history and do not take into account the differences between now and the late 1990s. Since then, most emerging markets have strengthened their national balance sheets and - outside of China - allowed their currencies to float. We are no longer at risk of waking up one day to suddenly find the banking system in Thailand or Indonesia broken. The stresses and strains are now relieved in every day trading in the currency markets. Central banks and governments are not insulated; they now respond to the ups and downs of the free currency markets.

In the case of China, if there *is* a credit bubble it will not impact the U.S. or other economies because China is isolated when it comes to domestic credit - especially real estate loans. China is not involved in derivatives that link one economy to another. There is no Chinese equivalent of Lehman Brothers. When Lehman Brothers collapsed, retirement savings accounts for innocent people in Hong Kong and Singapore were lost. If a Chinese real estate financier collapses, only China will be involved. And, China's national balance sheet is very strong and quite able to deal with any losses. Keep in mind that China has a very high personal savings rate and that many homes and apartments are paid for in cash.

The Friday the 24th U.S. stock market plunge was also tied to a report that manufacturing in China might be slowing down. However, those pessimistic pundits forgot that this is the lead up to a major Chinese holiday season - the Lunar New Year. China's economy usually slows for a few weeks before the week-long New Year celebration.

Outlook for stocks

As usual, there has been an overreaction to emerging markets fears. In the six weeks through January 24, investors pulled $422 million out of emerging market mutual funds. A survey recently found that 40% of Asian investors are hoarding cash. Emerging markets, including China, are solid long term investment opportunities.

Yes, growth in corporate profits will likely be less than it was in the last few years. The S&P 500 stock index is not likely to be up 30% this year. But profits will grow and interest rates will stay low. Stocks remain attractive for both capital gains and dividend income this year. No one knows whether stocks will act as I expect - be volatile, but not vulnerable or temporarily fall sharply. What we *do* know is that if there is a plunge, it will be a major buying opportunity. That is the lesson from the stock market's recovery after the 2008 financial crisis. The Fed now knows exactly what to do if the economy falters.

Based on current data, the odds are that stock prices will rise 8%-10% this year. Add dividends, and the total 2014 return on stocks will likely be in double digits.

COMPANY NEWS AND VIEWS

Microsoft, NASDAQ, MSFT, $37.06, reported a second fiscal quarter that beat all expectations. Analysts expected Microsoft to report earnings of $0.68 a share. Microsoft reported $0.78, far above even the most optimistic forecasts. Before that report, full year estimates were for earnings of $2.70 a share. Microsoft critics - the ones who keep calling for the death of the PC (personal computer) - are scouring the details looking for negatives. That is a tough job because revenue from Windows software fell only 3%, while revenue from consumers sales overall rose 13%. Cloud related revenue doubled as Microsoft gained ground on its competitors. Total revenue at $24.52 billion also beat expectations of $23.68 billion.

Clearly Microsoft is growing revenues and profits at rates much better than analysts expected. Microsoft is enjoying success in the consumer market, success in major markets like China, and impressive success in the enterprise or commercial market. Before the second quarter report, analysts were predicting Microsoft would earn $2.70 a share this fiscal year. That is likely to be revised upward to $2.80 or higher. Fiscal 2015, which begins July 1, 2014, will likely to be raised to $3.00 or better. The current dividend is $1.12 a year, for a 3% yield. The dividend will likely be raised after the new CEO is selected. The stock at about 12 times next year's earnings is undervalued. My twelve month target is $45. Microsoft is a buy.

Pfizer, NYSE, PFE, $30.10, reported a better than expected fourth quarter. Earnings per share, excluding items, were $0.56, up 22% from last year and $0.04 better than the $0.52 analysts expected. For all of 2013 Pfizer earned $2.22 a share. For this year, management's guidance is $2.20-$2.30 a share. Analysts are generally a little more optimistic - looking for $2.33 a share. Over the next five years, Pfizer does not have much in the way of patent losses to worry about. The aggressive share buyback program will continue, but management says somewhat fewer shares will be bought back this year. Pfizer is a low risk investment. The dividend currently at $1.04 a share provides a yield of 3.5%. Over the coming twelve months I expect the stock to rise to $35. Add the dividend and the total return becomes almost 20%. Pfizer is a buy.

