John Dessauer Investments, Inc.

www.johndessauerinvestments.com

John Dessauer's market review and update as of Wednesday September 21, 2016

With national elections just a few weeks away, pundits are busy looking at how stocks behave under different presidents. But they are missing the mark. It is far better to look at the Congress as well as the White House. Argus research has done just that and the results are in line with what you would expect. Republicans are more business and stock market friendly than Democrats. However, the differences are not great and Argus concludes that Washington politics is not a primary driver of stock market performance. Here is the Argus research and conclusion:

"First, the Democrats. Since 1945, and excluding dividends, the S&P 500 has averaged gains of 9.5% when Democrats controlled Presidency, House, and Senate; 6.1% when Democrats controlled two of the three; and 7.7% when Democrats controlled Presidency, House, and Senate or two of the three. Since 1945, and excluding dividends, the S&P 500 has averaged gains of 13.0% when Republicans controlled Presidency, House, and Senate; 8.4% when Republicans controlled two of the three; and 9.2% when Republicans controlled Presidency, House, and Senate or two of the three. The division between the two parties on presidential leadership since 1945 is remarkably even as measured in years, but not in stock performance.

The perception that the market does better when Democrats are in charge likely stems from a focus on the Presidency — and here, the perception is correct. For the 71

years between 1945 and 2015, Democrats have held the White House for 35 years (and 2016 marks the 36th year). For those years since 1945 in which Democrats have held the White House, the S&P 500 has averaged appreciation of 10.2%, excluding dividends. For the 71 years between 1945 and 2015, Republicans have held the White House for 36 years. For those years, the S&P 500 has averaged appreciation of 6.2%, excluding dividends. End of day, Washington likely ranks fairly low on the list of market drivers."

The odds on an interest rate increase at this month's Federal Reserve Board meeting have gone down. The economic data remain mixed. However, economists still expect the economy to gain momentum in coming months. Their expectations are based on modeling and theory. Arguably, Chief Executive Officers (CEOs) are in a better position to assess the underlying strengths and weaknesses of the economy. The Business Roundtable surveys CEOs every quarter. Contrary to the economists, CEOs see the U.S. economy stuck in slow-growth mode. In addition they have little optimism that the November elections will change the outlook.

The Federal Reserve Board members have been relying on a strong labor market to underpin their optimistic expectations. The third quarter survey of CEOs indicates that labor market conditions might weaken slightly in coming months. In the third quarter survey, 27% of CEOs said their firms plan to add to U.S. payrolls in the next six months. That is down from 29% in the second quarter survey. Firms expecting to reduce employment rose from 35% to 36%. The changes from the second to third quarter are not dramatic. They do not point to a major slow down or recession. But they also do not support expectations that the labor market will continue to gain strength.

The outlook for business investment remained unchanged from the second to the third quarter, with 38% of CEOs expecting their firms to boost investment spending in the next six months. That is a low number. Investment is critical for long term economic growth. With less than 40% of businesses expecting to increase investment, it is difficult to be very optimistic about the economy gaining momentum.

There was a bit of optimism in the survey. The CEOs expect the economy to grow at a 2.2% annual rate for all of 2016. That is up from 2.1% in the second quarter survey. But, a 2.2% rate is just the average during the now seven-year-old economic recovery.

Doug Oberhelm, CEO of Caterpillar, is the current chairman of the Business Roundtable. Here is his take on the third quarter survey of CEOs: “This reflects the unfortunate new normal. The U.S. economy is pretty much stuck in neutral.”

Economic data coming from government agencies confirms Doug Oberhelm’s conclusion. For example, U.S. retail sales fell more than expected in August amid weak purchases of automobiles and a range of other goods. Optimists also took a hit from other data showing a drop in manufacturing output last month. American manufacturers are still struggling with the after-effects of a strong dollar and the collapse in oil prices. Speaking of the dollar, the currency market is the Federal Reserve’s greatest concern. Raising interest rates risks a stronger dollar that cuts American exports and makes imports cheaper for American consumers. The fact that manufacturers are still struggling to regain markets after the last, rather modest, rise in the dollar highlights that risk.

Currency markets are all about interest rate differentials. Interest rates are extremely low, and in some cases, even negative in Europe and Japan. By comparison U.S. securities already look far more attractive. A further increase in U.S. short term interest rates risks sparking a sharp increase in foreign buying of U.S. securities.

Net capital inflows remained quite strong in July, $140.6 billion. And that includes a net outflow of $22 billion by China. China has been reducing foreign reserves to support the yuan. If the yuan stabilizes China will no longer have to liquidate U.S. dollar and other holdings. That, by itself, would strengthen capital inflows and put upward pressure on the dollar. You can be sure the Federal Reserve Board members are watching capital inflows closely. They do not want to suffer the embarrassment of having to reverse course and cut interest rates after an ill-timed interest rate increase.

Meanwhile there are early indications that third quarter earnings will beat expectations. Intel, for example, has raised the outlook for sales and profit margins, citing better than expected sales of PCs and the adoption of new technologies such as the Thunderbolt port. Stocks remain our best investment choice.

I will have the next market review and update for you one week from today on Wednesday September 28, 2016.

All the best,

John Dessauer

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