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John Dessauer's market review and update as of Wednesday September 30, 2015

As I watched the major stock market indices fall day after day, I thought of the late Yogi Berra's famous saying, "Its déjà vu all over again." Apparently, investors learned nothing from their mistakes selling stocks in early 2009. They are "doing it all over again." And they will soon have the same regrets.

According to research from Bank of America Merrill Lynch and EPFR Global, investors piled into cash-equivalent, money-market funds over the last week, making the asset class more popular than bond and equity funds for the first time in 25 years. In the week ended last Wednesday, $17 billion was added to money market funds. The cash came out of stock-oriented ETFs, mutual funds and corporate bond funds. Cash, as an asset class, is outperforming (in terms of cash inflows) both stocks and bonds for the first time since 1990.

In late 2008 and early 2009 individual investors had a good reason to be afraid. The U.S. and global economies were in serious trouble. Fear of a coming economic depression was not unrealistic. Were it not for former Federal Reserve chair Bernanke and his unprecedented quantitative easing, the U.S. could still be stuck in a nasty recession. Fortunately that is not the case. Instead of a depression we have enjoyed a slow but persistent recovery. Yes, the Chinese economy is slowing. The official government target is for an annual growth rate of 7%. And, yes, that may be too optimistic. The real annual growth rate may slow to 5%. But, as Argus Research says: "U.S. exports to China

account for less than 1% of U.S. GDP," not enough to warrant the full blown panic by individual investors.

Daniel Lockhart, president of the Atlanta Federal Reserve Bank says: "China is slowing to still a very respectable pace of growth. It is ratcheting down a little bit, but there is a decent chance that the world is overreacting."

Here at home the Commerce Department revised the second quarter U.S. GDP growth rate up to a 3.9% annual rate instead of the 3.7% reported a month ago. The upward revision was supported by better than originally thought consumer spending and a reduction in business inventory estimates. Consumers account for more than 70% of the U.S. GDP. The increase in consumer spending therefore is very good news. The smaller inventory calculation is consistent with increased consumer spending because it shows that inventory was not staying on business shelves - it was being purchased by consumers.

For this quarter the Atlanta Federal Reserve's estimate for growth is a 1.4% annual rate. The reason for the expected slowing is the decrease in August sales of existing homes. The National Association of Realtors said existing home sales slowed to an annual pace of 5.31 million units in August - well short of the 5.51 million economists expected. However the third quarter 1.4% growth estimate is subject to change, and may have to be revised upwards. One reason is that new home sales rose more quickly than expected in August and the July figure was revised upwards. The housing recovery may be stronger than expected by the Atlanta Federal Reserve. New home sales rose 5.7% in August to 552,000 units.

The U.S. housing market is in transition. Investor buying for quick profits is drying up as home prices rise. Traditional buying for a home to live in is on the rise. During the transition there are bound to be month-to-month ups and downs. Economists - even at the Atlanta Federal Reserve - should not put too much emphasis on one month's data.

Even if the Atlanta Federal Reserve is right, and the U.S. economy slowed to an annual rate of 1.4% in the third quarter, that is not a good reason to sell stocks. Consumers are beneficiaries of lower cost energy and commodity prices. It takes time for that to be seen in quarterly rates of growth, especially in today's uneven economy. But it is highly likely that the U.S. recovery has gained some momentum and that an annual rate of growth between 2% and 3% is becoming sustainable.

The other reason being given for the selling of stocks is fear that corporate profits will be down in the third quarter and down again in the fourth. However, exclude energy-related stocks and the opposite is more likely. The rate of growth has slowed, but businesses are still able to keep profits growing.

Reuters ran an article last week with this headline: "Wall Street is bracing for a Grim Earnings Season." Starting Thursday October first, third quarter earnings season will begin. Analysts have been busying downgrading their estimates. Their collective earnings estimates now call for a 3.9% decline from a year ago in profits for the companies in the S&P 500 Index. To give them credit, analysts have been following corporate managements, who have been lowering third quarter expectations.

However, Michael Arone, Chief Investment Strategist for State Street Global Advisors, says expectations probably are now too low: “Earnings have consistently been one of these things where it’s natural for folks to under-promise and over-deliver. We’ve seen that time and time again. Both in the first quarter and the second quarter, the actual results were dramatically better than the expectations heading into that quarter and that’s also what I am expecting now.”

There is support for his optimism. The Commerce Department’s upgrading of second quarter growth added: “After-tax corporate profits were also stronger in the second quarter than previously thought. Profits after tax with inventory valuation and capital consumption adjustments showed a 2.6% rebound from a slump in late 2014 and early 2015, instead of the 1.3% increase reported last month.” This report covers profits for all U.S. companies, private as well as public, and it includes companies in the energy sector. There will be one more revision, and given the upward bias seen so far, the next revision is also likely to be up. A doubling in the rate of growth of this very broad measure of U.S. corporate profits is significant. It indicates that profits overall are likely growing faster than expected.

In addition, it is important to keep in mind that while analysts expect overall S&P 500 company profits to decline, excluding energy, they expect profits to be up 3.7% from a year ago. Given the natural bias to under-promise, over the coming month or two we may be pleasantly surprised as actual third quarter profits are reported. Nike has already reported third quarter results that were significantly better than expected.

The bottom line is that today's stock sellers are likely to suffer regrets much sooner than those who sold in 2008 and 2009. Cash, even with a 0.25% interest rate hike, will not look so good a few months from now.

I will have the next market review and update for you one week from today on Wednesday October 7, 2015.

All the best,

John Dessauer

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