John Dessauer Investments, Inc.

John Dessauer's Outlook

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Stocks Will Keep Climbing and Jobs Will Keep Struggling

The Ukraine and Russia's heavy handed intervention rattled world stock markets, but not for long.

First, Russia's aggression in the Ukraine is not a surprise. Sara Palin talked about a potential Russian invasion of the Ukraine during the 2008 presidential elections. Second, the West has potent financial tools that could be used to punish Putin. Russians are deeply involved in world finance. The U.S. and Europe could ban a thousand or so individual Russians from entering their countries. Making Russian bankers, investors and businessmen stay home would inflict real hardship. Putin has been in office for 15 years. He knows just how far he can go without incurring real financial and political damage to himself and his colleagues. Do not sell stocks because of the turbulence in the Ukraine.

America's share of global trade has been declining because China has been growing so much faster. Pessimists focus on our loss of market share in global trade. They ignore the fact that America's role in world financial markets has been growing. Led by our Federal Reserve, global liquidity has recovered and the global economy is growing again. Because the recovery in jobs has lagged far behind the financial markets our Fed and other world central banks will keep stimulating growth through accommodative monetary policies. Stocks will keep climbing because profits will keep growing. Jobs will keep struggling until politicians and economists figure out how to get the U.S. job creation engine out of neutral.

To her credit, our new Federal Reserve Chair Janet Yellen is staying on the path her predecessor, Ben Bernanke, had been following. In more ordinary economic circumstances the Fed would start raising interest rates when the unemployment rate fell to 6.6%. Yellen, like Bernanke, finds the unemployment rate suspect, overstating the health of the job market. From its high at 10% in 2009, the unemployment rate has fallen to 6.6%. If that was all you knew, you would think the U.S. economic recovery has been very strong. The opposite has been the case. The unemployment rate has not fallen because of tremendous job creation; it has fallen because so many Americans have become so discouraged that they have dropped out of the labor market. Since the 2008 financial crisis and recession, the U.S. has not been creating enough new jobs. Before the crisis our economy was the envy of the world, creating millions of new, well paying jobs, quarter after quarter for several decades.

The dismal change in job creation has polarized politicians and economists. As long as the unemployment rate was above 7%, the question being debated was how to get businesses to invest and hire instead of hoarding cash and waiting. That debate led nowhere. All sorts of ideas - mostly good ones, such as tax reform for business profits - have remained debating points. There has been no pro-business action. Instead, businesses have continued to face headwinds from uncertain labor costs to new regulations and turbulence on world markets.

Since there has been so little progress on the job creation or demand side, attention has shifted to the supply side. Some economists now argue that the makeup of the labor force has changed, and that is why the unemployment rate has come down while millions are still out of work. There is no doubt that something has changed. In late 2007, 63% of Americans had jobs. That plunged to below 59% in 2009 and has barely changed since. Has America's labor supply become permanently stunted? At this time there is no good answer. We understand that the longer someone is out of work the more difficult it becomes to qualify for a job. Skills need to be kept up to date. We also know that claims for disability have skyrocketed since the recession began. Economists, especially those who tend to be supportive of the Obama administration, are claiming that yes, the U.S. labor market has changed permanently because of demographic factors. They point to the aging baby boomers and say they are tired of working, are taking early retirement and applying for disability. That is a very depressing position. If correct, it would mean the unemployment rate is telling the truth

- that the economy is very close to its full potential (defined as unemployment at 5.5%). If that were the case, if growth of 2%-3% were the best this economy could muster, then the Federal Reserve should start raising interest rates soon because inflation becomes a real risk when an economy reaches full potential. If correct, this would be bad news for stocks and bonds. Rising interest rates would depress bond prices and discourage stock buyers.

Fortunately, the Federal Reserve is not buying the idea that the U.S. labor market has permanently changed due to demographics. While neither former Chairman Bernanke nor the new Fed Chair Janet Yellen have come out and said this is political baloney - an attempt to excuse Obama administration policies for the lack of new jobs - both have been clear that they see the labor market still struggling and in need of help.

