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John Dessauer's market review and update as of Wednesday January 20, 2016

The stock selling stampede should soon be over. Stocks around the world look oversold. The global economy faces challenges, but is not in serious trouble. We should soon see the beginning of a stock market recovery. It is easy to say that patience is the best strategy. But when the Dow Jones Industrial Average suddenly plunges 547 points on a Friday, feelings of fright can be overwhelming. There never are guarantees when it comes to future stock market performance.

But stocks tend to follow profits. And profits tend to follow nominal economic growth rates. Therefore, investors are correct to be watching economic growth rates in China, emerging markets, Europe and the United States. However, two very important factors are being ignored by the pessimists and the popular media. First, there is an ongoing rebalancing of growth in the global economy. Second, the widely different central bank monetary policies have caused the U.S. dollar to gain unusual strength. And, that, because of dollar borrowing, has stressed some economies, especially emerging economies. While challenges remain, the rebalancing is close to a positive resolution and the dollar is likely to stabilize or retreat from recent highs. The outlook for stocks remains positive.

The plunge in both the Dow Jones Industrial Average and the S&P 500 stock index during the first eight days of 2016 was the worst in the history of both stock indices. Then, just when investors thought it couldn't get any worse, it did. On Friday January 15, the Dow Jones Industrial Average followed through with a plunge that took

the venerable Dow Jones Industrial Average down another 547 points before bottoming out and rallying to close down “only” 389 points. In terms of stock market volatility, it doesn’t get any worse. No wonder so many are so frightened. And, of course, the usual pessimists have been piling on with forecasts of further massive stock market declines and coming global recession. The lessons of 2008 and 2009 have been quickly forgotten. The same emotions that destroyed so many portfolios when stocks collapsed seven years ago are back. Economic conditions today are far better than in 2008-2009. In fact there is no comparison. The world is not on the edge, at risk of a new depression. To be sure there are challenges, but they are focused on how to improve the current rates of slow growth. Current data indicate higher rates of nominal growth this year than last in Europe, the United States, Japan, the United Kingdom, and among emerging markets. The stock selling stampede is in sharp contrast to improving underlying economic conditions. Odds are that stocks will recover rather than that economic conditions will deteriorate.

Morgan Stanley Wealth Management analysts expect nominal growth in the United States to rise from 2.6% last year, to 3.6% this year. That is still well below the peak growth rates of past recoveries, but enough to provide a solid base for growth in corporate profits. Better, but still sub-par, growth is due to three main reasons. First, is the collapse in oil prices, which has forced energy companies to reduce capital spending and cut payrolls. Second, the strong dollar has hurt U.S. manufacturing because “made in the USA” has become more expensive for foreign buyers. The Morgan Stanley US dollar trade-weighted index is up 20% recently, and 33% since 2008. Just four years ago, in 2012, gold was close to $2,000 an ounce and rising. Popular pundits were confident gold

was headed for $5,000 an ounce and the dollar to oblivion. Today, gold hovers around $1,000, and popular pundits see only one way for the dollar to go: up. Just as they were wrong four years ago, the pundits are likely to be wrong again today. The current sentiment on the future of the dollar is so optimistic as to be an extremely rare condition. Since the 1970s the most prevalent dollar position has been negative. Historically, when investor sentiment reaches euphoria, stocks peak and decline. That is likely to be the case with the dollar as well. The dollar is likely to take a break or pull back in coming months. That will not only help U.S. exports, it will be a huge relief for emerging markets. Third, while the U.S. has created new jobs, the mix has included too many part time and low wage jobs and not enough higher paying jobs. That is why there is political pressure to raise the minimum wage and why the U.S. wealth gap has widened. A recent study by the Brookings Institute found that the poorest Americans earn just a fraction of what they made before the recession of 2008. Alan Berube, a senior fellow at the Brookings Institute, said: “It’s really about the poor losing ground rather than these upper-class households pulling away.” The bottom line is there is still plenty of room for improvement in the U.S. economy and we are slowly but surely making progress. There is no fundamental justification for the steep decline in U.S. stocks.

The persistent slow U.S. growth and plunging oil prices are global game changers.

For many decades the U.S. economy was the primary engine of global growth. Not only was the global economy dependent on strong U.S. growth - the U.S. was the most important market for goods made elsewhere. Think of Japan after World War Two and China more recently. Both prospered for decades by emphasizing exports to the U.S.

The great recession of 2008 changed export patterns, but still the U.S. remained relatively stronger than many other economies until 2014. Last year the U.S. rate of growth was largely matched by Europe, Japan, the United Kingdom, and what Morgan Stanley refers to as the G10 economies. This year is expected to be a repeat, with U.S. growing, but not much different than other developed economies.

The other major game changer is the oil price plunge. This has shifted power from oil producers to oil consumers. At the moment, the suffering of oil producers is dominating headlines and popular economic thinking. Two of the BRIC emerging markets are clearly suffering. Russia is in recession. Brazil is also in a recession, but one that is made much worse by political mismanagement. Neither is likely to suddenly recover this year. However, this year the benefits for oil consumers are likely to emerge and start capturing headlines. In addition, the outlook is much brighter for other emerging markets. Emerging markets have been the biggest borrowers of U.S. dollars for the last decade. The rise in the dollar made interest and principal payment more of a burden. Dollar indebtedness has been one of the biggest negatives, dragging on the emerging market economies.

Morgan Stanley thinks the damage done by the dollar's unusual strength might be responsible for more than emerging market damage. "The bottom line is that the strength in the U.S. dollar could be solely responsible for the massive slowdown we experienced in certain sectors and regions." They go on: "In 2015 global growth deteriorated almost as much as during the financial crisis in 2008. This is amazing and argues that the *global* economy has already experienced a painful recession during the past year. To have

another year of negative growth following such a steep decline would be unprecedented in modern times."

On China, Morgan Stanley reminds us that the yuan, China's currency, rose 30% from 2005 to 2015. That was too much for *any* economy, and especially too much for China's economy, which is in a major transition from exports to domestic consumption. That is already helping to stabilize the yuan. China recently changed its currency policy, and is now targeting a basket of currencies rather than just the U.S. dollar. The risk to the Chinese and global economies from a yuan plunge has been significantly reduced. Odds are the Chinese will achieve their goal of 6.5%-7% GDP growth this year.

As you can see from this short note, the changes - or rebalancing, as Morgan Stanley calls it - that are happening in the global economy are complex. But they include major positives. Investors and the media have chosen recently to stay focused solely on the negatives. That will change as reality replaces speculation. I will have more in coming weeks. Meanwhile, stay fully invested in stocks in financially strong companies. And remember, companies are announcing dividend *increases*, not dividend cuts.

I will have the next market review and update for you one week from today on Wednesday January 27, 2016.

All the best,

John Dessauer

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