John Dessauer Investments, Inc.

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John Dessauer's market review and update as of Wednesday May 10, 2017

"No doubt many investors are scratching their heads. ***How can this be the best earnings season in two years while at the same time Q1 GDP was a paltry +0.7% ???"*** Steve Reitmeister, Executive Vice President, Zacks Investment Research

Steve's answer might come as a surprise. Here is his analysis: "I know…It makes no sense on the surface. So, let me pull back the curtain and put this mystery into proper perspective.

The world economy is rebounding. Especially in Europe, Japan, and parts of South America. Even China is showing more pep in its step. Thus, with over 40% of the earnings for S&P 500 companies coming from outside the U.S., this increased global growth is making up for the shortfall in the States."

The latest data from Europe confirm Steve's analysis. In the first quarter, the euro region economies grew by 0.5%, about a 2% annual rate. And the good news is broad based and gaining strength. In April, euro-zone manufacturing grew at its fastest pace in six years. Also in April, the European commission's economic-sentiment index - based on surveys of service industries, manufacturers, builders and consumers - rose to its highest level in a decade. Europe has lagged the United States in recovering from the 2008-2009 financial crisis and recession. Now finally, Europe's easy monetary policies are showing results.

With earnings so robust thanks to global growth picking up, what will happen if the U.S. economy gains strength? Earnings growth could accelerate. No wonder stocks are holding up even though some valuations look stretched.

Robert Shiller publishes a stock valuation measure called the cyclically-adjusted price-earnings ratio (CAPE). Not everyone agrees with his method. Professor Jeremy Siegel, for example, says the index is flawed because it does not consider changes in accounting rules over the years. In other words, Professor Siegel thinks that earnings being reported today are of a much higher quality than those reported decades ago. Never-the-less Shiller's CAPE index gets a lot of attention. Ten years ago, in the run up to the 2008-2009 financial crisis, Shiller's CAPE index rose to 27.6. Today the index is at 29.48. While that is far from a record (44.19 in December 1999), it is high enough to cause angst among Wall Street market pundits.

However, there is no law that says the CAPE must return to its long-term average at 16.7. In the depths of the 2008-2009 crisis, when depression was an all too real possibility, the index was below the long-term average for only ten months.

The CAPE index's long term average is based on data going back to the 1800s. Over the last 30 years the CAPE index's mean has been 24.5. By that measure, todays index does not seem so threatening. It could be that stocks are simply anticipating a future acceleration in earnings.

The two fundamental threats to stocks are a sharp rise in interest rates due to rising inflation, and the opposite - a decline into recession. Neither is on the horizon. It may be quite a long time before either risk becomes serious enough to pull stocks sharply down.

According to a poll conducted by Bank of America Merrill Lynch, investors are simultaneously bullish and skittish about stocks. A net 32% of fund managers said they thought stocks were overvalued. But, 40% have a higher-than-normal allocation to stocks in the portfolios they manage.

Economists at the Atlanta Federal Reserve bank came very close to the correct prediction for the opening quarter of this year. They forecasted growth of 0.6%. The Bureau of Economic Analysis reported growth of 0.7% for the quarter. Having been right is not a guarantee that future forecasts will be as accurate. But the Atlanta Fed's forecast for this quarter is such a complete change from the opening quarter that it at least deserves serious consideration. The Atlanta economists say that growth this quarter will accelerate to a 4.2% annual rate. That would be an enormous quarter-to-quarter change and a surprise to many.

The conventional wisdom is that the U.S. economy is still burdened by the scars from the 2008-2009 recession, and that growth is not going to really improve until Washington provides tax reform and infrastructure spending. Federal Reserve Bank chair Janet Yellen seemed to agree last week when she announced that there would be no change in interest rates. However, Janet Yellen and other members of the Federal Reserve board have been up and down on the economy over the last couple of years. This time they could be too pessimistic. The economists at the Atlanta Fed may be right. After all, we have had strong job creation and the unemployment rate has dropped to 4.4%. Perhaps the cumulative effects of years of sub-par growth have created a foundation for stronger growth. It could also be that the surge in confidence after the elections is starting

to appear in economic activity. It won't take much - growth above 2% would be enough - to boost earnings and justify current stock market optimism.

This is what Morgan Stanley says: "Although optimism is a late-cycle phenomenon, history tells us the best returns often come at the end. It has taken eight long years to get here, but Wall Street and Main Street are finally starting to feel a bit better about the future. The cyclical upturn that began a year ago has less to do with President Trump and more to do with the global business cycle that bottomed in the first half of 2016. Trump simply "turbocharged" the cycle and stoked animal spirits on Wall Street and Main Street with tangible effects on the real economy and markets."

Morgan Stanley sees earnings growth and a reasonable P/E of 19 boosting the S&P 500 stock index to 2,700 over the next twelve months, for a 13% capital gain. Add in dividends and the total return potential remains attractive.

If Trump and the Congress pass tax reform and the economy responds by growing at a faster pace - 3% or better - earnings growth will beat expectations and the upside for stocks will be greater. The best strategy is to stay invested in stocks.

I will have the next market review and update for you one week from today on Wednesday, May 17, 2017.

All the best,

John Dessauer

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