In her recent testimony before Congress, Janet Yellen talked about the weak economy, the weather, the proposed raise in the minimum wage, and tapering. She acknowledged that bad winter weather had taken a toll, but said there isn't enough evidence yet to be sure of the extent of that damage. She was not willing to promise a pause in tapering. She simply said that if the damage were severe the Fed would take the appropriate action. Keep in mind that there is a huge difference between tapering and actually tightening monetary policy. The Fed is on track to end the monthly bond buying this October. That will mean the end of expanding the Fed's balance sheet, but there is no talk of actually selling bonds to tighten monetary policy.

The Fed has determined that the nation's banks are in good shape and no longer need the extreme support from huge monthly bond purchases. Banks provide the foundation for the economy. However, there is a lot more to the economy than just the banks. The Fed can do just so much. The economy also needs support from government.

On the minimum wage front Yellen sided with the CBO (Congressional Budget Office) saying their assessment was as good as any. Yes, she said, a rise in the minimum wage would help those who presently have a job, but it would come at a cost to the overall labor market. Some conservatives have been drawn into the minimum wage debate, arguing that a higher minimum wage would encourage people to go back to work. According to that line of thinking, as long as the benefits from not working

are financially better than the wages from working, people will stay on the dole. Raise the minimum wage, and supposedly millions will go back to work. The obvious flaw in this thinking is that it assumes that there are jobs at the new higher minimum wage. All the evidence says there aren't enough jobs today at the lower minimum wage. The U.S. has a huge jobs deficit that cannot be cured by raising the minimum wage. At least our new Fed Chair Yellen understands this, even if some politicians don't.

(I have an idea. If the minimum wage is to be raised, why not apply it to workers that have been on the job for at least a year? Let businesses keep hiring at the lower wage for new employees. That might minimize the damage to the job market.)

The world economy today is very different. The U.S. role has changed. We used to dominate world trade; no longer. However, we still dominate in one major respect - financial markets.

Last year U.S. imports of goods were $2.3 trillion. That's a little more than 12% of world imports. In the late 1990s U.S. imports of goods accounted for almost 20% of world imports. China's imports now run at about $2 trillion, or 10% of world imports - not far behind the United States. Even more significant is that China's yearly imports have surged by more than $800 billion since the recession of 2008. It won't be long before China becomes the world's biggest importer. China is already the world's biggest *exporter*. China is Japan's and South Korea's biggest market for their exports. China is our third biggest market and our fastest growing market.

In 1980, after spending several years working in Switzerland, I began publishing my newsletter. The essential theme was that investors needed to start looking at the world beyond the United States. Things have changed. Investors now can easily invest in securities from countries all around the world. However, it seems that in one important respect many have not fully understood the extent of the changes. For example, many wonder how the U.S. stock market averages can be at all time highs while the economy has been lagging so far behind past recovery experience. They know that China has been growing rapidly. They readily lament U.S. failings, worry about the dollar, and complain bitterly about the loss of U.S. competitiveness. However, they also cling to the old days when the U.S. economy dominated the world economy. It was said that when the U.S. economy caught a cold, the rest of the world got pneumonia.

Jim O'Neill, former chairman of Goldman Sachs Asset Management, recently wrote: "You might be surprised how much of my 33 year career in the City of London was spent thinking about a single economic indicator: U.S. nonfarm payrolls." Economists, politicians, and especially investors had a lot hanging on the state of the U.S. economy. The U.S. labor market data were considered the best indicator of the underlying health of the U.S. economy.

Jim O'Neill's experience covers more than three decades. The U.S. domination of the global economy lasted for much longer than that, perhaps five or more decades. Old habits are hard to change. Knowing that the world has changed, and breaking away from reliance on the U.S. labor market are two very different things. Many economists, a whole lot of politicians and too many investors still cannot believe the world's stock market recovery is real and fundamentally justified. In their minds it is not possible for there to be such a huge disconnect between stocks at record highs and U.S. labor market data stuck at or near recession lows.

