# John Dessauer Investments, Inc.

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**John Dessauer's market review and update as of Wednesday January 27, 2016**

**The stock market is not always a leading indicator. There have been times when stocks sank, but the economy kept growing. When stocks sank, like today, pessimists took advantage of investor fears. They convinced many that hard times were coming. But they were wrong. The economy did not yield, it kept growing. Stocks recovered and went on to new highs. While you never can say that a recession is impossible, the best experts today put the odds on a recession at 20%. In other words, these experts believe the economy is most likely to keep growing. Plus, the U.S. Federal Reserve last month, by raising interest rates, made a big bet that the economy is gaining strength.**

**Has the global stock selling stampede made fools of the Federal Reserve board members? Will the Federal Reserve be forced to come to the rescue of the stock market and reverse the December interest rate hike? Or, will the Federal Reserve stand tough and let the stock market sort itself out? Answering these questions starts with a clear understanding of why the Federal Reserve raised interest rates.**

The Federal Reserve is primarily focused on the U.S. labor market. There has been an ongoing debate among Federal Reserve board members about whether or not data on the low labor participation rate, and part time versus full time jobs, should be given more serious consideration now than in past cycles. In the past the Federal Reserve became concerned about future inflation when the unemployment rate approached 5%,

and gave little consideration to job types and the labor participation rate. In December board members who are concerned about those data capitulated and voted for the interest rate increase. They did so because they do not want to get blindsided by rising inflation with interest rates near zero. Better to very gradually raise interest rates than have to boost rates more aggressively.

Both sides see plunging oil prices and a strong dollar as temporary deflationary issues. Oil prices will eventually bottom and then stabilize or partly recover. Once oil stops falling, it will no longer be a deflation issue. Likewise - the dollar won't keep rising, and when it stops, it also will no longer be deflationary.

Early economic data for December support the interest rate hike. New job creation was very strong, at 292,000. And sales of existing homes surged. To be sure the U.S. economy is not booming, but neither is it heading for a contraction.

In addition to the U.S. interest rate hike, pessimists point to the slowing Chinese economy. But, China's economy has grown over the years and now is a $10 trillion economy. Growth of 6.9% contributes more to global growth than 10% did when China's economy was much smaller. Further, China's growth far exceeds growth in the U.S. or Europe. Instead of lamenting slower growth, investors should be celebrating China's continuing strong growth.

Morgan Stanley's CEO in a television interview said he saw no fundamental reason for the U.S. and global stock plunge. On China's stock market, he said that the market is 80% retail and not well connected with China's economy. As I have remarked in past weekly comments, Chinese stocks have a history of ignoring the underlying economy. During times when China's economy was growing 10% a year, Chinese stocks

did nothing. More recently Chinese stocks soared as the economy slowed. Now Chinese stocks have come back down. They may overshoot before stabilizing, but it is foolish for investors in Europe or the United States to be following the lead of retail Chinese investors.

In the United States, he pointed out that American household balance sheets are stronger than they have been in decades. Americans have increased savings and reduced debt. That might disappoint retailers in the short run, but it means that the long term potential for growth in consumer spending is now on solid fundamental footing. He also pointed out that American corporate balance sheets are stronger than they have been in a long time. When asked about the banks he said they too have strong balance sheets. This analysis of financial strength among banks, other corporations and households says that economic risks have been significantly reduced. The panicky selling by individual investors is out of touch with reality.

The MSCI (Morgan Stanley Capital International) global stock index is now down 20% from its 2015 high. U.S. stock indices are also well down from their 2015 highs. At some point investors will awaken to the fact that the selling has gone too far. The question then will be about the recovery. Growth in revenue and earnings will determine how strong the stock market recovery will be. The current consensus among analysts for companies in the S&P 500 stock index is for revenue growth of 4.8% this year and 5% in 2017. Their outlook for earnings has growth at 8.1% this year and 12.6% in 2017. Analysts form their views based on information they get from the companies they follow. Obviously, corporate managers are more optimistic than the stock market pessimists. I find this very interesting, because mangers of publicly traded companies

tend to understate their estimates of future revenues and earnings. They prefer to surprise analysts and shareholders with better than expected results. Also, being too optimistic can mean legal trouble from the SEC and corporate attack lawyers.

The current “bottoms up” optimism among analysts and corporate managers is in line with the Federal Reserve’s plan to gradually raise U.S. interest rates. It is in sharp contrast with Federal Reserve critics and stock market pessimists.

We are in the midst of fourth quarter 2015 earnings season. As always, results are mixed, but a majority of companies so far have beaten earnings expectations. As quarterly earnings reporting winds down, we will get hard numbers on valuations for individual stocks and the broad market indices. Rising earnings and falling stock prices mean valuations have been compressed. That by itself will bring an end to the selling stampede. However, it likely will take longer, at least a few weeks, for buying to return and drive stocks back to their 2015 highs.

I will have the next market review and update for you one week from today on Wednesday February 3, 2016.

All the best,

John Dessauer

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