John Dessauer Investments, Inc.

John Dessauer's Outlook

July 2013

Forecast: Another Year of Slow Growth and Rising Stocks

Last month Fed Chairman Bernanke spoke about the future, and stock markets around the world fell sharply. Investors jumped to the conclusion that the Fed was going to change policies - going from easy money to tight money and higher interest rates. That may happen, some day, but not any time soon. On June 26, more than a week after Bernanke's tapering talk, the BEA (Bureau of Economic Analysis) released data revising first quarter growth down from a 2.4% to a 1.8% annual rate. For now and for the foreseeable future, the challenge will be coping with growth that is too slow.

St. Louis Fed President James Bullard is regarded as a bellwether. In 2010 he published a paper calling for the Fed to avert deflation by purchasing Treasury notes. He also called for the Fed to engage in open-ended bond buying with no set goal or ending date. What Bullard called for has become Fed policy. What is Bullard saying now?

First, he said the Fed Chairman's remarks about tapering the bond buying program were "inappropriately timed." Bullard says the chairman should have waited until the economy was actually strengthening and inflation was picking up. As for what comes next, he said the Fed may need to INCREASE monthly asset purchases above the current $85 billion if inflation slows any more. This would be the opposite of what investors fear.

Clearly, investors did not pay attention to what Bernanke actually said and further lost touch with economic realities in the United States, Europe and China.

The United States

The news from the United States is mixed. Job creation is running at a slow pace. The employment-to-population ratio is far too low. Politicians may quibble about the unemployment rate, but the hard truth is that there is no threat to inflation or corporate profit margins from rising wages. The U.S. is still many millions of jobs short of a full recovery from the financial crisis of 2008, five long years ago. Housing is showing signs of genuine improvement. Sales of existing homes are running at an annualized rate of 5.18 million. Prices have started to recover. The improvement in sales of existing homes is spilling over into new home construction. There is one warning sign: Robert Shiller, co-founder of the Case-Shiller Home Index, says too many home purchases are by investors looking to rent, rather than by home buyers. That view is consistent with a still weak labor market. Retail sales have been resilient. They rose 0.6% in May, the biggest gain in three months and better than economists expected. There are three reasons why consumer sentiment has improved: higher stock prices, higher home prices and a dramatic slowdown in business firings. The economy may not be creating enough new jobs, but we are not losing jobs at the rate of years past. The economy is growing, but not very fast - about 2% a year for the last few years. The Fed itself just cut its forecast for this year to 2.3%-2.6% - hardly a boom. There is no way of knowing for sure how dependent the economy is on the Fed's easy monetary policy. However, it would be risky for the Fed to taper off too soon.

There is a measure of economic weakness that is causing concern. The Fed's favorite measure of inflation is running at a 53 year low. Over the twelve months to April, that measure showed consumer prices up a scant 1.05%. This concerns Bullard, who worries that any further slowing in inflation could set us on a course to deflation. That is why he says the Fed may have to do the exact opposite of what investors fear and increase the bond buying program.

What about one of the pessimists' favorite themes - that the Fed's easy money has created asset bubbles in stocks and bonds? Bullard says this "is a concern" though "there just isn't enough tangible evidence" for that to sway policy now. The reason is that most of the new money has ended up back at the Fed in the form of deposits by the nation's banks.

The one reason the Fed has to be thinking about tapering off the bond buying is the increase in the Fed's balance sheet. It has now run up to $3.41 trillion. There are limits to how large the Fed's balance sheet can grow without imbedding unwanted future challenges. While we don't know what that limit is, $4 trillion sounds like a huge number.

The bottom line is that investors did overreact to Fed Chairman Bernanke's remarks. The economy is growing too slowly for the Fed to start tapering any time soon. In addition there is a risk the economy will slow rather than gain strength. The Fed will keep interest rates low and keep buying bonds at an aggressive rate longer than investors think.

Europe

It isn't only politicians who have been debating how to resolve Europe's sovereign debt crisis. In fact, conflicting economic ideas have been behind the debate all along. Individual economists are still battling furiously, but beyond academia, a consensus is emerging.

