John Dessauer Investments, Inc.

www.johndessauerinvestments.com

John Dessauer's market review and update as of Wednesday November 9, 2016

The elections will soon be over. The President and members of Congress will be chosen. But they won't take office until January. Meanwhile, the current forces shaping the economy and financial markets will continue. The Federal Reserve left interest rates unchanged in November. However, economists think they will raise rates at their meeting next month. Data on the U.S. economy remain mixed, but with a bias toward slowing. Stock markets around the world have been sloppy in the weeks leading up to the U.S. elections. The U.S. S&P 500 stock index has been range bound at 2,120-2,160 since July. After the elections there could be a short-term stock market rally or a slump. However, once the immediate post-election adjustment has been made, both Morgan Stanley and Argus expect stocks to move to new highs.

"We also believe that by year's end, better growth, better inflation trends, and improved prospects for fiscal spending will allow equities to move on to new highs." (Morgan Stanley November Issue of *On the Markets*.)

"We continue to expect a typically strong close to the 2016 year in the market's best quarter." (November issue of *Argus Update*)

This stock market optimism may seem out of touch with the challenges facing business managers. *The Economist* in the October 22 issue framed it this way: "The most striking battle in modern business pits the techno-optimists against the techno-pessimists……… The real question is not whether the IT revolution has run out of steam or whether creative destruction is grinding to a halt…..Rather it is whether the new economy can counteract the forces raged against it: aging populations; a political class responding to populism by restricting trade and by over-regulating business; and education systems that in many places are failing. The big danger is that, while optimists and pessimists battle it out, the world becomes ever more divided between islands of high productivity surrounded by a vast ocean of stagnation."

I have described the U.S. economy as having "pockets of prosperity." This is consistent with the view expressed by *The Economist*. We are accustomed to economic disparity among nations. We know there are very poor countries as well as quite rich countries. We also know that the financial crisis of 2008 and the recession that followed did a lot of damage to both rich and poor countries. Overall, however, the global economy appears to have almost fully recovered from the recession. But the political divisions in the U.S. and other rich countries tell us that broad economic data are not telling the whole story. France's once extremely popular socialist President's approval rating has collapsed, now at 4%. He may not have enough political strength left to participate in the coming primary election. Conservatives have gained strength and could gain control of legislative and executive branches of the French government. The Brexit vote showed a sharply divided country. These deep divisions are consistent with nations made up of pockets of prosperity or islands of high productivity surrounded by vast regions stuck in stagnant economic conditions. The pockets of prosperity are growing, but ever so slowly, causing high frustration among those left behind.

Major change in government policies definitely would help to step up the rate of growth of the pockets of prosperity, providing reason for the frustrated to become more confident that their turn for the better is coming. France appears ready to make major change in government policy. In the UK the Parliament may get the chance to weigh in on whether or not to leave the European Union. That could calm the fears that Brexit might push the UK economy back toward recession. Here at home we will have to wait and see what the next President and Congress will do to hurt, help, or do nothing for those still left behind after the financial crisis and recession.

How have so many publicly held companies been able to grow sales and profits in this divided economy? About 60% of the companies in the S&P 500 stock index have reported third quarter earnings, and while the growth rate might fall short of the Argus earlier forecast, third quarter earnings will show growth of 2%-3%. The earnings recession is finally over. The answer to the growth question is that there are enough pockets of prosperity to provide opportunities. Of course if there were more pockets of prosperity or if the existing grew faster we would probably not have had the earnings recession and current growth rates would be much better. However, thanks to the current growth among the pockets of prosperity, earnings growth is likely to continue in the fourth quarter.

Peter Canelo, Chief Investment Strategist for Argus Research expects high-single-digit to low-double-digit annual growth for fourth quarter S&P 500 earnings. Looking out to next year he expects earnings to be up 12% over 2016 results. Morgan Stanley adds that following the 78% beat rate so far among the 60% of S&P 500 companies that have reported, analysts are busy revising up estimates for the fourth quarter and 2017. As a result the forward P/E has compressed and now stands at 16 for the S&P 500 Index. The P/E will fall further if fourth quarter earnings also beat expectations. Morgan Stanley thinks there will be modest P/E expansion, to 18-20 in 2017. A P/E rise to 18 would mean double digit gains in stock prices over the coming twelve months. Add dividends and, on a total return basis, stocks would likely be the best performers in the coming twelve months.

Morgan Stanley concludes: “All told, US stocks do not appear expensive relative to interest rates and inflation, but uncertainty has suppressed the appetite for risk-taking. Resolution of US elections in November, especially for Congress, has taken on renewed importance for determining policy direction, while a Fed rate hike in December will likely be greeted with relief—at least by stock market investors.” A year-end rally followed by new highs in 2017 is what Morgan Stanley expects. While the past is no assurance about the future, Morgan Stanley has been right more often than wrong.

I will have the next market review and update for you one week from today on Wednesday November 16, 2016.

All the best,

John Dessauer