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John Dessauer's market review and update as of Wednesday August 10, 2016

Following its chief economist's advice to use "a sledgehammer to crack a nut" the Bank of England cut interest rates and introduced a 60 billion pound government bond buying program.

The idea behind launching a massive stimulus is to prevent - or at least moderate - an expected 2017 post-Brexit slump in the British economy. While generally welcomed, there are critics. Bill Michael, global head of financial services at KPMG, had this to say: "Today's decision will test the limits of monetary policy which many would argue ran out of runway some time ago." Michael's critique mirrors similar pessimism in the US. Following news of a very sluggish first half of 2016, pessimists argued the slump proved the Federal Reserve's monetary policy had exhausted its effectiveness. Some go further and claim the US is headed for a recession and the Federal Reserve is powerless to prevent the decline.

However, the US Labor Department had some bad news for the pessimists. In July the US added 255,000 jobs and the number for June was revised upwards to 292,000. The surge in job creation means that the US economy is growing, not sliding towards recession.

Michelle Meyer, a senior economist at Bank of America Merrill Lynch in New York had this to say: "The July jobs report was everything you could have asked for and more. Provided the strength in jobs is confirmed with other economic data, the Fed will have sufficient reason to hike (interest rates) this year."

Will the jobs strength be confirmed by other data? Economists at the Atlanta Federal Reserve bank certainly think so. They are forecasting third quarter growth at an annualized 3.8% rate. However, as has been the case so often during this long slow recovery, there are reasons to be cautious. The surge in job creation in June and July did not change the unemployment rate. It stayed at 4.9% because so many Americans returned to the workforce. And a broad measure of unemployment that includes people who want to work but have given up searching and those working part-time because they cannot find full-time employment, rose one tenth of a percent to 9.7 last month.

The stronger than expected June jobs report was not enough to boost overall second quarter growth. Growth last quarter came in well below expectations, at a 1.2% annual rate. But, three or four consecutive monthly jobs gains in the 250,000 range might boost growth above 2% or even to the Atlanta Fed's 3.8% forecast, especially if the gain in jobs is accompanied by an up-tick in wage growth. Wages rose 0.3% last month bringing the year-over-year growth to 2.6%, a solid non-inflationary improvement.

At this point my conclusion in last week's Market Review looks better. The US economy is not heading for a recession. While I think it is too soon to embrace the Atlanta Fed's optimism, the odds on third quarter growth of 2% or better have improved.

A stronger US economy would be very good news for corporate profits and US stocks. It would also demonstrate the effectiveness of monetary policy, and provide a basis for confidence in the Bank of England's sledgehammer. A strengthening economy could be contagious, spreading confidence to consumers, bankers and investors in the UK and elsewhere. Confidence is an essential building block for every economy.

Stocks are up. Both the Dow Jones Industrial Average and the Standard & Poor's 500 have ticked up to new highs. Are stocks fully valued? Have they now discounted any future improvement in economic growth?

Bond guru Bill Gross, of Janus Funds, says he doesn't like bonds and he also doesn't like most stocks. When it comes to stocks he has a lot of company. Investors have been taking money out of US equity mutual funds and exchange-traded funds in record amounts. Outflows over the last eighteen months have now exceeded the cumulative outflows from 2008-2012. It is remarkable that stocks have done so well in the face of so much selling. It is also encouraging that there are so many pessimistic investors. In Morgan Stanley's words: "To say that this is the most unloved bull market ever would not be a stretch, and this is not how bull markets usually end."

The widespread, gloomy investor sentiment is understandable. Earnings for the S&P 500 companies have been in a decline since 2014. There are exceptions. Some companies have been able to grow sales and earnings during this slow recovery. But overall price/earnings multiples are now high by historical measures. High price/earnings multiples can be scary, especially if you agree with the pessimists that the outlook is still for a decline in profits. If there is one thing that drives stocks more than anything else, it is profits.

In the August issue of *Argus Update* Jim Kelleher, director of research, explains why he sees S&P 500 profits growing at a high single-digit rate this quarter, a low double-digit rate next quarter, and continued strength in 2017. In other words, Argus thinks the long decline in S&P profits is over and that starting this quarter we will see profits growth accelerating. His optimism is based on more stable commodity & energy markets and signs that the US industrial economy is awakening. He concludes that high-quality US equities will deliver average to above average total returns in the coming year.

The outlook for both US economic growth and US corporate profit growth is improving.

However, we won't get official growth numbers for this quarter until October. Until then, the debate between optimists and pessimists will continue. Investors will keep worrying about a recession, rising interest rates and declining corporate profits. Others will cheer monthly numbers on jobs and consumer spending.

With so much to worry about, investors are unlikely to suddenly rush back into stocks. That is a major plus for stocks. The last thing we want is to have stocks prematurely surge to higher levels. It is far better for stocks to respond to sales and earnings growth. If Argus is right and profits are growing again, stocks will keep climbing the wall of worry.

I will have the next market review and update for you one week from today on Wednesday August 17, 2016.

All the best,

John Dessauer