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John Dessauer's Outlook

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Outlook 2014: Better than Expected Economy, but Smaller Stock Market Gains.

Last summer investors panicked when Fed Chairman Bernanke talked about Fed tapering. Interest rates shot up and stocks went down. How things have changed! Now that the Fed has actually begun tapering, interest rates are back up, but stocks are celebrating. Investors listened to the Fed chairman when he called last summer's panic unwarranted, and pledged to keep short term interest rates near zero for a long time, even after the Fed began tapering. Interest rates on ten–year Treasury bonds are back to 3%, but that is still low by historical measures. And, with short term interest rates near zero, the ten-year rate is not going much higher. Keep in mind that the Fed is still buying $75 billion worth of bonds a month. That is an annual liquidity injection of $900 billion. The unprecedented monetary easing continues, albeit at a slightly lower pace. We are a long way from the end of monthly bond buying and an even longer way from the day when the Fed will begin pulling back and reducing the size of its balance sheet.

The outlook for the U.S. economy has improved significantly since the beginning of last year. That is why the Fed decided to begin tapering. This does not mean we are heading for a new economic boom - far from it. What it means is simply that the risk of a new recession has subsided, and the odds now favor sustainable growth at about a 3.0% annual rate. It also means the job market has improved and we are now creating enough new jobs to bring the unemployment rate down. However, there are several million Americans who have been out of work so long that they have temporarily given up looking. It will take a long time for the job market to improve enough that they can find the jobs they so desperately need. And, while the wage levels for new jobs are rising, they are still well below the pre-2008 level. Five years after the great recession, and the U.S. economy

has finally gained enough strength that we no longer need to fear a sudden slide back.

Investors are right to celebrate the good economic news. The question is: has the celebrating pushed stocks to a level where the good economic news for 2014 is now in the price? If that is the case then the New Year will be very dull for investors. Stock prices would remain flat and dividends would be stockholders main reward. In a dull market some stocks would still provide good gains. Stocks that are trading at low P/Es, for example, could rise nicely if the company beats current lackluster expectations. **Cisco Systems, NASDAQ, $21.93,** is a good example. Trading at slightly more than 10 times current earnings estimates, Cisco could move up by 20% or more if earnings in coming quarters beat expectations. Stocks in companies that can raise their dividends would also do well in a dull market. There is no reason to sell stocks even if they are currently discounting the coming good economic news.

There are two risks. The first is a melt-up - an outbreak of exuberance that suddenly pushes stock prices up significantly. That is what caused the technology stock bubble in 2000. Some say stocks are already so high that there is a dangerous bubble ready to burst. However, the bubble master - Robert Shiller, who won a Nobel Prize for his forecasting models that predicted the technology stock and housing bubbles - says no. Professor Shiller describes a bubble as “a psycho-economic phenomenon. It’s like a mental illness. It is marked by excessive enthusiasm, participation of the news media and feelings of regret among people who weren’t in the bubble.” Bubbles are also often accompanied by a credit expansion. Morgan Stanley says if you search on Google Trends, you will see that “stock bubble” has reached its highest level of interest in five years. True investment bubbles are rare events. We are safe as long as there are so many thinking the next bubble is developing right before our eyes.

The other risk is economic. There still are many uncertainties and many headwinds. The economy could disappoint, the labor market could remain weak, unemployment might not come down as much as the Fed expects. Corporate profits might not meet expectations. Investor sentiment could turn negative, dragging stock prices down. Of course the U.S. is not an economic island. We are part of the global economy and many U.S. corporations have a global business footprint. Assessing the economic risk to

the stock market means taking a good look at conditions both at home and abroad.

Fed Chairman Bernanke has company, but not all Americans are convinced

Christine Lagarde, managing director of the IMF (International Monetary Fund) said her organization is raising its outlook for the U.S. economy. "We see a lot more certainty for 2014." The IMF will issue its revised forecast this month. It will likely be better than the 2.6% rate predicted late last year. Americans are not so sure the economy will improve in the New Year. A CNN poll conducted in mid December showed 70% saying the economy was in poor shape. The good news is the number of pessimistic Americans dropped to 50% when asked about 2014.

