John Dessauer Investments, Inc.

www.johndessauerinvestments.com

John Dessauer's market review and update as of Wednesday July 27, 2016

There are two fundamental forces supporting stock prices. One is a positive perception, by analysts and investors, of the future growth of sales and profits for individual companies. The second is attractive income from dividends. The first has always been a major force in driving stock prices. The second has also always been a force, but never as strong as today because of the very low- sometimes negative - interest rates. AT&T, NYSE, T, $43.11 is an example.

Morningstar research recently reviewed AT&T after second quarter earnings were released. Their analysts found AT&T's profit margins and cash flows to be "solid." But they also concluded that AT&T faces headwinds that will likely keep sales and profit growth in the low-single digits for at least the next two years. Using traditional valuation techniques they concluded the stock's current fair value is $33, well below the current market price of $43.11. It is the $1.92 a share dividend that is supporting the higher stock price. At the current price the yield on AT&T is 4.45% - very attractive in this extremely low interest rate environment. The dividend is well covered by earnings of $2.71 a share last year and the expected $2.85 a share this year.

Morningstar's $33 fair value stock prices raises the question, is AT&T a high risk investment? Are investors who buy AT&T at $43.11 at risk of suffering a 23.5% loss? The answer is no, not as long as interest rates remain low. And if it takes as long as now expected for interest rates to rise significantly, sales and profits could grow enough to support the current or even a higher price. Investors buying at today's price could enjoy

the 4.45% annual yield and in a few years have a long term capital gain. It all depends on the future course of interest rates and that, in large part, depends on how the economy behaves. **AT&T** is a single stock, but Morningstar's analysis and the connection with interest rates is a story that applies to the whole stock market. Of course stocks would suffer if there were a sudden upward surge in interest rates, or a sudden downward surge in the economy. Fortunately, there is no evidence of either in current data. On the contrary, data from the US, Europe, China and the emerging markets point to a prolonged period of modest growth and low interest rates. If anything, interest rates are subject to further declines if growth softens for any reason. As Mario Draghi, European Central Bank President, said, there is a "downward tilt" in Europe after Brexit, but nothing that can't be countered by additional stimulus (meaning lower interest rates).

However, there is another, growing threat from Europe's fourth largest economy, Italy. Public debt in Italy has swollen to 135% of GDP. The adult employment rate is lower than in any EU country except Greece. Because of years of economic stagnation, Italy's banks are in deep trouble, with $400 billion worth of bad loans. The immediate worry is the solvency of Monte dei Paschi di Siena, the world's oldest bank. Investors have been fleeing Italian bank shares and bonds for some time. So the only practical way to save Italian banks is an injection of government money, which is politically impossible under present EU rules and regulations. EU rules require a "bail in" for troubled banks before taxpayer money can be used. In other words, holders of bank bonds have to suffer losses first. That makes sense in countries where institutions are the major holders of bank bonds, but not in Italy. Years ago, to solve an earlier bank crisis, Italy adopted a tax provision making it very attractive for individual investors to buy and hold bank bonds.

That tactic worked - individuals bought more than $200 billion worth of bank bonds. Retail investors provided banks with desperately need new capital. That capital has now been squandered on loans that have soured. Applying the “bail-in” rule in Italy would mean a political outcry as intense as the UK’s Brexit. Italians would rather leave the EU than suffer personal, catastrophic financial losses. Last November, one individual bank bond holder committed suicide because of losses when one small bank was “bailed-in.” That caused a political storm in Italy. As editors of *The Economist* magazine say, “If Italians were ever to lose faith in the euro, the single currency would not survive.”

EU leaders in Brussels are under attack not just from the UK, but Italy as well. What both have in common are good reasons to demand serious, broad-based reform of EU rules and regulations. In addition, the terrorist attacks, like that in Nice on Bastille Day, are weakening even the most liberal opinions on refugee immigration. Odds are that there will eventually be real, broad-based reform in the EU. Meanwhile, the euro will be under pressure and the US dollar will remain a safe haven. Generally that is positive for the US financial markets and it is another concern for Federal Reserve board members when it comes to raising interest rates. They do not want to see the dollar become too strong and threaten US economic growth.

There is good news on the US economy. But as has often been the case during this recovery, the news is mixed.

The Atlanta Federal Reserve Bank’s GDPNow model, updated on July 19, indicates personal consumption expenditures will expand in the second quarter by an annualized quarter-over-quarter rate of 4.5%. That is a pace not seen since the first quarter of 2006. However reports on factory activity and inventories suggest that

consumers were reducing commercial inventories, rather than encouraging factories to ramp up production. Never-the-less, when the BEA (Bureau of Economic Analysis) releases official figures, it is expected the US economy grew at a 2.6% annual rate in the second quarter. That is a significant improvement over the 1.1% first quarter pace, but not so strong as to trigger an immediate interest rate hike.

Stocks remain an investor's best friend.

I will have the next market review and update for you one week from today on Wednesday August 3, 2016.

All the best,

John Dessauer

©July 2016