The media coverage on the public part of the debate has been here in the United States rather than in Europe. Two U.S. economists, Carmen Reinhart and Kenneth Rogoff, conducted a study about government debt and economic performance. Their initial conclusion was that when government borrowing rose above 90% of GDP, economic growth slowed dramatically. From that came the further conclusion that deeply indebted European countries needed to slash government spending for there to be any chance of meaningful economic growth. A Keynesian militia, led by Nobel Prize winning economist Paul Krugman, responded with fury, arguing that government spending was the path to prosperity.

In April of this year Krugman and the Keynesian militia got an unexpected gift. Three economists from the University of Massachusetts found a spreadsheet error in the Reinhart-Rogoff work that exaggerated the drop-off in growth at high debt levels. Krugman responded with nasty accusations in editorials published in leading newspapers. Reinhart and Rogoff admitted the error, revised their calculations, and said that growth merely slows as government debt rises. This is a conclusion many economists agree with, hence a growing consensus on how best to deal with Europe's sovereign debt crisis. Reinhart and Rogoff continue to advocate cautious, proactive debt reduction, but now favor writing down bank debt and tolerating slightly higher inflation rather than immediate austerity.

It is too bad Paul Krugman refuses to stop bashing Reinhart and Rogoff. His provocative editorials are now a distraction. It is widely agreed that austerity that undermines growth does not help improve underlying

fundamentals. Writing down bank debt and boosting growth through economic stimulus does improve fundamentals.

Of course this moderate approach to austerity may not work in extreme cases like Greece. But it is likely to work in other countries where past government abuses have not been so severe.

The reason the developing economic consensus is significant is that this moderate approach to austerity is something most voters in most countries can agree with. The riots in the streets, and the ballot box rejection of past policy offers have been due to the previous stark attitude about imposing painful austerity. Now voters can be offered a more reasonable choice, one with real hope that there is a light at the end of the sovereign debt tunnel.

The emerging consensus does not mean an immediate end to the European sovereign debt crisis. It means that progress is being made resolving the dispute between creditors, governments, and the underlying economies. Europe's government debts will be less of a threat to financial markets - stocks in particular.

China

China bashers are at it again; this time about credit expansion and housing. China is engaged in another massive transition from state owned housing to private ownership. History says the odds favor success for the Chinese. This transition is part of a major economic rebalancing. China is moving away from export dependence and toward domestic consumption. This means that while overall growth will slow to 7.5%-8%, domestic consumption will keep growing at a faster rate. This opens opportunities for investors and businesses that are doing business in China or engaged in selling goods and services to China.

Of all the emerging markets, China is the biggest and in many ways the most important. Other emerging market economies benefit by trading with China. Even Japan, a large developed economy, is trying to use currency manipulation to gain an advantage over China. Whether as a trading partner or a competitor, China plays a role in the Pacific Rim and among emerging markets that is much larger than its raw economic data indicate. For at least three decades there have been China pessimists. As

long as the Chinese economy was growing at double-digit rates, these pessimists had difficulty attracting attention. However, when emerging market stocks become volatile and pull back 10% or so, the pessimists attract a crowd. The latest, "China is headed for a crisis" theory is called the 5:30 theory. No, that is not about the date or time of day. It has to do with credit expansion in China.

An unexpected cash crunch is what precipitated the current siren song about a credit bubble and coming financial crisis. The People's Bank of China did not add liquidity at recent auctions. That resulted in a jump in some short term interest rates. How can China, with an average household saving rate of more than 30%, have a cash crunch? The answer is China's overregulated and complex banking system. The Chinese government tightly controls bank deposit and lending rates. The rate on bank deposits is currently 3% and the lending rate is 6%.

When you get only 3% on a savings account, it is tempting to consider real estate as an alternative. The temptation is all that much greater when you already have accumulated plenty of savings thanks to a high annual savings rate. Buying real estate to rent can produce annual returns of 8% or more. Buying a home means an end to rent, and a chance to develop equity. There has been a boom in real estate transactions in parts of China. This has caused concern at the central bank. Several tools have been used to cool real estate speculation. Banks have been told not to lend to real estate speculators. Directions like that in China are really regulators' orders, and to be disobeyed at the bankers' peril. Bank reserve requirements have been raised. And recently, the central bank has allowed liquidity to tighten. Pessimists are focused on the spike in some short term interest rates. They conveniently ignore the fact that on June 18, 2013, China sold 2 billion yuan ($326 million) worth of three month government bills at an interest rate of 2.91%. China is not like Greece, Italy or Spain. China can borrow all it wants at low interest rates. The internal cash crunch is the result of deliberate action by the central bank and can be reversed at any time.

