

John Dessauer Investments, Inc.

www.johndessauerinvestments.com

John Dessauer's market review and update as of Wednesday June 1, 2016

First quarter corporate profits were down. The economy barely grew at all in the first three months. There has been a massive outflow from equity mutual funds. Yet, stocks are up, at near record highs. Is the stock market a leading indicator? Are corporate profits and the economy about to improve?

Low oil prices were a drag on corporate profits in the first quarter. They have been a drag for the last several quarters. Overall first quarter profits from the 500 companies in the S&P index were down about 4% versus a year ago. Now with oil at \$50 a barrel the energy drag is waning. Energy companies will be able to adjust if oil simply stabilizes at \$50. They may not be able to deliver strong growth in profits, but they will at least be profitable. The quarter after quarter of energy company losses will be over.

While that would be good news, there is more to the declining first quarter profits' story than oil prices. Excluding energy companies, first quarter profits were down about 3.8%. The strong dollar, anemic growth and changing consumer spending patterns took a toll on profits. Retail is an example. Traditional retailers, such as Macy's, reported declining sales and profits in the first quarter. The headline story was that these brick and mortar retailers were being devastated by new technology - the Internet and Amazon in particular. However, just as this explanation gained popularity, Wal-Mart, the world's biggest retailer, delivered a shock by reporting a strong opening quarter. Amazon and technology are changing the shape of retail in the United States, but that is not the whole story of the troubles at so many traditional retailers. Businesses can change and respond

to new competition. For example, Wal-Mart is spending millions of dollars ramping up its version of Amazon type online shopping. The bigger issue for retailers continues to be the weak economic recovery. There are too many Americans with part-time or low paying jobs. The recovery is seven years old and the economy is still growing at a slow rate, far below what happened after past recessions.

There is a myth so popular that it triggered the recent massive outflows from equity funds. The myth is that economic cycles are like people - they die of old age. In December Federal Reserve chair Janet Yellen said: “I think it’s a myth that expansions die of old age.” But die they do, if not of old age, then of what?

One answer is deliberate government action. In the early 1980s, for example, both Britain and the United States applied tight monetary policies with high interest rates to stop destructive inflation. The result was a deep and painful recession. Another example is external shock, like the soaring oil prices of the early 1970s. Consumers in rich countries were hit with rising energy costs like an enormous tax increase. Their discretionary spending declined sharply, and so did the national GDP. However, left alone, economic expansions can last a very long time. The modern record is held by the Netherlands. An expansion that began in the early 1980s endured for almost 26 years, until it was killed by the 2008 global financial crisis. The U.S. record is the ten year technology boom that ended in the 1990s. That expansion ended after a technology sector boom ran its course, and the Federal Reserve imposed restrictive monetary policies. There have been 12 expansions in the United States since the end of the Second World War. With the longest being ten years, the current seven year old expansion seems to be approaching old age. But appearances can be wrong. Just because the U.S. has not

enjoyed an expansion longer than ten years, does not mean this one is nearing its end.

Australia is in an expansion that began in 1991 and will likely surpass the Netherlands' 26 year record by early next year.

Long periods between recessions might seem counter-intuitive. That is because of our experience with U.S. recessions in recent decades. Economists explain: A booming technology sector might siphon off capital that otherwise would go into housing or infrastructure. Those sectors, in turn, could power growth once the technology sector runs its course. If all domestic investment opportunities are used up, capital should flow towards foreign investment, reducing the value of the currency and helping exporters to become engines of economic growth. Here is what the editors of *The Economist* wrote in the May 21st issue: "As long as the end of a boom in one sector does not engender self-fulfilling pessimism in the rest of the economy, the show should go on." And indeed it did in the Netherlands and is going on today in Australia.

Since the 2008 recession the United States has not really enjoyed a boom in any major sector. Thankfully, all major sectors except energy have improved and most are growing, albeit slowly. Given this close look at the life cycle of economic expansions, the logical conclusion is that this recovery could still be a long way from its natural economic end. At the least, we need a real boom in one major sector before the economy becomes vulnerable. Of course the Federal Reserve could kill the recovery. And that is what bothers so many investors. Why is the Federal Reserve so insistent on raising interest rates while inflation is so low? The answer is that the Federal Reserve board members worry far more about high inflation than low. That could make them too hawkish, ready to raise interest rates even if that puts the recovery at risk. The central

bank of Australia has taken a different approach and given itself an inflation floor to defend as well as a ceiling. Australia targets inflation to stay between 2% and 3%.

Perhaps that is the reason Australia's expansion has endured for so long. The concern for the U.S. economy is that our Federal Reserve interest rate hawks might one day discover, after it is too late to adjust the course, that it has raised interest rates once too often.

Governments, including our own, certainly are much to blame for the sluggish recovery from the 2008 recession. However, that should not be a surprise to our Federal Reserve board members. Instead that should be a lesson, that under present government regulation and tax policies, it can be very difficult to recover from a recession. It would be better to leave interest rates low until there are clear signs of an inflation risk, than to raise interest rates and imperil the recovery. However, I will not be shocked if the Federal Reserve raises interest rates again, perhaps this month or next.

If they do, we should expect volatility on stock and bond markets. Investors need to see real data showing the economy gaining strength before they will be confident the Federal Reserve is on the right course. It will be mid-July before we get a first look at second quarter economic performance. It will be good news for the stock market if the second quarter data, as many of the Federal Reserve board members expect, show the economy really gaining strength. The stronger economy would be cause for celebration and a modest interest rate increase would be brushed aside. If second quarter data are disappointing, that would be a problem for the interest rate hawks and grounds for stocks to pause and wait for more data.

Given all the uncertainty about the pace of the economy and future monetary policy, how did stocks survive the recent selling wave?

According to data on insider activity, the buying that has countered the equity mutual fund outflows has come from CEO's and others in management. Their buying says they feel the stock prices for their companies are attractive. They cannot be traders in their company's stock. Once they buy, they are basically stuck, holding for the long term. While we do not have details yet, it seems that the surge of insider buying gave other investors the courage to follow and buy while so many individuals panicked and sold. Investors are divided. Some see a new recession on the horizon, and a continuing decline in corporate profits. Others, including CEO's who have better data on profits and sales, disagree and have been buying. Odds are the CEO's will be proven correct and scores of investors will soon regret their sales.

My conclusion is that stocks are nowhere as vulnerable as the sellers think. Our Federal Reserve has economic growth as its top priority. If they make a mistake, I am confident they will reverse course quickly. This recovery can go on for at least a few more years. Slow growth is positive for corporate profits. Stocks remain our best investment choice.

I will have the next market review and update for you one week from today on Wednesday June 8, 2016.

All the best,

John Dessauer

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