John Dessauer Investments, Inc.

John Dessauer's market review and update as of Wednesday August 9, 2017

Former chairman of the Federal Reserve, Alan Greenspan is at it again. Once again he is warning of a coming stock market crash. The last time he did this he was several years too early, and stocks doubled after his gloom and doom warning. This time he is talking about bonds rather than stocks. But he believes that when the bond market bubble bursts, it will take stocks down as well.

"By any measure, real long term rates are much too low and therefore unsustainable. When they move higher they are likely to move reasonably fast. We are experiencing a bubble, not in stock prices but in bond process. This is not discounted in the marketplace."

Greenspan is not alone. Jamie Dimon, CEO of JP Morgan Chase, and Bill Gross of Janus Funds are also worried about the end of central bank bond buying and rising short term interest rates. Where Greenspan stands out is his expectation that when interest rates rise, they will rise fast. He knows central banks will move very cautiously raising short term interest rates. They will not raise interest rates quickly. How could interest rates rise "reasonably fast?" There are two possibilities. One would be a sudden reversal in the inflation trend. If inflation suddenly turned significantly higher, interest rates would follow. The problem with this possibility is that underlying economic growth is still quite low and inflation has been stuck at a low level for years. The Federal Reserve and other central banks would like to see inflation modestly higher. Furthermore, their collective hoard of bonds acts as a powerful anti-inflation weapon. They could shrink

their respective money supplies quickly if inflation started to rise higher than they would like. Greenspan knows that. So he must be worried about the bond market. Interest rates would rise quickly if there were a bond market panic and a tsunami of selling by investors.

However, in the current slow growth, low inflation environment interest rates are most likely going to stay low. Odds are that once again Greenspan is early with his warning.

The Associated Press published an article last week with this headline: "July Worst Month of Year for Auto Sales." According to Autodata Corp., sales of new cars and trucks in the U.S. fell 7% to 1.4 million in July. It was the seventh straight month of lower sales and the biggest percentage drop this year. Sinking car and truck sales point to continued economic challenges with consequently continued low inflation.

The question is why are car and truck sales shrinking? With interest rates still low, financing a car or truck is affordable. Gas is cheap. Bloomberg analyst Kevin Tynan says the only wild card when it comes to sales of cars and trucks is the replacement rate. How many units head for the junkyard each year? He added that for two decades 13 million units were scrapped each year. But that was less than the number of new vehicles being manufactured and sold. In addition, manufacturers have been improving the quality of their vehicles. A car or truck bought recently will last much longer than those made ten years ago. The logical conclusion is that the auto industry is suffering because of its past sales successes and its ability to deliver a much improved product.

I would add that an aging population doesn't help. Older people tend to keep their cars much longer than younger folks. The bottom line is that shrinking sales means that

car makers have not found the equilibrium point. Sales will keep shrinking until the right replacement rate is found. Auto makers used to be a major contributor to overall economic growth. With shrinking sales and job cuts they are now an economic burden. It likely will be several years before they are able to add to overall economic growth. This is another reason to expect continued slow U.S. economic growth.

Investors have kept an eye on China's economy for years. In the 1990s, China seemed irrelevant when it came to the U.S. economy and stock market. I remember giving talks and slide shows in an effort to raise investor awareness of China. Today market pundits and investors are well aware of China's importance to the global economy and stock market performance. China accounts for about 15% of the global economy, but it also accounts for one-third of global economic growth – more than the US, Japan and Europe combined. If China's economy stalls the rest of the world would suffer. Every so often pessimists succeed in scaring investors with claims the Chinese economy is stalling, and stocks take a dip. The classic argument is that China can't rebalance its economy away from exports to consumption.

Andy Rothman, investment strategist for Matthews Asia doesn't buy the negative hype about China. "I'm not dismissing the problems, but I'm skeptical of the doom-and-gloom scenarios."

"Income growth is strong, household savings rates are high, household debt is low and, as a result, consumer spending and consumer sentiment are very good."

Andy adds that the rebalancing is well underway. "Last year two-thirds of economic growth came from consumption. In fact, the consumer services part of GDP is the biggest part and has been the biggest part for six years." The pessimists are out of

touch with the reality. China is well along the transition from export dependence to domestic consumption.

What about all the headlines about empty apartment and office buildings? “As for ghost cities, I’ve been visiting them for a decade now. When I was living in China, every time one was mentioned in the newspaper, I’d check it out. I found that if you go back to these places a couple of years after the headlines, they’re no longer ghostly. They’re all filled.”

Andy Rothman has another very interesting observation about China’s economic progress. “When I started working in China in the 1980s, there were no privately-owned companies there. Now more than 80% of workers in China work in small, entrepreneurial private companies, and these businesses are driving growth.”

In response to the global financial crisis of 2008-2009 China ramped up infrastructure spending on roads, bridges, power plants, water systems and other projects to provide jobs and a long term benefit to the economy. That is why China’s government debt to GDP ratio has risen. Andy Rothman adds: “That’s the origin of the dramatic increase in Chinese debt and, because the state directs state banks to lend to state companies, there’s no private participation here. There’s no equivalent of a Lehman Brothers or Bear Sterns. Therefore, there’s no mark-to-market pressure.

Even so this is a problem and it will be expensive to clean up, but the Chinese government has the luxury that we didn’t have here in the US of being able to control when that problem gets cleaned up. ….so the government can say it will clean up 5% of it this year and 10% of it next year. That’s what they’re starting to do”

The bottom line is that the China pessimists are wrong again. China will be a source of economic growth for a long time to come.

Stock prices may flutter, after all it is August, but the long term story of global growth is intact.

I will have the next market review and update for you one week from today on Wednesday, August 16, 2017.

All the best,

John Dessauer

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