The explanation is that the U.S. labor market data by themselves are no longer a useful indicator for investors. U.S. labor market data is now just one point among many others that economists and investors need to take note of. Jim O'Neill says: "By 2021, will traders and dealers around the globe be setting their alarms for China's labor statistics? They should probably be doing it already."

U.S. financial markets are still the largest, most liquid and most influential. That is why emerging market currencies convulsed when the U.S. Fed began tapering.

The government was slow to respond to the financial crisis and recession. There were political concerns about bailing out failing institutions. Politicians could not agree on the best way to help the economy and start creating more jobs. In many respects, Washington is still gridlocked on these issues. Our Federal Reserve did not hesitate. Under Ben Bernanke's leadership, the Fed took unprecedented steps to prevent the banking system and the economy from collapse. He has been sharply criticized for expanding the Fed's balance sheet to more than $4 trillion. The sharpest criticism came from pessimists who were absolutely certain that was going to result in a burst of destructive inflation. They see inflation as

too much money chasing too few goods. Adding $4 trillion to a $10-$12 trillion economy was, in their opinions, clearly too much money. The economy could not possibly produce enough goods to satisfy that huge monetary supply. They have been wrong. Instead of rising inflation, we have seen inflation rates stay below the Fed's tolerance level of 2%. Adding all that liquidity simply countered the downward pull of deflation.

Inflation hawks have not given up. They have watched the Fed add $85 billion a month for four years without an inflation problem, but refuse to give up their too much money idea. The inflation hawks now mutter that it is only a matter of time. Inflation is inevitable they say. On that last point they probably are correct. But, the inevitability does not flow from the Fed's dramatic actions to halt the downward pull of the recession. The liquidity that has been added will eventually be withdrawn. Inflation remains a core challenge because of the basic economic cycle. At some point the U.S. and/or the global economies will reach full potential. That is a point beyond which an economy cannot expand without encountering an inflation challenge. However, all the evidence says the U.S. and global economies are still running at levels well below their potential and that is why unemployment rather than inflation has remained the major issue.

Inflation worries have not been confined to the United States. Bernanke's bold moves upset other central bankers. They too were concerned that such a huge increase in liquidity would do more harm than good. Central bankers in Europe, for example, did not rush to follow our Fed. They were slow to address the mountains of bad loans at banks in Europe, and even slower to take bold measures to stimulate an economic recovery. That is the primary reason Europe's economic recovery has lagged so far behind the lackluster U.S. recovery. Of course the euro structure - with more than a dozen different fiscal policies and a complex banking system – was a contributing factor. After it became clear that the Bernanke Fed's bold moves were not stoking the fires of inflation, and instead were showing positive economic results, Europe's central bankers took notice and began to follow. While they have not exactly duplicated our Fed, they have moved in the same direction – adding liquidity by buying debt from Europe's banks. The result has been a long awaited turn for the better, real economic growth, albeit quite slow, but growth instead of recession.

What we learned in January when a mini panic erupted on emerging market currency and stock markets is that the U.S. is still number one when

it comes to financial markets. We may have slipped in terms of trade. We may be bucking political fiscal headwinds, but thanks to our Federal Reserve we still dominate world financial markets. Currency traders were frightened by news that our Fed was reducing the monthly bond buying. They thought U.S. interest rates would rise and the dollar would gain strength. They rushed to sell emerging market currencies and buy U.S. dollars. That in turn frightened stock market investors. They remembered the crisis of the late 1990s, when currencies collapsed and capital outflows crushed emerging market banks, triggering a full blown stock market panic. Such is the influence of our Fed. A minor move at home can result in financial turbulence in markets far away. The good news is that former Fed Chairman Bernanke is right - the Fed can taper without causing a damaging rise in interest rates. Currency traders are learning that lesson now. Capital outflows from emerging markets have not gathered momentum. Currencies in that region have stabilized. Emerging stock markets will soon recover.

