John Dessauer Investments, Inc.

John Dessauer's market review and update as of Wednesday July 19, 2017

Analysts at Bank of America Merrill Lynch are concerned about the developing shift in Federal Reserve and other central bank monetary policies. They believe we are at a "massive inflection point."

"Next 6 months, higher interest rates likely much more negative for stocks & credit given new central bank policies."

"Will likely lead to 'Humpty Dumpty' big fall in market in autumn, in our view."

They are not alone. JP Morgan Chase & Co. Chairman Jamie Dimon speaking in Paris last week said: "We've never had QE like this before, we've never had unwinding like this before. Obviously, that should say something to you about the risk that might mean, because we've never lived with it before. When that happens of size or substance, it could be a little more disruptive than people think. We act like we know exactly how it's going to happen and we don't."

The concern was precipitated by comments from Federal Reserve Chair Janet Yellen. In prepared remarks for Congress she wrote: "The United States economy is healthy enough to absorb gradual rate increases and the slow wind down of the massive bond portfolio accumulated by the Federal Reserve during the financial crisis." As to the timing of the wind down in the bond portfolio, she added that reductions are likely to begin "this year."

The U.S. Federal Reserve has accumulated more than $4 trillion in bonds. The Bank of Japan and the European Central Bank together have another $10 trillion in accumulated bonds. For almost ten years central banks have been massive net buyers of bonds, especially government bonds. Now they are going to reverse course and become net sellers. That is what concerns Jamie Dimon and analysts at Bank of America Merrill Lynch.

Keep in mind that when central banks, led by the U.S. Federal Reserve, began their QE programs, critics warned that they wouldn't work because flooding economies with money would simply lead to high inflation, high interest rates and a deeper recession. The critics weren't just wrong, they were completely wrong. Contrary to popular expectations, inflation did not even come up to central bank hopes. Flooding economies with money did save the day and avoided a long recession or worse.

Are concerns by economic leaders like Jamie Dimon wrong? Probably not, however central bankers are well aware of the risks associated with changing policies. They were very cautious as they expanded their balance sheets. They will be just as cautious unwinding their bond portfolios.

Burkhard Varnholt, deputy chief investment officer at Credit Suisse Group AG got it right when he said: "The risk of near-term bond-market disruption seems limited. Yet, the further out, the future path of yields may be plastered with traps. Expect the Fed to readjust their strategy to every step-and to err on the side of caution, not boldness."

The Federal Reserve and other central banks are not going to do anything that even remotely might be viewed as harmful to economic growth. They have used unprecedented measures to keep their respective economies growing. They have been successful. Economic growth is alive and sustainable. Now it is time for governments to adjust their fiscal policies to assure that growth endures, or better yet, accelerates. Their collective problem is ongoing deficits.

Mick Mulvaney, director of the office of Management and Budget, in his mid-year update to Congress had some bad news. He now sees the deficit for the current fiscal year up 16.4% over the calculation made in May. That is the second increase in the projected annual deficit. Now the total for this fiscal year is $702 billion. The problem is lower than expected tax collections. Individual and corporate tax collections are now expected to be $140 billion less than initially estimated. The Obama administration raised taxes and imposed a special 3.8% tax on capital gains and dividends, but actual tax collections have gone down. This is real-time evidence that raising tax rates does not necessarily mean more tax revenue. People change their money management strategies when taxes and regulations change. The problem is that congressional budget accounting always assumes there will be no change in taxpayer behavior no matter what is done with tax rates.

An annual deficit of $702 billion is not sustainable. The national debt at $20 trillion has doubled in the last eight years. The huge debt imposes very real and scary risks. The U.S. Treasury has to sell $702 billion worth of new debt as well as refinance short term debt that comes due. Until now, selling treasury securities has been easy thanks to the QE program of the Federal Reserve. However, now the Treasury no longer has that big willing buyer and must attract buyers from the private sector. The last thing the Treasury wants is to be forced to increase interest rates to attract buyers. And the U.S. Treasury will be competing with governments in Europe and Japan as they too look for buyers to finance their ongoing deficits. While the Federal Reserve and other central banks intend to keep interest rates low, the market for government securities may have other ideas.

So Jamie Dimon is right. Things are changing and we don't know exactly what will happen. The obvious solution to the government debt challenge is faster economic growth. As we can see in American politics, it is difficult and time consuming to get effective change in government fiscal policies. That doesn't mean the stock market is headed for a Humpty Dumpty fall.

The analysts at Bank of America Merrill Lynch understand that there is a flaw in their prediction. Corporate profit growth has been accelerating. Profits are the underlying support for stocks. With growth accelerating, stocks are not likely to fall off the wall. To counter the current reality, the Bank of America Merrill Lynch analysts predict fundamental change in the underlying economy, namely a slowdown in jobs and wages that would precede a topping out in corporate profits. Autumn is just a few months away, too soon for that sort of fundamental change to develop. Odds are the analysts at Bank of America Merrill Lynch will have to modify their forecast. In a month or so I expect the Humpty Dumpty fall will be moved to spring of 2018.

Stocks remain the best investment.

I will have the next market review and update for you one week from today on Wednesday, July 26, 2017.

All the best,

John Dessauer