Consumers account for about 70% of the U.S. economy. That is why their opinions, savings and spending patterns are so important. A change by even a minority of consumers can have an exaggerated impact on the rate of economic growth. Fortunately, one well-known pessimist has been very wrong about the American consumer. Remember Nouriel Roubini? He made headlines a few years ago with his gloomy post recession analysis and predictions. He based his pessimism on a conviction that consumers had been so punished by the financial crisis that they would go from spenders to savers and stay that way for years. He seemed right for a while. The U.S. savings rate did climb as Americans reduced their debts. However, he was wrong that Americans would stop spending and keep saving indefinitely. Overall household debt *has* come down, thanks mainly to mortgage debts being wiped out by foreclosures. Home equity loans, likewise, have been sharply reduced. But recent data show an uptick in credit card debt. That is not worrisome because the ratio of household income to debt service is at the lowest in decades. In addition, thanks to rising stock and home prices, household net worth is at a record high. Real estate added $428 billion to household net worth in the third quarter. Equities and mutual funds added another $917 billion, bringing the total to $77.3 trillion. American household finances are stronger now than anyone expected after the 2008 financial crisis. Instead of suffering irreparable damage, Americans have recovered fairly quickly.

Where professor Roubini really got it wrong was the U.S. savings rate. The rate never did reach his 10% forecast. But it did spike up to 6% in

2009 and stayed well above 5% until the beginning of last year. Last year the savings rate came back down. The rate was down to 4.2% in the third quarter of last year. Contrary to Roubini's forecast, American consumers are back, providing essential support for the economy.

Consumer spending rose in November by the most in five months. Household purchases rose 0.7% after a 0.6% gain in October that was larger than previously reported. Paul Edelstein, director of financial economics at HIS Inc., said "Jobs are growing, confidence is growing, households and asset values are climbing. There appears to be some sort of gathering momentum in the economy." The spending continued in December. MasterCard Advisors reported a 2.3% increase in retail sales between November 1 and December 24. That was far better than the early forecasts of flat to down slightly for U.S. holiday sales. The better than expected retail sales is a strong indication that, in spite of millions on long term unemployment and low wages for new jobs, many millions of Americans are feeling better about their current financial position and their future prospects.

There are other signs of growing strength in the U.S. economy

Manufacturers are more optimistic about 2014. Industrial production increased 1.1% in November, the best in a year. The October number was revised from negative to a positive 0.1%. Manufacturing, which makes up 75% of industrial production, rose 0.6% in November. That was on top of a 0.5% gain in October. A survey by the Institute for Supply Management (ISM) found that manufacturers believe sales will be stronger in 2014. In Early December ISM reported that manufacturing unexpectedly accelerated in November, at the fastest pace in more than two years.

Purchasing managers expect a 4.4% rise in sales in 2014 after a 3.4% increase in 2013.

Service companies likewise are optimistic about the New Year. Fifty-

six percent of those surveyed expect 2014 to be better than 2013.

Orders for durable goods rose 3.5% in November.

Sales of new homes beat expectations in November, holding near a five-year high at a 464,000 annual rate. Sales of existing homes have come down, but were running at a respectable 4.9 million rate in November. Housing is still providing support for the economy.

No one expects the economy to suddenly be able to grow at the 4.1% annual rate seen in the third quarter of last year. A burst in inventories contributed to that surprising number. Businesses will continue to hold inventories, but we are not likely to see a build-up like the third quarter again anytime soon. However, the U.S. economy can sustain a growth rate of 3.0%. Much will depend on continued strength in the jobs market. There was good news in November when the U.S. added 203,000 new jobs. New claims for unemployment continued to fall in December. Odds are the U.S. economy is entering the New Year on a much stronger foundation for sustainable growth.

We support the global economy and the global economy supports us.

It used to be that the global economy was pretty much dependent on the United States. It was said that if the U.S. economy caught a cold the rest of the world got pneumonia. With the emergence of China as a global economic powerhouse, that has changed. The U.S. economy is still number one in terms of size and influence, but today the global economy is far more complex and diversified. One way to see the complexity is to look at the U.S. current account deficit. When it was growing, the pessimists salivated. When it went above 6% of GDP they were positive the end was near. In the third quarter of 2013 the BEA reported the current account deficit was down to 2.2% of GDP. The pessimists now ignore the current account deficit data. What happened is that economies like China have grown and become important trading partners. Gone are the days when China subsisted on exports. China is now the fastest growing export market for the United States and a few other developed countries. Some important emerging markets have grown large enough to become players on the stage of the global economy. What is happening at home in the U.S. economy is still

very important. But, what is happening to the global economy is now equally important.