Jim O'Neill laments "that financial markets and economic realities are out of kilter." He is right, but the solution is not to rein in the Federal Reserve. The solution is fiscal policy reforms that stimulate investment and job creation. Janet Yellen in her recent comments before Congress said something truly significant. She said that hopefully the Fed will do no harm. If only the political egos in Congress would be so humble and realistic. She at least recognizes the risks in government activity, even at her own Federal Reserve. She understands the importance of staying on alert to make sure that well intentioned, well thought out policies do not cause unintended harm.

What this all means for investors is that we can thank our Federal Reserve, not for pumping up stock prices - they did not do that - but for taking bold action that avoided depression and established a basis for a recovery, such as it is. The slow growth recovery has been good enough for businesses to grow profits, strengthen balance sheets and reward shareholders. We can expect more of the same from Janet Yellen's Fed. Stocks remain the best choice for income and capital gains.

COMPANY NEWS AND VIEWS

Home Depot, NYSE, HD, $82.45, suffered from the record setting bad weather in the northern half of the United States, but delivered fourth

quarter results that matched expectations. Operating income dropped 1%, but thanks to stock buybacks, earnings per share rose 7.3% to $0.73. For the full 2014 fiscal year Home Depot earned $3.76 a share, up 25% from last year. Management said the board has authorized a 21% increase in the dividend to $0.47 per share per quarter, for a 2.3% annual yield. For this year, management expects earnings to rise 16% to $4.38 a share. Home Depot is a well managed company with a solid track record, and above average prospects for future growth. My advice is to buy Home Depot on any temporary pullback to less than $80.

Kraft Foods Group, NASDAQ, KRFT, $55.30, reported fourth quarter earnings per share of $1.55, far above any analyst's prediction. However, pension adjustments accounted for most of the earnings. Management did not provide earnings excluding those special accounting items. Analysts did their own math and concluded that adjusted fourth quarter earnings were $0.43 a share, far below their expectations. For all of 2013, management did provide adjusted earnings - they were $2.61 a share. That too was below expectations. On February 22, after the earnings announcement, S&P Capital raised their rating on Kraft to Buy from Hold with a $61 stock price target. S&P Capital's analysts expect 2014 operating earnings of $3.20 a share. After looking closely at the fourth quarter 2013 results, I am concerned that the analysts at S&P Capital may be too optimistic. The $2.10 annual dividend provides a current yield of 3.8%, which is attractive. I would buy more Kraft if the stock temporarily fell below $50.

Lowe's, NYSE, LOW, $50.60, reported a stronger than expected fourth quarter, and the stock moved up about 5%. For the final quarter, adjusted earnings per share were $0.31, which matched analysts' expectations. The surprise was that net sales in the fourth quarter were up 5.6%. **Home Depot** reported a 3% sales decline in the quarter. It was a rough quarter because of the winter storms that closed airports and disrupted sales for most retailers. Lowe's new distribution centers and product delivery methods paid off. The quarter provides strong evidence that Lowe's is closing the gap with Home Depot. Management added $5 billion to the stock buyback program. That is almost 10% of shares outstanding. For this fiscal year management says earnings will be $2.60 a share, up 21%. That is an impressive gain, fueled by the combination of sales growth and stock buybacks. The $0.72 a share annual dividend provides a current yield of 1.4%. The housing recovery is here to stay, making Lowe's a very attractive

long term investment. However, after the recent 5% jump, the best strategy is to be patient and wait for a pull back. Buy Lowe's below $50.