Halliburton, NYSE, HAL, $48.92, reported better than expected fourth quarter results. Earnings per share were $0.93 - $0.04 better than expected and 48% better than the fourth quarter of 2012. Revenue was up 4.8% over a year ago. Excluding special items Halliburton earned $3.20 a share in 2013, up 6.7% from 2012. For this year Argus Research has raised its earnings estimate to $4.30 a share. S&P is slightly more conservative with a $4.06 2014 earnings estimate. Analysts at Argus are impressed with Halliburton's international prospects. Business in Mexico is especially promising, and will be more so as Mexico opens it oil fields to outside investment. The stock fell after the report because of concern that domestic U.S. operations are slowing. While true, that ignores the strong growth outside the United States. The stock market slump took Halliburton down to almost 11 times the Argus 2014 estimate. I regard Halliburton as a buy below $50. My twelve month stock price target is $60.

Texas Instruments, NYSE, TXN, $43.25, reported fourth quarter sales and earnings that were in-line with analysts' expectations. Earnings in the final quarter of 2013 were $0.46 a share on $30 billion in sales. Management's guidance for this quarter at $0.40 disappointed analysts. However earnings for all of 2013 at $1.94 (excluding items) were 27% better than 2012. For this year analysts are expecting earnings of $2.21 or 14% better than 2013. Texas Instruments has nearly completed its transition to new, more profitable analog technology. The dividend is $1.20 a share per year, for a yield of 2.8%. Analysts are warming to Texas Instruments' stock. While the company appears to be on a new growth path, there remain uncertainties about the rate of future growth. My advice is to buy Texas Instruments on any dips below $40.

CLOSING THOUGHTS

Many investors feel threatened when political leaders talk about income inequality because they know what that means. The current political approach is not to lift up the poor. It is to bring down the rich through high taxes and wealth redistribution. What many forget is that these ideas are not new. They are at least four decades old. The American economy has been burdened with high taxes and questionable economic policies many times before. The remarkable fact is that in spite of all the attacks, our economy has not just survived; it rebounded every time and went on to prosper and grow. It is truly impressive that after a near depression in 2008, followed by questionable government policies, American household wealth has more than fully recovered. It is now at an all-time record high and rising.

Teddy Kennedy went to the same Massachusetts prep school I did. I know that he did not get the ideas of a windfall profits tax on oil companies at school. But, in the 1970s, after an oil price surge and long lines at American gas stations, he championed a punitive new tax on American oil companies. The tax was later repealed. It did no good and fortunately did not permanently damage American energy international competitiveness. I still wonder how the late Senator could imagine that such a tax, imposed only on American companies, could help consumers or raise much new tax revenue.

The failure of the windfall profits tax did not discourage Senator Kennedy or his supporters. Later that same decade, during the Carter administration, he proposed, and the president supported, a 70% tax on "unearned income." I became one of the unintended consequences. With a

wife and five children, I was living and working in Switzerland. My employer, Citibank, gave me cost of living support and subsidies for school tuition for my children in addition to my salary. All of that essential financial support was regarded as unearned income, subject to the new 70% income tax. The Carter administration also attacked the special tax benefits that Americans working overseas enjoyed. It didn't take long. Within a couple of years the number of Americans living and working in Europe declined sharply. It took two decades after the repeal of that punitive income tax before the American presence in Europe recovered.

It seems that "tax the rich" ideas never die, no matter how many times they fail. In the 1990s we imposed a 10% surtax on expensive yachts, cars and other luxury goods only the rich could afford. The tax failed. It did not collect enough new revenue to cover the revenue losses from a decline in jobs. It was repealed, but not before it essentially destroyed the American luxury yacht building industry. That business has still not recovered.