The reason China's central bank is manipulating liquidity is because there has been an increase in borrowing - especially for real estate purchases. The author of the 5:30 credit bubble theory is Zhang Zhiwei, an economist with Japan's Nomura Bank. He points out that several economies have suffered financial crises after the amount of credit jumped 30% of GDP in five years or less. That is where the 5:30 comes from - a 30% credit increase

in 5 years. China's total credit, including, off-balance-sheet loans, has risen to 198% of GDP from 125% four years ago. That is a 58% increase in total credit, far more than enough to qualify for Zhang Zhiwei's credit-bubble-crisis theory. It is also greater than the credit increases that preceded the 1990 Japanese financial crisis (+45%) and the Korean 1998 financial crisis (+47%).

Violate the 5:30 rule, and? In China that has meant double digit economic growth and rising prosperity.

There is a major problem for the Chinese credit-boom-crisis proponents. Credit booms are supposed to ignite the economy and result in a burst of high inflation. The opposite has been the case in China. The economy has slowed and inflation remains subdued. There is another problem. This is not China's first credit boom. From 2001 to 2004 there was a credit boom in China that violated the 5:30 rule. It became so bad that the central government had to inject $45 billion into two of China's largest banks to save them from their lending mistakes and rising bad loans. (If that sounds familiar it should. That was a Chinese bank bailout.) The pessimists' problem is that not only was there no financial crisis after 2004; the Chinese economy averaged annual growth of more than 12% over the following three years.

Is China different?

The answer is yes, and no. China's financial structure is very different from those of the United States or other developed economies. The high household savings rate is just one part of the difference. However, the basic rules of economics apply to China in the same way as they do to other economies. A classic credit bubble in China would either be strongly addressed by the central bank or result in unwanted inflation, high interest rates, and rising unemployment. The difficulty is in analyzing data on the Chinese economy. Ting Lu, from the Bank of America, another economist who studies the Chinese economy, thinks the decoupling of credit growth and prices in China is partly a statistical illusion. Official measures of credit are distorted by double counting. If a big company borrows money cheaply and then lends it to another at a higher interest rate, the amount will be counted twice. This means the official measure of total credit is swollen, but difficult for outsiders to adjust. Economist Richard Werner of Southampton University goes a step further. He says only banks can lend money into

existence. Therefore, only bank lending should be considered when looking for credit bubbles. Bank lending in China is tightly controlled and highly regulated. It is, therefore, difficult for a destructive credit bubble to gain a foothold.

China has a history of turning what looks like a bunch of bad loans into a roaring success. The reason is that China is still an underdeveloped economy.

For many years pessimists argued that a major crisis was coming in China because of sate-owned enterprises and bad loans. It was called the triangular credit bubble. Remember, during the communist days the State owned everything, including every business. At the end of the communist days and the beginning of China's economic awakening, there was a huge problem. The state-owned businesses were either broke, or making things no one wanted even if they could afford them. The entire Chinese economy was bankrupt. What the government did was set up a system that provided jobs while encouraging capital inflows to create real, competitive businesses. It was very slow at the start. The bankrupt state-owned enterprises paid their employees with money borrowed from the banks. The bankers knew these were bad loans from the start, but they also were assured of regulatory support and, when needed, capital from the central government. We now know the pessimists were wrong. The seemingly impossible system worked. Over the years China has created enough real jobs that the state-owned enterprises and triangular debts are all but forgotten, even by the pessimists.

The pessimists are wrong this time too.

Past credit expansions were mainly associated with developing competitive, productive businesses. Until a decade ago, every apartment - and most homes - was still owned by the government. To its credit, the government has carefully encouraged home and apartment ownership. The challenges have been enormous. For example, the idea of insurance was foreign to most Chinese. If you don't own anything, why would you need insurance? Ever so slowly, things we take for granted, like insurance, are being accepted by the Chinese. The result is another massive transition from government provided, to personal ownership of apartments, land and homes.

