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John Dessauer's market review and update as of Wednesday May 17, 2017

By some measures stock prices appear to be stretched. However, many experts say current valuations are fine because interest rates are so low. Interest rates still are near record lows. The obvious question is, will interest rates stay low or will inflation, the old familiar stock killer, come roaring back? Pessimistic prognosticators warn of inflation and much higher interest rates. They are enjoying popular favor because of experience in the 1970s, when inflation soared and stocks collapsed. There is another interest rate issue being debated by government treasurers, including the U.S. The question is, should the government take advantage of low interest rates and issue 50 year or longer government bonds? Some governments have already taken the plunge. Critics argue that interest rates may stay low far longer than expected. If that is the case, stock valuations will stay higher than average far longer than many expect.

The conventional threats to equities are a sharp rise in interest rates, or the opposite - a decline into recession. The U.S. and other central banks have successfully beaten back the recession threat. They have proven that unprecedented policies such as quantitative easing work. In the United States, they have worked well enough for the Federal Reserve to start raising interest rates and shrinking its balance sheet. For investors in equities that leaves the question of interest rates as the remaining long term risk issue.

The Federal Reserve did not raise interest rates at its May meeting. But, more interest rate hikes are expected starting next month. For the moment stock market analysts are not worried about rising interest rates. They see the change in Federal Reserve policy as an adjustment, getting monetary conditions back to "normal." That leaves the question about interest rates in the long run open. It may seem strange, but discussions about how best to manage the United States' $14 trillion in government debt have intensified the debate about the outlook for long term interest rates.

On May 3, officials said that Treasury Secretary Steve Mnuchin had set up an internal work group to study the potential for ultra-long term government bonds.

Some countries have already taken the plunge. Britain, Canada and Italy have sold 50-year government bonds. Mexico, Belgium and Ireland have issued 100-year debt.

The U.S. national debt is equal to three-quarters of our GDP. Interest payments are already $280 billion a year, or more than three times the combined budgets of the Departments of Education, Commerce and Labor. Every one-tenth of one percent rise in interest rates increases the annual interest burden by $14 billion. With the Federal Reserve "normalizing" interest rates there is a real risk that the cost of financing the national debt will increase.

The weighted average maturity of the U.S. National debt is 5.7 years and the effective interest rate is 2.03%. The current yield on 30-year government bonds is 3%. Selling longer dated bonds would likely require a higher interest rate. The current very low average interest rate makes the question of locking in interest rates for 50-100 years more difficult. Paying 3%, 4% or more on 50-year and longer bonds makes sense only if short and medium term interest rates ultimately rise above today's long term rates. If we

are headed into a period of high inflation, like the 1970s, then by all means the Treasury should sell as much really long term debt as possible. Because of the U.S. inflation experience in the 1970s, and the experience of countries like Mexico that have a history of easy money and high inflation there is a popular bias in favor of selling ultra-long dated government bonds. However, there are other opinions, and good reason to question the wisdom of ultra-long term debt.

Alex Gurevich of HonTe investments, a California based fund management firm, says interest rates in America are more likely to remain at current levels than to revert to the mean seen in the late 20th century. There are reasons to think that Mr. Gurevich may be right. The inflation of the 1970s was oil related. Soaring oil prices were a prime cause of high inflation. For several decades it was believed that world oil production had peaked. We were heading into a time with ever higher oil prices and ever higher inflation.

The shale revolution in the United States has changed the dynamics of the oil market. Oil prices have come down and are not likely to soar again. OPEC finds itself in an unexpected and uncomfortable position. The inflation threat from oil is not likely to materialize again for a very long time, if ever.

The growth rate for China, the world’s second largest economy, has declined and is likely to decline further as that economy grows still larger. Huge government debts in many of the world’s developed economies have already forced governments to be fiscally more cautious and responsible.

The bottom line is that there are macro-economic factors that will keep growth and interest rates restrained for a long time.

Time will tell what Secretary Mnuchin's study group recommends. My personal bet is that there will be a compromise, and that the U.S. will take a chance and issue some 50-year bonds.

As far as stock prices are concerned Morgan Stanley's P/E of 19 for the S&P 500 stock index looks secure. Interest rates are not going to rise enough to force the P/E to a lower level. That means stock prices will rise or fall on sales and earnings results. The first quarter results are the best in two years. The outlook is for more good news this quarter.

On Monday May 8, the CBOE Volatility Index touched an intraday low of 9.72, the lowest since 1993. The stock market is calmer than at any time in my memory. Investors are relaxed and willing to patiently wait for a stronger economy that will lift sales and earnings to a higher level.

I will have the next market review and update for you one week from today on Wednesday, May 24, 2017.

All the best,

John Dessauer

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