Richard Hoey is the chief economist for BNY Mellon. He recently offered a forecast that the global economy will accelerate in 2014, growing at a 3.5%-3.75% rate. He provided four reasons for the mildly optimistic forecast. First, central banks in the developed economies will provide liquidity. Easy money will continue. Second, the fiscal drag from the sovereign debt crisis in Europe and the government deficit in the United States is easing. Europe is slowly resolving its banking challenges and the U.S. is enjoying rising tax revenues and a slowdown in the growth of federal government spending. Third, there will be less deleveraging in 2014. American households are largely through their debt reduction efforts. The U.S. state and federal governments also have made progress reducing deficits. And even in Europe there is less pressure on government borrowing. Fourth, the world will enjoy moderate energy prices. That is thanks in large part to the dramatic increase in oil and gas production in the United States.

Recent data support Richard Hoey's forecast. For example, factory output in the Euro-region grew at a faster than expected pace in December. An index based on a survey of purchasing managers rose to 52.7, a 31 month high. In the United Kingdom, unemployment unexpectedly fell to a four-year low in the three months through October 2013. The unemployment rate is now 7.4%.

Hoey is not alone. Jim O'Neill, former chairman of Goldman Sachs Asset Management published an article for Bloomberg on December 9 with this title: "Cheer Up: World Growth Is Accelerating."

O'Neill wrote: "Current pessimism about the world economy is overdone. The world's three biggest economies—the U.S., China and Japan—are all in decent shape. Barring a major new deterioration in Europe and unforeseen calamities in the rest of the developing world, a moderate acceleration of global growth looks likely."

In response to pessimists focused on past volatility in emerging markets, O'Neill makes a poignant point: "As an antidote to gloom on this subject, it helps to remember that the United Nations' goal of halving world poverty between 1990 and 2015 was achieved five years early."

Lifting people out of poverty is more than humane - it also boosts economic activity. It is a process that once well developed, becomes self-intensifying. Focusing on China is understandable. China is by far the largest of the emerging markets. However, taken together, other emerging markets involve more hundreds of millions of people, potential middle class buyers of goods and services. Yes, there will continue to be volatility in emerging markets, but the process of reducing poverty is now so well entrenched that it truly has become self intensifying. That is why so many professional investors think emerging markets are the best bet for the long term.

China

Chinese officials met in Beijing for their annual economic summit. The official Xinhua News Agency reported that the latest calculation for growth in 2013 is 7.6%. That is slightly better than the government's 7.5% target, but the third consecutive year of slowing growth. Chinese officials held on to their 7.5% forecast for 2014. Economists, however, expect growth to slow again to 7.4%. China is clearly transitioning from export dependence to domestic growth. Slower growth is inevitable. The double digit pace that was the norm during the decades long climb from poverty to prosperity became unsustainable. With growth above 7% China will remain a contributor to global growth this year and next.

The Stock Market

It is an old saying, "we can't see the forest for the trees." It describes a person who is so absorbed in the details that he or she can't look at the situation as a whole. Today this applies to most of us when it comes to the stock market. We are absorbed in the details, corporate profits, profit margins, cash flows, P/Es, dividends and price trends. Every once in a while someone comes along and provides us with a look at the forest. This time it is Professor Mark Perry who exposes the forest when he points out the following: "The fact that the U.S. economy is producing 5.6% more output now than in 2007 with 2 million fewer workers would explain why corporate profits are at record levels and more than 40% above the pre-recession peak (not adjusted for inflation)".

He is right. The U.S. economy - as expressed in real GDP - has not just recovered from the deep 2008 recession; it is 5.6% above where it was

at the end of 2007. This remarkable achievement has been accomplished with fewer workers. Labor costs are the largest item on every business's expense sheet. When production rises faster than labor costs, profit margins and therefore profits expand. It is highly likely that this trend, where production grows faster than employment, will continue this year.

