John Dessauer Investments, Inc.

www.johndessauerinvestments.com

John Dessauer's market review and update as of Wednesday March 16, 2016.

Wednesday March 9, 2016 was a stock market anniversary. Seven years ago the Wall Street Journal asked "How low can stocks go?" Stocks had been falling fast, wiping out trillions of dollars of equity in American mutual funds, IRAs and individual portfolios. Pessimism was pervasive. The stock market crash was widely believed to be the beginning of another great depression, like the 1930s. Fortunately, the pessimists' dismal forecasts were wrong. March 9, 2009 was the bottom for stocks. From that day on, stocks rose, leaving the panicky sellers with regrets. The seven year stock market recovery has restored $14 trillion in stock values and pushed the S&P 500 stock index up 200%. You might think that would be cause for celebration. Instead investors are awash with anxiety. And, just like seven years ago, they are pulling money out of stocks. Over the last twelve months they have taken out $140 billion from equity mutual funds and ETFs (Exchange-Traded Funds). While there are reasons for investor anxiety, history says the selling is a mistake. Stocks will likely be higher six months from now.

According to data compiled by Bloomberg and Investment Company Institute, stocks tend to rise after people aggressively withdraw money from stock mutual funds. Since 1984, there have been twelve times when monthly outflows from stock mutual funds were at least 2 standard deviations from the historic mean. The S&P 500 stock index rose an average 7.1% six months later. That is significantly better than the normal return of 3.9%. This time the gain may well be better than 7.1% because of the

performance at the beginning of the year. The first six weeks of 2016 delivered the worst ever beginning of a year for U.S. equities. In addition the volatility was extreme. There was a surge in the number of days with market moves of 2% in either direction.

Analysts and market pundits are fond of watching corporate insider transactions. The idea is that officers and directors know more about the strengths and weaknesses of their respective companies than outsiders. Likewise corporate insiders know more about the strength and weaknesses of the slice of the economy their businesses serve. Officers and directors of a wide range of companies have been authorizing share buybacks. If the existing trend continues share buybacks will reach $165 billion this quarter. At the same time, hedge fund managers and individual investors are on track to liquidate $60 billion in equities. Which group do you think has the better real time information on the strength of the economy? In my opinion, the persistent corporate stock buybacks are a vote of confidence in the future for respective companies and the underlying economy.

Now that stocks have partially recovered from the recent selling wave, we are likely to see buying on dips. The volatility may continue, but more and more, the evidence says the worst is over for stocks. The question for investors now isn’t how low can stocks go; it is the outlook for the economy and corporate profits. Economists and institutional investment advisors tend to be optimistic. They see the economy growing at 2% or better this year and next, and they see corporate profits climbing enough to push the S&P 500 stock index to a new high. Others worry that rising costs at home, and pressures from abroad - especially China - will mean disappointing profits and lower stock prices. The latest news from small business suggests that the U.S. economy is still struggling.

The National Federation of Independent Business (NFIB) said its small business optimism index dropped one point to a reading of 92.9 in February. That is the lowest since February 2014. The index also dropped in January, down 1.3 percentage points. Small business owners face strong headwinds. Profits are being squeezed by rising labor costs that can't be passed on through higher prices. Demand is flat, retail sales are not growing. Small business owners are therefore very cautious about capital spending and hiring. The good news is the optimism index was up in December. The fall in January and February has taken the index back near the prevailing level of last fall and not to a new low. But the further truth is that small businesses have been suffering for a long time. The dramatic increases in taxes and government regulations over the last seven years are a much bigger burden on small business than on larger enterprises. Large businesses have more resources to deal with the costs from higher taxes and greater regulatory oversight.

The NFIB survey of small business owners showing sustained weakness is at odds with economic data such as employment, consumer spending and manufacturing. The latter have suggested a pick-up in economic activity in the opening months of this year, after growth slowed to a 1% rate in the final quarter of 2015. NFIB officials said the seeming conflict may be due to the employment question used in their survey. It is backward looking. Even so, it remains clear that small businesses are struggling and have been for some time. The plight of small business may go a long way toward explaining why so many Americans feel left behind or think the economy is still in recession. Small business needs relief from excessive regulation and burdensome taxes. Until that happens, slow growth in the overall economy will likely be the norm.

News from Europe indicates that the euro zone economies are growing, not headed for a recession. Eurostat confirmed last week that the 19 countries in the euro zone grew by 0.3% in the final quarter of last year. For all of 2015 the growth was 1.6% - much better than the 0.9% growth in 2014. Euro zone economies - like the United States' economy - are doing better, but still growing slowly.

Chinese officials are in the midst of their annual twelve day summit meeting. While they normally do not provide specifics, they do set goals. The Chinese economy grew 6.9% last year. At the opening of the summit, officials admitted that it will be challenging to keep the world's second largest economy growing at a 6.5%-7% rate. China needs to create more jobs and restructure the state owned enterprises. At the same time the economy is in transition from export dependence to domestic consumption. Fortunately, China has enormous foreign exchange reserves and modest government debt. In addition to cutting bank reserve requirements, China plans on increasing the government's deficit to 3% of GDP from the previous 2.3% target. Critics have been forecasting a Chinese economic crisis for the last two decades. We should stop and remember that in the 1970s and early 1980s the Chinese government owned everything. There were no private sector businesses. Worse, all the government businesses were effectively bankrupt, making things no one could afford to buy. China was stuck in abject poverty, worse than anything Americans have ever seen. In 35 years - less than a generation - China has created hundreds of millions of real jobs and created private sector companies that make goods that are sold around the world. The Chinese have faced unbelievable challenges and succeeded, with very few failures. The economic growth rate had to slow because of size. But growth at 6.5% will produce more in terms of the

volume of activity than a 10% rate when the economy was much smaller. China is applying a combination of central bank stimulus and fiscal spending to make sure the transition goes smoothly and the overall economy keeps growing at a 6.5%-7% rate. In sharp contrast, the U.S. and euro zone economies are relying on monetary or central bank assistance alone, because their governments' respective debts are so high. China will continue to be a driver of growth for the global economy.

Bull stock markets usually die amid excessive optimism, and that's nowhere to be found. We have the opposite - excessive pessimism. Economies usually fall into recession after becoming overheated and threatened by rising inflation. Today we have persistent slow growth and a threat of deflation. The logical conclusion is that stocks will keep climbing, albeit more slowly, and the U.S. and global economies will keep growing, albeit slowly.

I will have the next market review and update for you one week from today on Wednesday March 23, 2016.

All the best,

John Dessauer

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