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John Dessauer's market review and update as of Wednesday November 4, 2015

The Bureau of Economic Analysis released their first estimate of economic activity in the third quarter. They say the economy grew at an annual rate of 1.5%. The good news is that inventory adjustments took about 1.4% out of the calculation. Excluding the inventory drag, the economy grew at a rate above 2% - not bad, but not up to historical post-recession levels either.

Last Friday I was invited to a luncheon where Leo Grohowski, Chief Investment Officer for BNY Mellon Wealth Management, was the speaker. BNY Mellon is one of the top money management organizations in the country with $193 billion in private client assets. I enjoy listening to their quarterly conference calls and, when possible, listening Leo Grohowski in person. BNY Mellon has teams of analysts and researchers digging out the details on stock and bond markets around the world. To their credit, they readily admit when they are wrong. For example, a year ago their Chief Economist Richard Hoey, was confident the rate of growth in the United States was headed for a three and three, meaning three consecutive years with annual growth at three percent or better. That has turned out to be too optimistic. Growth last year remained subdued, at a 2.4% rate. For this year the BNY Mellon's estimate is now for a repeat of 2014, with growth at 2.4%. Next year Richard Hoey and his team expect only modest improvement, with the rate of growth rising to 2.7%. Maybe by 2017, we will see the 3% rate develop. For now however, it is slow growth in the United States for as far as can be seen.

Slow growth is not all bad. It means this economic cycle is likely to continue for another year or two. The cycle killer – inflation - is, like the economy, subdued and no threat to markets or the economy. It also means the long positive run in stocks can continue for another year, maybe two. The current bull stock market is 79 months old. The average since 1928 is 58 months. The length of time without a major stock market decline is what worries some market pundits. They describe this market as being "long in the tooth," or so old as to come to an end on its own. One of the problems with the age analysis is that the gain from the March 9, 2009 low is roughly 194%. That is not much above the average of 167% and well below the 250% gains in several past bull markets. Another problem is that corporate profits are up about as much as stock prices. By most measures, stocks are in the fairly valued range rather than being clearly overvalued. BNY Mellon's conclusion is that stocks remain attractive, but capital gains in the coming twelve months will likely be in single digits.

Having said that, Leo Grohowski pointed out that the fourth quarter is typically the best for stocks in the S&P 500 index. Since 1928 the average performance for the S&P 500 has been plus 2.6% in the final quarter of the year. The sharp recovery in October is, therefore, consistent with past experience. U.S. stocks went through a 10% correction and now are most likely headed higher.

Leo had a chart showing the P/E or Price-Earnings Ratio for stocks in the S&P 500 at various levels of inflation. With inflation running at 0-2%, as it is now, the typical P/E is 17.9. With inflation at 2%-4% the typical P/E falls only slightly to 17.2. The Federal Reserve "hopes" inflation will rise to 2% in the next couple of years. In the past the P/E has not fallen sharply until inflation rises above 4%. It could be several years

before inflation rises above 2%, never mind reaches 4%. In terms of inflation risk, the U.S. stock market remains in a sweet spot and a P/E of 17.9 is not a sign of overvaluation. On the contrary, that P/E level is supported by the current low inflation.

Consistent with the slow economic growth outlook, BNY Mellon has modest expectations for growth in S&P 500 profits. For this year their expectation is for profits to grow 1%-6% from $113.04 in 2014 to $115-$120 this year. Next year they see S&P 500 profits rising to $120-$125 a share. Of course it is likely that some companies will grow their earnings at a faster rate. And others will beat the current modest expectations. So far 72% of the companies in the S&P 500 that have reported third quarter earnings have beaten expectations.

A major plus for stocks is that dividend payout ratios are still near historic lows. The low was a ratio of 35.3% in the 2000s. In the 1980s and 990s the dividend payout ratio averaged around 48%. The current payout ratio is 39.6%. This means that dividends are safe and likely to be increased in line with growth in corporate profits and cash flows. Combine a 4% capital gain with a 2%-3% dividend and stocks look far more attractive than bonds or cash.

Leo Grohowski thinks there is a 50-50 chance the Federal Reserve will raise interest rates by 0.25% in December. However, an increase of 0.25% is no risk to stocks. And it doesn’t make cash very much more attractive either. In other words, the media hype about an interest rate increase is just that - hype.

Leo spoke about other markets and the slowing growth in China. He thinks the plunge in Chinese stocks and the decline in other stock markets on news that China’s economy is growing at a slower rate has been an overreaction. China is in a major

economic transition. Shifting from manufacturing and exports to domestic consumption and services can be difficult and is likely to be a bumpy process. However, in the long run it is positive for China and the global economy.

He thinks it is too soon to add to stocks in emerging markets. He wants to see stability in oil and commodity prices and thinks that may take a year.

One chart really caught my attention. It was a chart showing the trade weighted U.S. dollar since 2005. At the current level of 120 the dollar is higher than at any time in the last ten years and far above the 2005 low of 95. The media have made it very clear that a strong dollar reduces U.S. company profits from foreign operations when they are translated into U.S. dollars. And, many companies are saying that third quarter results *were* hurt by the strong dollar. But U.S. companies are never-the-less reporting better than expected third quarter profits, and have been able to deliver outstanding growth in profits in the past several years in spite of a very strong dollar. The record of profit growth in the face of slow economic growth at home and abroad - and a strong dollar - is remarkable.

There may be more stock market volatility in the months ahead, but that is no reason to sell stocks. The outlook, while more modest, is still positive for stocks.

I will have the next market review and update for you one week from today on Wednesday November 11, 2015.

All the best,

John Dessauer

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