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John Dessauer's market review and update as of Wednesday December 28, 2016

Happy New Year, a few days early; may 2017 bring us the hope and change we have been waiting for. Confidence among consumers and business has already surged. And the Dow Jones Industrial Average is up about 2,000 points since the election. Now it is up to President-elect Trump and the Republicans in Congress to deliver on their promises for tax reform, health insurance reform and infrastructure spending. If they do, 2017 will be a very good year for the economy and the stock market.

The stock market surge since November 8, while impressive, is not likely to carry stocks much further right away. So far the stock market has, as expected, stalled at the 20,000 level for the Dow Jones Industrial Average. The perennial optimist, Professor Jeremy Siegel was interviewed on television a few days ago. He did not disagree with those who feel the current stock market surge is based on hope and expectations for future sales and profits. He said there are short-term considerations that will likely cause stock prices to fluctuate. But for the long term, he is optimistic. He believes we could see stocks climb an average of 7% a year for the next several years. At that rate the Dow Jones Industrial Average would reach 30,000, for a 50% gain, in six years.

Pessimists argue that stocks are over extended and vulnerable. They see the current economic recovery as "long in the tooth," overdue for the next recession. President-elect Trump has many critics. Even some usually optimistic supporters worry about his trade policies. They fear he will start a trade war with China that could push both economies into recession. That is unlikely because he is first and foremost a businessman whose top priority is creating better jobs and stimulating economic growth. Getting tough with China over intellectual property and opening their market for U.S. competition could be a good bargaining position.

Economic cycles usually end in a burst of inflation and high interest rates. The pessimists have a point. It has been almost eight years since this economic recovery cycle began. And the unemployment rate is below 5%, a level normally associated with the end of a cycle. However, this recovery has been subpar in every respect. The growth rate has been lower than in other post-war cycles. The Bureau of Labor Statistics says in the third quarter the U.S. economy grew at a 3.5% annual rate. That is better than other recent quarters. But, the outlook is for a slower pace in the final quarter of 2016. There has been a surge in confidence since the election. But that has not yet translated into a surge in economic growth.

The hope is that President-elect Trump and the Congress will succeed in stimulating faster economic growth and job creation. The legitimate concern is that faster growth could bring unwanted inflation. That is how economic cycles usually end. Growth accelerates, economic resources become stressed, and prices rise. In the past the Federal Reserve fought rising inflation with higher interest rates. The consequence was a recession. That is how the inflation of the 1970s was beaten. Interest rates went up and the economy sank into a nasty recession. This time the Federal Reserve has an additional weapon to use when the time comes and inflation rises. That weapon is the $2.5 trillion in government securities on the Federal Reserve’s balance sheet.

Keep in mind that the Federal Reserve is still dealing with a fragile economy. There have been only two 0.25% interest rate increases in the last twelve months. And the Federal Reserve is raising interest rates not to fight inflation, but to be prepared in case the economy weakens. The economy is strong enough that the Federal Reserve has stopped buying government securities, but not so strong that the balance sheet could be reduced. In fact the Federal Reserve has been replacing maturing government securities.

The Trump administration is inheriting an economy that is sluggish and vulnerable. Deflation rather than inflation is still a risk. For example, through September prices for food for home consumption were down year-over-year for ten months in a row, the longest downward stretch since 1960.

The U.S. economy needs stimulus. The Federal Reserve has done its part with monetary stimulus. It is long past time for Washington to provide fiscal stimulus. Because the national debt has exploded during the Obama administration some worry that increased fiscal stimulus will make the debt situation worse. They forget that the single answer to government debt is economic growth. Getting the U.S. economy back on a normal growth path might mean a short term increase in the federal deficit, but would mean future deficit and debt reduction.

Finally there is hope that the new administration will follow through and provide that stimulus through tax reform, health care reform and infrastructure spending. Assume the Trump administration is successful. You can be sure the pessimists and Trump critics will argue that we are headed for a repeat of past inflation outbursts. While that might eventually be the case, it will be many years before the Federal Reserve runs out of ammunition to keep inflation in check.

During her recent press conference, Federal Reserve chair Janet Yellen was asked about the $2.5 trillion on the Fed's balance sheet. She acknowledged the need to reduce the balance sheet, but said, first we need a stronger economy and then it will take several years to return the balance sheet to normal levels. Remember - when the Federal Reserve began buying government securities under the Quantitative Easing (QE) policy, many were convinced that pumping trillions of new dollars into the financial system would result is a massive outburst of inflation. The inflation hawks were right in principle, but wrong as a practical matter. The post financial crisis economy was in far worse condition that the inflation hawks appreciated. The opposite is also correct. Reducing the Federal Reserve's balance sheet by selling government securities is an immediate way of taking money out of the financial system. Shrinking the money supply is the most effective weapon against inflation.

The bottom line is that stimulating economic growth through fiscal measures will be a win-win for the economy now and in the long term.

P.S. I am on the Seabourn Quest headed for Antarctica. At the planet's extremes, north and south, the satellite internet connections can be unavailable. As I write this week's Hotline I don't know if I will be able to send the next one on time. I am watching the markets and will send the next Hotline as soon as I can.

Hopefully I will have the next market review and update for you one week from today on Wednesday January 4, 201.

All the best,

John Dessauer