I could be making the same mistake I made last year, expecting only modest gains in corporate profits and stock prices. However, when it comes to stocks, caution is always better than exuberance. My conclusion is that this is not a time to sell stocks. It is a time to buy and hold. Buy when individual stock prices fall to truly attractive levels. Otherwise patiently hold and enjoy the dividends. Can there be a nasty correction this year? Of course there can, but predicting that is fraught with error. Stocks may go higher before correcting. Stock prices after the correction could be higher than today. Market timing is always tempting and usually a bad idea.

COMPANY NEWS AND VIEWS

Cisco Systems, NASDAQ, CSCO, $20.24, held its annual investors day and the result was a split among analysts. Some, such as Argus Research, reiterated their buy recommendations. Others, including Citigroup, said sell, and offered an $18 stock price target. During the meeting on November 13, CEO John Chambers shocked the audience when he said that sales would likely decline as much as 10% this quarter and might keep declining for several quarters. Sales of set-top boxes are in decline. And there are troubles in some of the major emerging markets. Another factor in the sales decline is Cisco's wide range of new products for the carrier market. This has resulted in weak orders as customers assess the new products and the new technologies. These near term challenges discouraged some analysts to the point that they gave up on the stock. Others see opportunity in Cisco's stock. Argus Research says: "Cisco is in the early innings of one of its most promising development cycles in the past decade." They go on to say that the stock has come down so much (the 52 week high was $26.49) that the price fully reflects the near term challenges.

Cisco management has provided earnings guidance of $1.95-$2.05 a share for this fiscal year. Taking the sales decline into consideration, Argus Research has a $2.00 per share earnings estimate for this fiscal year and $2.16 a share for fiscal 2015. They see earnings growth in spite of the sales

decline. That is thanks to good cost management and the stock buyback program.

Cisco is financially very strong - that is a classic ownership criterion for successful, value oriented investors. At the end of the first fiscal 2014 quarter, Cisco had $32 billion in net cash. That is 29.4% of the total stock market capitalization and about $6 a share. In other words, at $20.49, investors are paying slightly more than $14 or 7 times earnings for Cisco's business operations. The annual dividend is $0.68 a share, for a yield of 3.36%.

I rate Cisco a buy, but recognize that the stock could fall below $20 as mutual fund managers sell. They are in a highly competitive business and are focused on their funds' performance quarter by quarter. Given CEO Chambers' concerns about the next few quarters, some might see Cisco as unattractive for the next few months. Cisco below $20 would be a bargain.

Nokia, NYSE, NOK, $7.75. The sale of Nokia's mobile phone business to Microsoft is expected to close in the next few months. After the sale, Nokia will have $7.2 billion in additional cash and three businesses. The largest, Nokia Solutions and Networks (NSN), is being restructured. Low profit businesses are being sold or closed. This causes some confusion, because while sales are falling, profit margins are expanding. The other two businesses combined account for about 10% of the new Nokia's sales. The mapping business is called HERE and predates Google. While small, this is an intriguing business that has growth potential as a part of the developing Internet Cloud technology. The third business is Nokia's enormous Patent portfolio. That business is called Advanced Technologies and will operate as a research and development business, hopefully developing lots of new patentable ideas.

There are lots of unanswered questions. The first is: what will Nokia do with all the new cash? One hedge fund manager is pushing for a special cash dividend for shareholders. Analysts speculate that the cash will be used to expand the NSN business through a major acquisition. These questions won't be answered until after the sale to Microsoft is complete, and the cash is in Nokia's bank account. Meanwhile, Standard & Poor's calculates that fair value for the stock is $7.50. In other words their analysts see real value in the stock, but think Nokia should be held until the new business plan becomes clear. I agree.

By way of history, Nokia has a remarkable record of transforming itself into highly profitable businesses. In 1865 Nokia became a major wood pulp producer. It then switched to electric power generation, then rubber products. In the 1980s Nokia television sets were the number one seller in Europe. And, as we know, in the 1990s Nokia was the world's biggest and best seller of mobile phones. The mobile phone business is still the world's second largest. The new Nokia starts out as a substantial business with 56,000 employees and plenty of cash. It will be very interesting to watch the new Nokia reach for world leadership in its three businesses.

My advice is to hold Nokia. Wait and see what the management will do with the cash.