Washington is at it again, this time by imposing special taxes on "investment income." That is the old Kennedy tax on "unearned income" with a slightly different name. Fortunately, the tax rate on "investment income" is far lower than the Kennedy 70% rate. Still, taxes on savings and investment are bad economics. This new tax on "investment income" will most likely also fail and have to be repealed.

On another subject, during a cruise through the Panama Canal, there was a lecturer who had been in charge of the U.S. management of the Canal. He told the story of how the Canal nearly was destroyed by President Carter. Carter, on his own, decided that the U.S. should turn over the canal to the then corrupt government of Panama, our Senate objected. A political battle ensued. By one vote, a ten year delay was imposed on turning over vital canal operations to Panama. However, some canal operations were turned over by President Carter. The corrupt politicians in Panama sold off special grass cutting equipment that was used to maintain the railroad connecting the two sides of the canal. The grass grew so high that trains were impeded and even derailed. Panama's politicians decided to burn the grass. The rail ties, soaked with creosote as a preservative, caught fire and were destroyed. That was the end of the railroad. The port facilities at each end of the canal need lots of money for basic maintenance because of the harsh climate. The corrupt politicians took the money and let the port facilities decay to the point that they could no longer be used. It soon became clear that turning the

canal over to a corrupt government was a very bad idea. That one vote in the U.S. Senate prevented a canal disaster that would have severely damaged world trade. Later, President Reagan launched an attack, captured Panama's corrupt president Noriega and helped Panama recover. The canal has been run profitably and successfully by Panama ever since.

I am telling these stories about Kennedy and Carter not to criticize them. It is too late for that. Shakespeare is right, "What is done, is done and cannot be undone." I am telling these stories to show how resilient the U.S. economy is. We worry about Obamacare, higher taxes and our sluggish rate of economic growth. We forget about our history and ignore our ability to get through tough times and come roaring back.

It may be purely political - an effort to change the subject, distract voters in this year's elections from health care concerns and the high rate of long term unemployment, but focusing on income for the rich versus the poor may be effective. Never mind the facts. Politicians and their supporters who propose higher taxes do not like to talk about results, such as the consequences of the 10% tax on luxury goods. They like to dazzle voters with Robin Hood talk of taxing the rich and giving the proceeds to the poor. Robin Hood lived in the forest and his band of merry men used very little of the plunder for their own support. The U.S. federal government is an enormous and very expensive bureaucracy. We are never told what percentage of the plunder from taxing the rich goes to support the bureaucracy and how much actually ends up helping the poor. Obviously, if the facts were favorable, the "tax the rich" supporters would be trumpeting them. They aren't, and the logical conclusion is that bureaucracies operate in support of their own interests first.

Democrats and Republicans alike have been expressing concern about the ability of poor Americans to climb up the economic ladder. Both have assumed that it has become more difficult in recent decades. Economists from Harvard, the University of California at Berkeley and the U.S. Treasury department got together to study the situation. The results were published in late January by the National Bureau of Economic Research. Everyone, politicians and economists alike, is surprised by the result. The conclusion after all that study is that young Americans from low-income families are as likely to move into the ranks of the affluent today as those born in the 1970s.

The study found that 9% of children born in 1986 to the poorest 20% of households were able to move up into the top 20%, little-changed from the 8.4% for such children born in 1971.

This study is evidence that all the scary crises, from the inflation-ridden 1970s to the near depression in 2008 have not been able to permanently damage the core of the U.S. economy. We still have the ability to overcome adverse government policies and harsh economic conditions.

Next issue: The March issue of *John Dessauer's Outlook* will be ready on Wednesday March 5, 2014.

Next weekly market review and update: Wednesday February 12, 2014

All the best,
John Dessauer

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