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John Dessauer's market review and update as of Wednesday January 11, 2017

"**Bull markets are born in pessimism, grown in skepticism, mature in optimism and die in euphoria." (Sir John Templeton)**

The dramatic improvement in American consumer confidence since the election of Donald Trump has been accompanied by a 2,000 point surge in the Dow Jones Industrial Average. Does this mean the stock market has suddenly gone from skepticism to euphoria? Is the long bull market run over? Will Dow 20,000 be the new ceiling?

Personally, I hope Dow 20,000 will be a barrier for a while, at least until corporate sales and profits begin to show results from President-elect Trump's goals to reform taxes and stimulate faster economic growth. Arthur Laffer, economist and former advisor to President Reagan, reminded investors in a Fox news interview that stocks initially went down after President Reagan cut taxes. Not until the results of the tax cuts began to appear in reported quarterly results did stocks turn around and surge to new record highs.

The circumstances are different today. The economy is not in recession. Americans are suffering from a long, slow recovery. For example, the average household income today is slightly less than it was nine years ago. There has been growth, but not enough for the economy to fully recover. Under these circumstances, it is possible that tax and regulatory reforms will have a more immediate and powerful impact on economic growth and corporate sales and profits than they did in the 1980s. Still, it will be at least

several months before we see results in quarterly earnings reports. The surges in consumer sentiment and stock prices are based on expectations, not current reality. But pessimists are wrong to characterize the stock market surge as “euphoria.”

Euphoria is a state of mind. It is popular optimism on steroids. We saw that in the early 1970s when Xerox and IBM sold at 80 or more times earnings. In the technology stock boom of the 1990s, the CEO of Motorola wrote a note to employees saying the stock price implied a picture-perfect future rather than reality. The stock did not immediately collapse, it took some time, but it eventually did come down sharply. Are there individual stocks that are priced way too high today? Of course there are. But, a handful of overpriced stocks does not meet Sir John Templeton’s definition of euphoria.

The symptoms of euphoria are widespread belief that the economy is growing at a high, but sustainable rate, that the next recession is years away, and that stocks are cheap because sales and profits will keep growing at double digit rates. The evidence of euphoria is cash flowing out of bonds, real estate, and gold and into stocks. Morgan Stanley uses a chart of cash flows between stocks and bonds as a measure of investor sentiment. Money flowed out of stocks and into bonds for five years after the 2008 financial crisis. In 2014 and 2015 there was a reversal as money flowed out of bonds and back to stocks. Last year the old trend resumed. Cash, once again, flowed out of stocks and into bonds. These cash flows indicate a high degree of worry among investors. They certainly do not indicate excessive optimism.

Could this long running bull stock market end in a classic burst of euphoria? I believe the answer is yes. But first we will need to see results from the Trump administration.

The recovery from the 1982 recession was strong, with several years of solid growth above 3%. That could happen again. Economists are cautious about this year. But by 2018 the economy is expected to be growing at a 3% or 4% rate. After that, it is possible that growth will accelerate, rising above 5%. That could set the stage for a period of investor euphoria. However, today, with so many normally optimistic investment professionals warning that Dow 20,000 is too high, there is no danger of euphoria or a stock market crash.

Furthermore, when the rate of economic growth picks up, interest rates will rise, making bonds less attractive. When interest rates go up, bond prices go down. It would not be a surprise to see money move away from bonds and into stocks when the rate of economic growth rises above 3%.

One day investors may once again become euphoric and stocks could come crashing down. However, that is not the risk today. The risk today is a pull back to pre-election levels. That is a normal, everyday stock market risk, and not one to justify an attempt at market timing. If Arthur Laffer is right, Trump administration economic success will be followed by a strong stock market that lasts several years.

Another reason to hold on to stocks is a report from officials in Beijing saying they are confident the Chinese economy grew at 6.7% in 2016. For months in early 2016, we were warned that China's economy was slowing down. Some economists predicted Chinese growth at 5% or less for 2016. They were wrong. They were also wrong about the plunge in oil prices dragging the global economy down into a new recession. The U.S. and global economies suffered a major blow after oil prices collapsed. Business investment fell sharply. Unemployment in the energy sector rose sharply. Global growth

slowed in 2015. However in 2016, growth resumed as the global economy adjusted to lower oil prices. The benefits to oil consumers more than offset the drag from oil producers. The good news from Beijing is likely to be followed by positive reports from emerging economies and Europe. It is remarkable that the U.S. and global economies have passed severe stress tests from a devastating financial crisis and a collapse in energy prices. They didn't just survive - they have continued to grow. Now the outlook for the U.S. economy has improved. We may soon replace China and take our familiar place as the primary engine of global growth.

I will have the next market review and update for you one week from today on Wednesday January 18, 2017.

All the best,

John Dessauer

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