There are crooks, thieves and speculators in China. Bankers in China make mistakes. Developers make mistakes. It is all part of the process of

taking risk in order to move the massive Chinese economy along the road to better balance between domestic consumption and export dependence.

China has succeeded with every past major economic transition. The odds are heavily in the government's favor when it comes to housing. The high personal savings rate and reluctance to borrow make the government's job easier.

Ken Courtis, former Asia vice chairman at Goldman Sachs Group says:" China is imposing the type of tough medicine it needs to squeeze excesses out of the system. You can't build long-term, sustainable growth if the system is not cleansed of excesses." China will keep growing during this transition, but at a 7%-7.5% rate rather than the 10% rates of the past. In 2012, China accounted for about one-third of global growth. That will remain the case this year and for years to come.

Investment strategy

Don't sell. The selling crowd has it wrong. The outlook is for continued slow growth, both in the U.S. and for the global economy. There is no upward pressure on inflation. The combination of slow growth and low inflation means interest rates will remain low. Stocks are the best choice, both for dividends and total return. Capital gains over the next year may not be as great as they have been, but are still likely to be sufficient to make investors happy by this time next year.

NEWS AND VIEWS ON OUR COMPANIES

Cisco Systems, NASDAQ, CSCO, $24.00, has unveiled its latest core router technology, called CRS-X. Cisco expects Internet traffic to triple over the next five years. The nature of the traffic is also changing. High Definition videos are becoming very popular. They are used not just for entertainment, but for business as well. Cisco's new routers are incredibly fast, double anything that currently exists on the market. And, they are cheaper than the competition. With Cisco, customers do not need to buy a whole new router; they can switch out line cards and upgrade their current CRS-3 systems. The new technology will ship by the end of this year. Customers such as Verizon are already impressed.

Cisco also has a consumer products division that includes home Wi-Fi routers. I have one. Recently the download speeds in my home office became very slow. Naturally, I blamed the Cisco router. I was wrong. The problem was a Comcast modem, which Comcast replaced at no cost once the problem was correctly diagnosed. Getting to the root of the slow speed problem was not easy. A Cisco representative spent well over an hour talking me through the procedures for finding the source of the problem. Once discovered, I said thank you many times. There was no charge from Cisco and the representative called me later to make sure the speeds were back where they should be. I was very impressed with Cisco's customer technical support. That is another reason to like Cisco.

GlaxoSmithKline, NYSE, GSK, $49.15. It doesn't happen often, but once in awhile the U.S. FDA (Food and Drug Administration) changes its collective mind. In this case, the drug involved is Glaxo's Avandia, used to treat type 2 diabetes. In 2009, 2.7 million people used Avandia and the drug was a billion dollar, blockbuster revenue source for Glaxo. In 2007 a study found a risk of heart problems and the FDA issued restrictions on the use of Avandia. After the restrictions took effect the number of patients using the drug collapsed. The recent number is a scant 3,000. Glaxo's research disagreed. A six year study of 4,447 type 2 diabetes patients showed no increased risk of heart disease. In response to the FDA, Glaxo asked scientists at Duke University to review their research. They did, and found it to be correct. Glaxo went back to the FDA and a panel there recently ruled in favor of Glaxo. Of the 26 panel members 13 voted to ease the restrictions, 7 wanted the curbs removed entirely, five wanted the restrictions left in place and one wanted the drug to be entirely removed from the U.S. market. The majority rules, so the Avandia case is back on the FDA's agenda. Avandia could be back, unrestricted, on the market soon. Even if the number of patient users rises to only a million or so, Avandia will, once again, be a major revenue source for Glaxo.

There is more to like about Glaxo. For example, the company has spent more than 2 billion pounds buying back shares in each of the last two years. Management plans to buy back another 1 to 2 billion pounds worth of shares this year. The sale of its proprietary drinks business could provide $2.5 billion more in cash that could be used for share buybacks. Then there is the attractive dividend, currently providing a yield of 4.3%. As if all this is not enough to make the stock attractive there is a drug called Breo Ellipta, a

new respiratory treatment, that has blockbuster potential. And Glaxo's pipeline has another half dozen new drugs in phase 3 trials.

