John Dessauer Investments, Inc.

www.johndessauerinvestments.com

John Dessauer's market review and update as of Wednesday October 26, 2016

When is a bubble, not a bubble? The answer is: when the real estate is in China.

On October 19, third quarter data confirmed that economic growth in China has stabilized at a 6.7% annual rate. While that is down from the double digit growth rates of the past, it puts to shame growth rates in much smaller European economies, and is a rate that Americans can only dream about. However, there is a dark side. When furniture and other furnishings are included, housing accounts for about 25% of China's GDP. House prices have climbed 16% in the past year. In the big cities, house prices have climbed 30%, and in some cases as much as 90%. Recent surveys found that 20% of the buyers are investors rather than owner-occupiers, and in major metropolitan areas this rises to 60% of buyers. Pessimists trot out photographs of tall apartment buildings standing empty in rural cities. Liu Zhendong, a real estate salesman in a town near Shanghai says: "It feels a bit like a bubble." China bashers argue that it is a bubble of huge proportions, ready to bring the entire Chinese economy down. This real-estate focused pessimism is not new. Investors, analysts and even the press have been predicting Chinese real-estate Armageddon for decades. In the 1990s when the tall buildings in Pudong, near Shanghai, stood empty, the China bashers were positive the entire Chinese economy was about to collapse. They were wrong then and they are wrong today.

Chinese household balance sheets are in good condition even after the recent surge in mortgage lending. One reason is the strict down-payment rules. Chinese buyers typically put up cash for as much as half the purchase price. If house prices fall, these owners have so much equity that they are not going to walk away as so many Americans did after the 2008 financial crisis. Thanks to the large cash down-payments, China's housing market is nowhere near as vulnerable to a downturn as the pessimists would have you believe.

The other reason the pessimists are wrong about Chinese real-estate is the country's communist background. Before Deng Xiaoping opened the Chinese economy to capitalism, the government owned everything, including 100% of the real-estate. Over the last few decades the government has sold off some of the real-estate, but stills owns most of the land. Larry Hu - head of Macquarie Group China Economics - argues that "bubble" may be a misdiagnosis. The real pathology he says is a severe imbalance in land supply. Smaller cities have plenty of land for building, but shrinking populations. Big cities, where people actually want to live and work, are sitting on large land banks, but releasing only small plots. Shanghai, for example, has about 1,800 square kilometers of farm land, but sold only 5 square kilometers for home building last year. The predictable result is soaring home prices in the big cites. Why don't the big cities sell more land? There are two reasons. First, the big cities rely on the money from incremental land sales. Second, in small cities, the governments hope sky-high home prices in big cities will discourage the flight and stabilize their populations. In other words, the land supply imbalance is a political issue as much as an economic one.

The bottom line is that China is likely to continue baffling the pessimists and keep growing at a very respectable 6.7% annual rate for at least the next few years. Pessimists who use China's real-estate issue as a basis for predicting the next global recession will have to come up with a new plan or come up wrong again.

It is still early, but indications are that third quarter earnings for the S&P 500 companies will show a return to growth, an end to the earnings recession.

As I write, only 52 out of the 500 companies in the S&P index have actually reported third quarter earnings. But based on those actual results, and the newly revised estimates for the rest of the companies, third quarter earnings are now projected to be up 0.2%. That is a dramatic change. Just two weeks ago analysts were predicting a 0.5% decline. The change has been largely driven by the much better than expected earnings from the banks and other financial companies. In recent days there have been positive earnings surprises from some technology giants, including Microsoft. This is likely to push the growth expectation up from the current 0.2% to perhaps 0.5%. That would be both a fundamental and psychological positive. For now, the researchers at Argus and Morgan Stanley are looking good with their early forecasts of a return to earnings growth in the third quarter.

The good earnings news comes on top of news that mutual fund managers are holding an enormous amount of cash. Cash balances are up to 5.8% of portfolios, from 5.5% a month ago. This is the highest cash balance since the aftermath of the 2011 terrorist attacks. It will not take much more good earnings

news to convince fund managers to reduce their cash holdings. The next big surprise could well be an upward move in stock prices.

Michael Hartnett, chief investment strategist for Bank of America Merrill Lynch, says this month's cash levels indicate that investors are bearish, with fears of an EU breakup, a bond crash and Republicans winning the White House jangling nerves."

Hartnett's team also says elevated cash balances potentially sets the stage for a stock-market rally. "When average cash balances rise above 4.5 percent a contrarian buy signal is generated for equities. When the cash balance falls below 3.5 percent a contrarian sell signal is generated."

Cash balances at mutual funds are well above the 4.5% buy signal level. Hartnett's group did not focus on that widening gap, but logically the more cash accumulates the greater the rally potential.

Stocks remain the best investment choice.

I will have the next market review and update for you one week from today on Wednesday November 2, 2016.

All the best,

John Dessauer

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