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John Dessauer's market review and update as of Wednesday September 2, 2015

The U.S. Stock Market is in uncharted waters, but that is good news.

The Dow Jones Industrial Average plunged, falling more than 3% on two consecutive days. That hasn't happened very often, but every time in the past the Dow bounced back on day three. Not this time. The Dow fell again on the third day following the two 3+% declines. This new behavior should not be a surprise. The U.S. stock market plowed new ground before the recent plunge. The last 10% correction was in 2011, four years ago. Corrections of that magnitude are supposed to come along more frequently. The four year stock market calm was unprecedented. This new behavior pattern provides fuel for both pessimists and optimists. Pessimists see the three day plunge after the four year calm as a sign of technical stock market deterioration. They believe stocks are headed a lot lower. Optimists look at the improving U.S. economic data and believe the stock market plunge has wrung out any excesses. They see stocks recovering and moving on to new long term highs.

A close look at individual investor behavior tends to support the optimists. Retail or individual investors hold 89% of mutual fund assets. In July there were huge withdrawals from both stock and bond mutual funds. That is the first time that has happened since the last quarter of 2008. Credit Suisse estimates $6.5 billion left equity funds in July as $8.4 billion was pulled from bond funds. Those outflows were followed up in the first three weeks of August, when investors withdrew $1.6 billion from stocks and $8.1 billion from bonds. According to Morningstar's data, individual investors always sell when they should buy and vice versa. That was certainly true in 2008 and most likely will be the case again this time. The smart strategy was to buy stocks in the wake of the great recession. At least in 2008 the sellers had good reasons to be frightened. This time the panicky selling seems out of touch with the economic reality. In 2008 the U.S. economy was in danger of falling into the next great depression. The opposite is the case today. The BEA (Bureau of Economic Analysis) just issued a revision of second quarter growth. The BEA now says the U.S. economy grew at a 3.7% annual rate, a huge change from the month earlier estimate of a 2.3% annual rate of growth. Not only is the U.S. economy not heading for a depression, the recovery is gaining strength. The added second quarter strength came from consumer spending and housing. Wages finally started to show meaningful gains in July. That could mean sustained growth in consumer spending.

The dollar has peaked and is no longer gaining strength. That will take the pressure off U.S. exporters and improve foreign generated corporate profits when expressed in terms of dollars. These are reasons to be optimistic about the future for stocks. And, there is more.

One year ago the price for a barrel of oil was $100. It is now $40-$50, a huge change. The immediate impact from a falling oil price has been negative. Jobs in oil related activity have been lost. Capital investment in energy exploration and production has declined. However, in the longer term the benefits from low cost energy are enormous. The data on consumer price inflation is an early signal of what lies ahead.

Inflation is down and staying low. One major reason is the decline in energy costs. Low inflation is a major plus for consumers and businesses.

When inflation soared in the 1970s, after oil prices rose, consumers suffered, stocks fell, bonds plunged and savers were punished. It is far better to have oil prices down and inflation low.

It takes time for the full benefits from low cost energy to develop. Businesses that use a lot of energy, such as airlines, use futures contracts to smooth out their energy costs. When oil suddenly falls sharply airlines are stuck with their futures contracts. They do not feel the benefits from low oil until the futures contracts expire. New energy intense businesses do not just spring up. Investors have to be sure the oil price decline is real and not going to reverse as suddenly as it came down. Now that we know there will be plenty of oil for a very long time, investment in energy intense businesses is starting to increase. Over the coming twelve months the negatives from the oil price plunge will fade and the benefits will emerge. All energy consuming economies will benefit. Today's concern about slowing global growth will prove to be an error.

Another plus for the economy and the stock market is an accommodative Federal Reserve. The Federal Reserve has not raised interest rates since 2006. That is a long time, too long for some Federal Reserve board members and Federal Reserve bank presidents. That is why there is growing pressure to "normalize" short term interest rates. However, even those most in favor of raising interest rates in September are concerned about the financial market volatility, especially the wild stock market. The Federal Reserve will not raise interest rates until stock and bond markets calm down. And, when the time comes the Federal Reserve will raise rates gradually. The Federal Reserve is not a threat to the stock market.

The Chinese stock market finally had a good day last Thursday. Chinese stocks soared after the government added yuan the equivalent of $9.3 billion to Chinese money market funds. News of the added liquidity encouraged stock buyers. As one economist explained China is in a “tricky” difficult phase, shifting from export dependence to domestic consumption. Others have been through similar transitions, successfully. Made in Japan was the trade challenge in the decades after World War Two. And, Japan was a far more aggressive currency manipulator than China has ever been. The Japanese yen was held at more than 300 to the dollar for more than twenty years, long after that could be justified economically. The yen manipulation was not broken until the 1980s. South Korea is another economic story of a successful transition from exports to domestic consumption. Morgan Stanley makes a strong case that China is in a position similar to Japan and South Korea as they shifted from exports to domestic consumption. China’s record of economic accomplishments is far better than either Japan or South Korea. Hundreds of millions Chinese have been lifted out of extreme poverty to a middle class living. That is many times the populations of Japan and South Korea. China bashing is popular among American politicians. Japan especially, but South Korea too, was the object of American political anger as they shifted economic focus. At one point Japan was forced to shift automobile production to the United States. China will fare better because China is already the fastest growing market for American exports. Economic reality will trump political populism.

Growth is seldom evenly distributed among the members of the global economy. Disasters, like the 2008 recession are able to affect many economies simultaneously. Growth is more of a challenge. Oil dependent economies, such as Brazil, are now suffering, while oil consuming economies are benefiting. The rate of growth in the global economy is a blend. At the moment the negatives from the oil price decline are impairing the global growth rate. That is beginning to change. In coming quarters the estimates of global growth are likely to be raised as the benefits from lower cost energy improve growth rates in oil consuming economies.

Look for the Dow Jones Industrial Average to regain the 17,000 level soon and 18,000 before year end.

I will have the next market review and update for you one week from today on Wednesday September 9, 2015.

All the best,

John Dessauer