The risk in Glaxo is reduced by its diversification. Glaxo gets 25% of its revenue from over the counter health care products. There is also geographic diversification. 33% of revenue comes from the U.S, 21% from Europe, 8% from Japan and 20% from Emerging markets.

In 2007 Glaxo's stock traded at $60. While up in recent days, it is still below its former high. A return to $60 would be a14% capital gain, plus the annual dividend for an 18% total return - not bad in this low interest rate environment. Glaxo is a buy, but with a word of caution. Even though the Glaxo story is compelling, there are doubters. The stock could pull back at any time before moving to the $60 level. A pull back to $50 or lower would be a compelling entry point.

Pfizer, NYSE, PFE, $28.00, spun off 20% of its animal health business through an IPO (Initial Public Offering). The cash raised from that sale will, in part, be used for stock buy backs, reducing the number of Pfizer shares outstanding. That is good news for Pfizer shareholders. The animal health business is now a separate company called **Zoetis, NYSE, ZTS $31.50,** trading on the New York Stock Exchange. Pfizer offered an exchange opportunity for Pfizer shareholders. If they wanted, they could submit Pfizer shares to be exchanged for shares in Zoetis at a 7% discount. The exchange was oversubscribed because Zoetis is a strong company, a leader in the growing animal health business. The offer created something of a dilemma for Pfizer shareholders. Pfizer is an attractive investment and the stock is undervalued. Argus Research, for example, rates Pfizer a buy with a $32 twelve month stock price target. The exchange will further reduce the number of Pfizer shares, making the stock even more attractive. On the other hand, Zoetis is also an attractive investment with solid long term growth prospects. The solution to this dilemma is to own both. If you did not submit Pfizer shares for the exchange you can now buy Zoetis on the NYSE. My rating on Zoetis is buy.

Rite Aid, NYSE, RAD, $2.85, has turned a corner. For the first fiscal quarter that ended June 1, 2013, Rite Aid reported its third consecutive profitable quarter. Profits in the quarter were $0.09 a share. Rite Aid has gained enough financial strength that it was able to refinance high cost debt. Taking advantage of low interest rates will save Rite Aid $85 million a year.

The stock had run up prior to the earnings news. It came back down along with the market and also because Rite Aid said first fiscal quarter revenues were 2.7% lower than a year ago. In addition, same store sales were off 2.5%. The sales decline is not alarming. If anything, the sales slump is good news. Sales were down for two good reasons. First, there was an increase in sales of generic drugs. They cost less, hence a sales decline. But they are more profitable. Second, Rite Aid is closing unprofitable stores.

Rite Aid, barring some broad economic catastrophe, is not at risk of going broke. However, it will take more time for the company to establish a solid, profitable base from which sales as well as profits can grow. I continue to rate Rite Aid a hold.

CLOSING THOUGHTS

There is a tax scandal far greater than the IRS's abuse of power for political purposes (the scandal the popular media focus on).

It is wrong - federal criminal laws may have been broken - but there is nothing new about the IRS being used for political purposes. President Nixon used the IRS to attack his enemies, just as the current administration has in attacking conservative organizations. This kind of abuse of power goes all the way back to Franklin Delano Roosevelt. Since neither the Congress nor any administration, Republican or Democrat, has managed to straighten out the IRS, it is doubtful that this scandal will lead to meaningful reform. More than likely, a few will be pensioned off and otherwise no one will really be held accountable. The IRS and its staff will remain ready to assist the next administration with political "enemies."

Using the IRS does work. Most Americans are not aware that our tax laws are a code, far different from the rest of our civil and criminal laws, which derive from English common law. The presumption of innocence is not included in the tax code. For example, in an audit, the IRS examiner looks at your checkbook and assumes that every deposit is taxable income. It's up to you to prove otherwise. Under the U.S. tax code you are guilty unless you can provide convincing evidence to the contrary. I have been through two IRS audits. At the end of each one my returns were accepted as filed, no fault was found. But, in both cases my life was turned upside down

for weeks. During the audit I spent all my time sifting through files, looking for documents and I spent thousands of dollars on accountant's fees to deal with the IRS questions. No wonder donors to political organizations worry about being audited. No one wants an IRS agent in their home or office for weeks, sifting through personal financial records.

