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John Dessauer's market review and update as of Wednesday October 28, 2015

In a few days the Bureau of Economic Analysis (BEA) will announce their first estimate of U.S. economic activity in the third quarter. Bond and stock markets will rise or fall depending on the news. But, whatever the BEA says now, the data will be revised over and over again for years to come. For example, the BEA recently told us that the economy grew at a significantly slower rate between 2012 and 2014 than previously thought. No wonder there is so much debate about the present strength or weakness of the economy.

Members of the board of the Federal Reserve are divided on the question of when to start raising interest rates. Part of the problem is that in the last couple of years the economy has bounced around far more than in the past. In just the last six quarters growth has risen to a 3.9% rate or more three times and fallen below zero twice. That is a lot of volatility in an economy the size of the United States'.

The BEA admits that its data collecting may not be keeping up with changes in the economy. Technology is revolutionizing how many businesses do business. Cloud computing, for example, is growing rapidly. There is an old saying for business managers: know your customer. Today, with the benefit of technology - cloud computing in particular - data on customer behavior and preferences can be collected, stored, analyzed and updated in real time. It isn't only the BEA that gets surprised by the fast advancing technologies. Microsoft's stock price jumped up 10% after quarterly results were announced. The reason was that Microsoft's cloud computing business is growing faster than analysts thought. I am sure the number crunchers at the BEA will do their best to come up with more reliable first estimates on quarterly economic growth. But, there will always be the unpredictable factors such as weather. And, technology in the private sector seems always to be several years ahead of the government. The debate over current economic conditions will continue.

Torsten Slok is chief international economist for Deutsche Bank. He thinks the U.S. economy is very strong. Here is what he said ten days ago: “In my view, there is a big disconnect between the current narrative in both equity and rates markets and the actual economic data. This economy is stronger than its reputation and for some reason many investors want to hold on to the 2009 story of “the economy is not good”. We are likely to reach full capacity over the coming 12 months and that is why Yellen, Fischer, and Dudley continue to talk about liftoff in 2015.”

When I first read his remarks I thought he must be talking about some other economy. The idea that the U.S. economy could reach full capacity in 12 months seems unrealistic to me. And I am not alone. In fact I have some unexpected company.

Harvard economist Larry Summers was Treasury Secretary under President Clinton and an economic advisor to President Obama. He is now a professor and president emeritus at Harvard University. Here is what he said last Wednesday about today’s economy: “We’re caught in a vicious cycle. Incomes are too low, therefore investments are too low. We need to get out of that cycle.”

When it comes to the need for more investment especially by business he adds: “But to get that business investment, more demand is needed. The key is you got to have demand if you want companies to invest. Otherwise they’re investing in capacity they don’t need.” He acknowledges that near-zero interest rates hurt savers. But he argues they help short-term borrowers, evidenced by record car sales. His answer is to enact “smart tax reform” to stimulate demand rather than raising interest rates and risking cooling car sales and slowing the economy. In my view Larry Summers is closer to the truth about today’s economy than Deutsche Bank’s Torsten Slok. In addition, I find it very refreshing for Summers to pinpoint the basic connection between business investment and demand. That comes close to being politically incorrect for an economist associated with the Democratic Party.

The bottom line is not to pay too much attention to the reactions by stock and bond markets to the BEA’s first estimate of economic activity in the third quarter. It will be revised. And it will be years before we get a final reading on the third quarter - far too late to be useful for establishing an investment strategy.

China is aggressively attacking slowing growth. A top policy maker at the People’s Bank of China says China will be able to keep economic growth around 6-7 percent over the next three to five years.

Last week, in a surprise move, China cut its benchmark one-year lending rate by 0.25% to 4.35% and lowered big banks’ reserve requirement ratio by 0.50% to 17.5%. This was the fourth interest rate cut this year and the sixth in the last twelve months.

Stock markets worldwide soared last Friday after China’s surprise rate cut. The Dow Jones Industrial Average is now comfortably above 17,000 and within reach of 18,000. So far there have been no big downside earnings surprises among the S&P 500 companies that have reported. There have been reports of earnings declines, but those were expected. The surprises have been on the upside from companies such as

McDonald’s and Microsoft. Once again those who panicked and sold during the stock market recent turbulence made a big mistake. The best strategy is to stay invested in stocks in quality companies.

Special footnote: The media give carbon dioxide a bad name. But there are real benefits.

“The benefits of carbon dioxide are not even controversial in scientific circles. The fact that rising emissions are making plants grow better is not news and is discussed in the reports of the Intergovernmental Panel on Climate Change. The satellite data show that there has been roughly a 14% increase in the amount of green vegetation on the planet since 1982. This has happened in all ecosystems, but especially in arid tropical areas, and that it is in large part due to man-made carbon dioxide emissions.” (Professor Mark Perry’s blog, Carpe Diem)

I will have the next market review and update for you one week from today on Wednesday November 4, 2015.

All the best,

John Dessauer