John Dessauer Investments, Inc.

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John Dessauer's market review and update as of Wednesday February 3, 2016

The worst may be over for stocks.

The Morgan Stanley Capital International (MSCI) global stock index is down 16% in 2016, and down 20% from its April 2015 high. Some stock market pundits say this is more than a correction in a "bull market" - this is the start of a new long term "bear market." For them to be right, the stock market decline has to be followed by deteriorating economic conditions and a new global recession. Some major economies are struggling: France, for example, has declared an "economic emergency." Economic growth has been stagnant in France for a very long time. Unemployment has been in double digits for years. However, before the pessimists cheer, they should know that things are not so bad as to convince the French to abandon their 35 hour work week.

Closer to home, the BEA (Bureau of Economic Analysis) has reported that the U.S. economy grew at a scant 0.7% rate in the fourth quarter of 2015. That is a big disappointment. The economy grew at a 3.9% rate in the second quarter and at a 2% rate in the third. The fourth quarter slump gives credibility to those who worry about a developing U.S. recession. Statistically, there is always a 10% risk of recession in any year. The slide from 3.9% in the second quarter to 0.7% in the fourth raises the risk of recession. Morgan Stanley, along with other financial powerhouses, sees the risk of a U.S. recession now at 20%; still low, but higher than last year. A further disappointment is that the U.S. economy made no progress – that is, no increase in growth year over year. The U.S. economy grew 2.4% in 2015, the same as in 2014.

The causes of the U.S. fourth quarter slump are familiar: a strong dollar and weak oil. The strong dollar hurts U.S. manufacturers more than lower energy costs help. Weak oil depresses revenues and profits for energy companies. They respond by cutting spending and laying off workers. Fortunately, there are signs the end may be near for the declines in the energy sector. The number of new claims for unemployment have stopped rising in Texas, a major energy state. They are still rising in North Dakota, another major energy state, but the rate of increase has slowed significantly. BP's CEO might be right. He predicts oil will bottom out this quarter and then recover slightly. He is not an oil optimist. He thinks oil prices will stay low for several years. But, if he is right and oil prices stabilize, the oil damage reports will diminish and the benefits from low cost energy will begin to dominate economic statistics.

Last year, U.S. consumer spending grew at a 3.1% rate. The overall growth rate for the economy was lower (2.4%) because business outlays declined 1.5%. The BEA has not provided all the details yet, but it appears that U.S. consumers were frightened by the sudden steep decline in the stock market. They chose to increase savings rather than spend all the money provided by lower energy and a stronger labor market. Still, last year was dramatically better than 2009, when consumer spending declined 1.5%. And, there is no sign that U.S. consumers are ready to reduce spending. There may be fluctuations in the rate of spending growth, but that does not signal a coming recession.

On the contrary, there are growing signs that, at long last, American workers are going to get a raise in wages. Wal-Mart, the largest private employer in the U.S., is raising wages for its hourly employees either to at least $10 an hour or by 2 percent of their salaries, starting Feb. 20. Under the plan, senior hourly workers will get $15 an hour, up from $13, and assistant managers will also see a boost.

Wall Mart's initiative could put further pressure on companies across industries to boost salaries to retain or attract workers, said Ryan Sweet, a senior economist at Moody's Analytics Inc. in West Chester, Pennsylvania. After Wal-Mart raised its wages to $9 an hour last April, big discount chains such as Ross Stores Inc., T.J. Maxx and Target Corp., Wal-Mart's biggest direct competitor, followed suit and also increased their minimum pay to $9 an hour last year. The U.S. federal minimum wage is currently $7.25.

Wal-Mart's wage raise is not only being followed by the big retailers; other businesses are also ready to raise wages. A net 20 percent of small-business managers last month said they plan to raise pay, matching the highest level since 2006, according to a survey by the National Federation of Independent Business, a lobbying group that claims membership of 325,000 small and independent business owners.

"We are close to full employment," Sweet said. "Slack is diminishing in the labor market — it hasn't vanished, but we are reducing the slack — and that's going to translate into stronger wage growth this year and 2017."

Stronger wage growth is what the Federal Reserve is counting on to boost demand and foster stronger economic growth. If Wal-Mart's wage hike is a leading indicator, then we can expect not just improvement in the rate of U.S. economic growth, but stronger final demand and higher corporate sales and profits. If that turns out to be the case, investors will have panicked for nothing, and stocks will more than fully recover.

Central bankers are ready to stimulate their economies. The latest example is the Bank of Japan (BOJ). Last week the BOJ cut interest rates again, this time to negative territory. The U.S. Federal Reserve was cautious this month and left interest rates alone. With global stocks down so sharply, the odds have changed on the next U.S. interest rate increase. Now expectations are for another interest rate increase only after stocks recover and economic growth improves, perhaps this summer.

On Tuesday, January 26, Chinese stocks fell another 6% and U.S. stocks went up! It took a while, but finally U.S. investors have stopped following the Chinese stock market gamblers. I saw another sign that the worst might be over for U.S. stocks: in two days there were 6 million shares of SEI Investments sold. The average daily volume is 750,000 shares. Naturally, the stock price fell sharply under that enormous selling pressure. It turns out the selling was by one or more hedge funds. I have no idea why any hedge fund would get involved with SEI shares. Perhaps they thought they could pressure Al West into selling on their terms. In any case, the wild stock market has discouraged the hedge fund managers. They bought at $50 and sold at $39. SEI is an example of how hedge funds can push individual stocks around with no concern for the long term or the fundamentals. SEI reported 2015 revenues and earnings as expected. For 2015, SEI reported earnings per share of $1.96. The consensus among analysts is for earnings this year to increase 8% to $2.12 a share. Of course, if financial markets do better than now expected, SEI's 2016 earnings will beat the current estimate. Someday, SEI will become a merger or takeover candidate. In the meanwhile, SEI's solid cash flows, earnings, and strong balance sheet make the stock attractive

I will have the next market review and update for you one week from today on Wednesday February 10, 2016.

All the best,

John Dessauer