John Dessauer Investments, Inc.

John Dessauer's market review and update as of Wednesday May 24, 2017

After months of calm, all of a sudden, the Dow Jones Industrial Average plunged, falling 372.82 points in a single day. The cause was intense political turmoil, not fundamentals. Earnings continue to beat expectations and the U.S. economy is growing, not contracting. Fortunately, as expected, the bump was short and shallow. Stocks rebounded the next day. A few years ago, a 372.82 Dow plunge would not have been considered shallow. But with the Dow above 20,000, a 372.82-point decline qualifies as shallow. Given the sharp political divide, we may see more stock market turbulence. However, fundamentals - earnings in particular - will prevail.

"While political swings may trigger volatility in the short term, longer term they are unlikely to have a major effect on the U.S. stock market. U.S. stocks trade off earnings, earnings are linked to growth, and I don't think it's going to have a meaningful impact on growth." Kevin O'Nolan, multi-asset portfolio manager at Fidelity International.

On May 18, the *Heard On The Street* column in *The Wall Street Journal* had this to say about stock market volatility and the short term risks:

"The stock market's performance, until Wednesday, was in part because of improving global fundamentals. The other driver was expectations of tax cuts and easier regulation boosting earnings.

You can separate the two by comparing the increase in profits versus the increase in valuation. Profits are looking better…

The remainder of the S&P's gain came from steeper valuations—the index now trades at about 17.2 times expected earnings versus an already pricey 16.4 on Election Day. If investors completely lose confidence in the Republicans' ability to deliver, this part of the gain could be wiped out. That would mean a roughly 5% decline from here."

Given that stock market timing is inherently difficult, political turmoil and short term volatility are not good reasons to change investment strategies.

Two weeks ago, I quoted the director of Zack's research. He raised the question of how first quarter earnings could be so good for U.S. companies when the economy limped along in the opening quarter. Now, thanks to an article in the May 15 issue of *The Wall Street Journal,* I have more details and some guidance for this and following quarters.

According to Thompson Reuters I/B/E/S, first quarter earnings for companies in the S&P 500 stock index are on track for a year-over-year increase of 14.6%. That is the best in two years and impressive by any measure. Analysts are saying the rest of the year is looking good. Earnings rising at a double-digit rate provide fundamental support for stocks. When earnings are growing and the outlook is bright, stock valuations often rise in anticipation of future earnings. On that basis, Morgan Stanley thinks the P/E on the S&P 500 stock index could rise to 19 from the recent 17.2.

The challenge for investors is that the current economic climate is better for U.S. multinational companies than for companies that rely on earnings from domestic activities.

“The U.S. economy remains stuck in the same slow-growth track, but with the unemployment rate at 4.4% the job market has gone from tightening to tight. That has set the stage for wages to accelerate, putting earnings at risk.” (Justin Lahart, *The Wall Street Journal, Heard On The Street* May 15, 2017)

However, the U.S. accounts for only 44% of the sales at the companies in the S&P 500 stock index. The rest comes from business outside the U.S., and there the outlook remains strong. The unemployment rate in the euro-region is at 9.5%, meaning there is plenty of labor market slack, and that the euro central bank is far from tightening. Ethan Harris, economist at Bank of America Merrill Lynch says: “The U.S. is running up against labor-supply constraints and Europe isn’t.” Workers in Europe are not in a position to ask for raises and companies running below capacity are not under pressure to add workers. In addition, the euro has recently gained strength versus the U.S. dollar. That means stronger profits when translated into dollars for quarterly reporting purposes.

Outside Europe, emerging markets have largely recovered from the devastation following the 2008-2009 financial crisis. They are now benefiting from Europe and the recovery in developed economies.

“The upshot is that the more business a company does overseas, the better its profit growth ought to be in the year ahead.” (Justin Lahart *Heard on the Street)*

This does not mean that only big multinationals are benefiting from the improving overseas economic growth. The benefits tend to spread throughout the U.S. economy. That could be seen in Wal-Mart’s opening quarter results, which comfortably beat expectations.

Pessimists are now focusing on the challenges from a U.S. 4.4% unemployment rate. For example, analysts at Goldman Sachs estimate that for every 1% increase in labor cost inflation, the S&P 500 will see a 0.8% decline in earnings. Missing in that analysis is data on how many American workers are still sitting on the sidelines waiting for companies to offer jobs at better wages. The still low labor participation rate is an indication that the number could be significant. If so, then the U.S. labor market still has some slack and wages may not become a significant downward pull on profits any time soon. In any case, a 14.6% rise in first quarter profits is cause for celebration. The earnings recession clearly is behind us. And stock valuations suddenly don't look as stretched as many stock market pundits claim.

"We frequently hear that the current forward price/earnings (P/E) multiple for the U.S. stock market is exceptionally high. At an 18 P/E, that is a factual statement, but not necessarily an accurate one. Based on the past 40 years, the P/E ratio for the top 500 U.S. stocks has ranged between six and 32, and 18 ranks in the 87th percentile. However, such a cursory statement does not take into account the exceptionally low interest rate environment. Comparing P/E ratios today with those in the early 1980s—when interest rates were in double digits—is comparing apples and oranges." (Morgan Stanley *On The Markets* May 2017.)

No one, not even the most stubborn pessimist, is predicting a return to double digit interest rates. On the contrary - we are hoping the U.S. economy gains enough strength for the Federal Reserve to "normalize" interest rates over the next year or two. Stocks remain attractive.

I will have the next market review and update for you one week from today on Wednesday, May 31, 2017.

All the best,

John Dessauer

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