CLOSING THOUGHTS

Oil - from strong headwind to stronger tailwind

It seems like yesterday that pessimists were confidently predicting economic collapse because of "peak oil." We were told that oil production from the North Sea to Saudi Arabia was declining. The world was past the peak in global oil production. But it wasn't yesterday, the last "peak oil" media episode occurred several years ago. The once popular "peak oil" notion sticks in my mind because over the last four decades we have been bombarded with a never ending stream of oil-based pessimistic prognostications.

It began with the oil crisis of the 1970s. I remember the long lines at gas stations waiting for a few gallons of gasoline. Oil prices soared. Inflation spiked to double digits. The economy faltered. Stocks and bonds plunged. By the early 1980s, as the U.S. economy slid into the worst recession since the great depression, oil was clearly understood to be an economic hinge pin. Oil experts collected data. While supplies did increase and prices stabilized, the data were not encouraging. There were forecasts of coming oil production distress in Saudi Arabia. Supposedly all the "elephant" fields had been discovered. The pessimists confidently predicted oil prices would climb well above $200 a barrel, with all sorts of economic woes to follow.

Higher oil prices were an incentive for companies to be more aggressive in their hunt for more, and to invest heavily in technology to

unlock difficult sources. The oil pessimists dismissed all the talk about the benefits of technology and the possibility of finding more oil. They insisted, right up until U.S. oil production began to climb, that developed economies were doomed and only fools should think about investing in stocks.

It must have been a huge shock to all those pessimistic oil experts to see this December 16, 2013 Bloomberg News headline: "North America to Drown in Oil as Mexico Ends Monopoly."

It was bad enough for them that technology delivered millions of barrels of oil from sources once thought impossible to reach. New discoveries off Brazil, in Africa and the Gulf of Mexico must have been a blow to them. Then came a whole new technology – fracking - and oil production in the United States began to climb. There is now so much new oil production in the United States that pressure is building to lift the long standing ban on oil exports. Keep in mind that all the new oil has been developed on private lands. The present administration in Washington likes to take credit for the increase in oil production, but still firmly opposes oil exploration on Federal lands. I am sure the "peak oil" pundits don't want to even think about the day when federal lands are once again open for oil exploration.

The Bloomberg headline is about Mexico. There apparently is an enormous amount of oil onshore and offshore in Mexico that is lying dormant because of mismanagement at Mexico's government-controlled oil monopoly. The mismanagement has persisted so long and investment in oil production has fallen so low that Mexico is suffering a decline in revenue from oil. The Mexican government needs more revenue and an obvious way to get it is to open up Mexico's oil for private enterprise. Mexico's President, Enrique Pena Nieto, is actively working to end the government's oil monopoly. Experts say Mexico has the biggest crude resource in the Western Hemisphere. Opening up Mexico for private investment will mean a huge injection of capital for Mexico and a welcome huge increase in revenue for the government. It is coming. Mexico's oil won't be on the market next year, but in a few years it will start to flow. When it does, the world will have gone from "peak oil" to an abundance of oil. Exxon says that will leave the Asia-Pacific as the only oil importing region.

An abundance of oil does far more than remove a major threat to the global economy and world stock markets. It means businesses and

consumers worldwide will have plentiful, affordable energy for the next couple of decades, perhaps longer.

Understandably, the 2008 financial crisis gets all our attention. Past oil-induced economic crises are forgotten. However, financial crises are manmade. They can be prevented and, as we can see from the stock market's current recovery, they can be cured. Exhausting the global oil supply would be a crisis of another magnitude. Once gone, fossil fuels, oil in particular, cannot be replaced. Furthermore, efforts to find other sources of energy have come up short. Wind, solar, ethanol and all the other fascinating new developments are exciting. But none has proven to be truly affordable or been able to provide energy on the scale of oil and other fossil fuels.

Investors should be celebrating the oil flood. We have at least a few more decades before the world will have to make the transition away from oil and fossil fuels. In addition, oil companies in particular have become more attractive. Yes, even lowly **BP, NYSE, BP, $47.45**, with its 4.8% dividend yield is a buy. Likewise, **Halliburton, NYSE, HAL, $50.70,** has growth opportunities for many years to come.

Next issue: The February issue of *John Dessauer's Outlook* will be ready on Wednesday February 5, 2014.

Next weekly market review and update: Wednesday January 15, 2014

All the best,
John Dessauer

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