

John Dessauer Investments, Inc.

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John Dessauer's market review and update as of Wednesday September 9, 2015

China's stock market and China's economy often go their separate ways.

The Chinese stock market freefall does not mean the Chinese economy is headed for a hard landing. Plus: The core U.S. jobs problem is that small businesses are closing faster than they are being created.

Last Friday morning on CNN Money.com the headline was: "U.S. Unemployment lowest in seven years." On that news the Dow Jones Industrial Average went down more two hundred points. Clearly, investors were not impressed with the low 5.1% unemployment rate. Perhaps the better description of investor behavior is that they were not fooled by the government's unemployment rate calculation. The White House likes to brag about the low unemployment rate. The problem is the rate is down for the wrong reasons. The U.S. is not creating millions of full-time, high paying jobs. The primary reason the unemployment rate is so low is that so many have become so discouraged that they have left the workforce, having given up looking for work.

Unimpressed by the unemployment rate, investors focused on the number of new jobs created in August and were disappointed. In July the U.S. added 245,000 new nonfarm jobs. In August the number fell to 173,000, well below the expected 220,000. Wages were up a bit in August, but still only 2% higher than a year ago. The August employment data indicate the U.S. labor market is still struggling. A recent report on small business creation and failure explains why.

Small businesses create the most new jobs and employ about half of the private workforce. They are the launch pads for innovation and opportunity. The recession of 2008 and the wave of new regulations that followed have taken a toll on small businesses. They have been slow to recover and for the first time since records have been kept (more than three decades), the Census Bureau reports that small business “deaths” now exceed small business “births”. To be sure there are success stories, such as Uber, but for most, the hurdles from taxation, new regulations and scarce financing are insurmountable. Wendy Guillies, president of the Kauffman Foundation, reported earlier this year that more than half of young companies that applied for credit were turned down.

Yes, banks took on too much risk in the years leading up to the recession of 2008. And, an opposite reaction was to be expected. But, have we gone too far and overregulated the banks? Small business owners certainly think so. And there has been an interesting sidebar on bank regulation. Remember that dismal day in August when the Dow Jones Industrial Average suddenly plunged 600 points, and several leading stocks fell more than 20% in seconds after the market open? It turns out that because of Dodd Frank the major banks were on the sidelines. Before Dodd Frank, the major banks would have been participants as traders during times of market volatility. Without the banks, traders say as the Dow plunged, liquidity quickly dried up, making the situation worse.

There is more to the story of small business than jobs. Small business creation is a powerful factor in reducing the wealth gap. International studies of wealth gaps found that countries where it was easy to start and maintain a small business had the smallest

wealth gaps. Americans are very concerned about the number and quality of jobs and our growing wealth gap. The solution is obvious, if difficult to accomplish. The solution is to make it easy to create small businesses and then provide an environment where they can prosper and grow. This will require tax reform, regulation reform, health care reform and increased access to financing. Unfortunately, we first will need political reform - a major change in priorities in Washington.

Small business owners are clear about what they want from Washington. Last month the National Small Business Association conducted a survey asking small business owners to rank their priorities for the administration and Congress. The top responses were to simplify and cut taxes, reduce the national deficit, and end the partisan gridlock. According to Thomas F. McLarty, former White House chief of staff under President Bill Clinton, the message from small business to the political leadership is: “Lead, or get out of the way.”

Meanwhile, it is safe to assume the U.S. labor market will continue to struggle, and good paying and full time jobs will be in short supply. There will be pockets of opportunity, but outside of the pockets it will remain hard to find a good full-time job until there is major change in Washington.

Stocks are a leading indicator in the United States. That is not the case in China. First, Chinese stocks doubled while the economy slowed. Then Chinese stocks went into freefall while the economy kept growing at a pace far better than those of Europe or the United States. The bottom line: Don't connect China's stock market with China's economy.

When China's economy was growing at double digit rates, there were years when the stock market was stuck in neutral. In those times no one saw the lackluster stock market as an indication of slower growth ahead. The economy boomed and stocks hardly budged. Now that China's stock market has grown and become popular with individual investors, the gloom and doom crowd leaps to the conclusion that the Chinese stock market crowd, all of a sudden, has been transformed into a group of seers with economic foresight. China's economy is in a difficult transition, growth has slowed, but at the current 7% annual rate China is still an economic powerhouse.

"I think the market reaction globally is overdone," said Mark Schwartz, who is chairman of Goldman Sachs in Asia-Pacific. "I think China is going through a very normal transition, from a state-controlled, state-dominated system, to a more market-oriented system."

Schwartz told CNN the world must be patient. He expects it will take at least a decade, and maybe as many as 20 years, for Beijing to complete the reforms. "I think China is committed to reform as long as growth doesn't fall below 5% or 6%, and I think China is committed to reform as long as it can continue to create employment for 8 million to 12 million new entrants into the labor market each year," he said.

Economists and market pundits get excited when the U.S. creates more than 200,000 new jobs a month. China has been creating 800,000 to 1,000,000 new jobs a month for decades. I am always amazed that so many Americans will buy into the China bashers' rhetoric without any perspective. China is a powerful economic story. Hundreds of millions of Chinese have been lifted out of abject poverty to a middle class standard of

living. In sharp contrast, the United States has seen the number of Americans living below our poverty level increase in recent years.

Major economic transitions not only take time - they are seldom smooth. China has run into a soft spot, but the People's Bank of China has already cut interest rates, and lowered the amount of cash banks are required to keep on hand, in a bid to support growth. The central bank has also allowed the biggest devaluation of the yuan in decades, which should provide a boost to exporters. Beijing has the ability to roll out even more stimulus, if required.

Mark Schwartz: "I believe China has got plenty of financial firepower, plenty of financial flexibility and plenty of policy levers that it can pull. I still believe China has lots of options in which to stabilize the economy. I don't think there is a hard landing scenario that is really going to play out."

Goldman Sachs estimates the Chinese economy will grow 6.8% this year. That is modestly below the official government goal of a 7% annual rate, but hardly a reason for investor panic.

I will have the next market review and update for you one week from today on Wednesday September 16, 2015.

All the best,

John Dessauer

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