What could be worse than the threat of an audit if you make a substantial contribution to the opposing politician or political party? As wrong as this abuse of power is, it has not had a major impact on the economy. Our tax structure, in particular how we tax corporations, *does* have a major economic impact. The bipartisan Congressional attack on Apple was the far greater scandal, with the potential of doing great harm to job creation, and therefore to the economy.

Attacking tax havens has been a U.S. practice for a long time. In the 1970s I managed Citibank's European money management business. Most was in Switzerland, where I lived and worked. Before the Swiss government would grant me a work permit, Citibank had to get a letter from the U.S. Comptroller of the Currency saying that I would be allowed to abide by Swiss laws. In those days the Swiss were very protective of Swiss bank secrecy. The U.S. and other countries did not like bank secrecy because taxpayers could hide money in Switzerland and avoid taxes back home. Of course, doing that was against the law and had severe penalties if discovered. Over the last several decades the Swiss and others have softened their position on secrecy. The U.S. and other high tax countries have, from time to time, offered amnesty to taxpayers with secret offshore accounts. As a practical matter, the use of secret offshore accounts by U.S. taxpayers has declined significantly. By the way, there is nothing illegal about having money in an offshore account, in Switzerland or anywhere else. That has always been completely legal. What is illegal is hiding the income and not reporting the existence of offshore accounts.

Sovereign nations enact their own tax laws and they differ widely from country to country. I recently spent a few days in Bermuda, a peaceful island, but under attack from U.S. authorities over tax laws. U.S. authorities label Bermuda a tax haven. At the root of the attack is the use of complex corporate structures by multinational companies - including Apple, Google and Amazon - to minimize their tax burden. Bermuda's Finance Minister Bob Richards is fighting back. He insists that Bermuda is not a tax haven.

Bermuda did not pass tax laws to benefit Google, Apple or any other corporation. Bermuda passed tax laws that are best for Bermuda.

There is no personal or corporate income tax in Bermuda. Why not? Because these are expensive taxes to administer, so Bermuda focuses on taxing employment and consumption. Bermuda has a payroll tax and imposes taxes on hotels and property. Bob Richards said it is impractical for Bermuda to change its tax laws to stop corporate profit shifting. It is the responsibility of other countries to tackle their own situations. He added: "Delaware applies less stringent reporting requirements on companies than some other US states and European countries. This has allowed Delaware to become a major center for corporate registration."

For its part, Bermuda has agreed to the automatic sharing of taxpayer information on beneficial ownership of companies registered there. That will uncover corporations that might be hiding, but does nothing to change the basic tax landscape.

It is outrageous that the U.S. and other developed countries are attacking smaller countries they call tax havens. They claim they are looking for their lost tax revenue. The truth is they might get more overall tax revenue by reforming their own tax laws to deal with the realities of the global tax landscape.

Apple was not accused of violating any U.S. tax law. But both Republicans and Democrats tried hard to intimidate Apple and make the company look like a tax scofflaw. CEO Tim Cook did a great job answering questions. He did not get angry or become accusatory; he simply stood his ground by saying that Apple fully complies with tax laws in every country in which it does business. Attacking Apple through Congressional hearings exposes the weakness in the current U.S. corporate tax position. Taxing corporations may fool voters who do not understand taxes, but it does not help investment or employment here at home. The overly complex U.S. corporate tax laws need to be simplified and the corporate tax rate brought down. That would help boost job creation and raise overall tax revenue for the folks in Washington.

John Chambers, CEO of Cisco Systems had this to say in a recent interview with CNBC: "I cannot repatriate the $47 billion. The U.S. tax system is broken. We have waited for four years for this almost $50 billion

that we have got overseas to come back. We are assuming that is not going to happen." He says Cisco will be making investments in different countries in coming years. "This is where tax policy can determine where you grow and where you don't." Cisco still has the majority of its employees in the United States, but for how much longer?

Next issue: The August issue of John Dessauer's Outlook will be ready on Wednesday August 7, 2013.

Next weekly hotline: Wednesday July 10, 2013

All the best,

John Dessauer
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