Mondelez, NASDAQ, MDLZ, $34.00, reported fourth quarter and full year 2013 results that were slightly below analysts' expectations. Fourth quarter earnings were $0.42 a share. Full year results were $1.51 a share. Mondelez was previously known as Kraft Foods, Inc. The American grocery business has been spun off and operates under the name Kraft Food Group. Mondelez is supposed to be the growth part of the business, with 80% of sales outside the United States. While the quarterly results were disappointing, there were some signs of growth. Fourth quarter 2013 earnings grew 15.8% on a constant currency basis. Full year 2013 results were up 13.5%. For this year, management expects earnings on a constant currency basis to be $1.73-$1.78 a share, up 16% from 2013. Emerging market turbulence hurt Mondelez in both sales and earnings in 2013. However, emerging markets still offer above average long term opportunities for growth. Growth is the reason for owning Mondelez. The dividend yield is only1.6% and the $0.14 per share quarterly dividend was maintained for the current quarter. Activist investor Nelson Peltz has joined the board and is pushing for more aggressive cost reductions. Odds are that Mondelez will begin to demonstrate its long term potential this year. My advice is to buy Mondelez below $30.

CLOSING THOUGHTS

There is a book in my office titled *Triumph of the Optimists*. I often think there should be a companion book titled *Persistence of the Pessimists*.

In 1980 I began writing my newsletter. I had the naive notion that providing information about international markets would be a best seller. It took years before my letter became profitable. During those early years I watched other writers, all pessimists, make fortunes predicting calamities that never happened. When a real market calamity came along, such as the plunge in the gold price in the 1980s, it was a surprise and not on the pessimists' list. Ever since, I have been fascinated by the persistence, or should I say the endurance, of pessimism. Over the years, the reasons for being pessimistic change, but the attitude and conviction that horrible things are coming endures.

Today's most popular idea is Global Warming - that we are killing ourselves and the earth with manmade carbon dioxide emissions. Will this turn out to be any more accurate than the population explosion and famine forecasts of the 1960s? Or more accurate than the "Limits to Growth" and oil shortage ideas of the 1970s and 1980s? As in the past, there are scientists on both sides. Richard Lindzen is a professor at MIT. His reaction to global warming is to say: "So what." More specifically he says "the earth is not especially sensitive to greenhouse gases because clouds will react to counter them." He has identified a specific mechanism. "On a warming planet, less coverage by high clouds in the tropics will allow more heat to escape to space, countering the temperature increase." Of course he is ignored by the media, gets none of the millions from government agencies to study warming, and is shunned by many other scientists. This is not a new phenomenon.

In 1968 Paul Ehrlich wrote a best seller titled *The Population Bomb*. He predicted famines and disease would spread over the earth by 1980. He claimed it was already too late to prevent the famines that would sweep both the developing and developed worlds. Julian Simon, a professor of business, also became concerned about overpopulation. He discovered that population growth and economic growth went together, and that there was no evidence of food shortages. The world's population, he found, was rising because fewer children were dying, and life expectancy was increasing - *good* things, not bad. Simon (I can resonate with his feelings) became irritated that Paul Ehrlich was making a fortune with his pessimistic predictions. Simon challenged Ehrlich to a bet. Simon said choose any five commodities and then watch their prices over ten years. They agreed on $1,000 worth of five metals Ehrlich selected. In 1990 Simon won the bet and Ehrlich sent him a check for $576. By then none of Ehrlich's apocalyptic predictions had come true. The "inevitable" famine of 1980 was a false fantasy - it didn't happen. Julian Simon was right. However, after winning the bet and being proven right, do you think Julian Simon was awarded the MacArthur "genius" grant? No, it was Paul Ehrlich who was declared the "genius." He also won many other distinguished awards and was lauded as the best of the environmental prophets.

Julian Simon did not make a fortune and was largely ignored by the media and the scientific community. However, he did continue his work and enjoyed a successful career. In 1984 he collaborated on a book called *The*

Resourceful Earth. In it he argued that short-term crises create incentives to innovate, and that the history of the last two centuries showed a constant improvement of material standards, access to resources, health, longevity and quality of life. Thank you Julian Simon. Those positive trends he observed three decades ago are still in place. Despite financial crises, recessions and persistent pessimism, poverty is declining, quality of life is improving, and the future looks as good as it ever has.

As investors we should stay on the side of the optimists. The book *The Triumph of the Optimists* is about wealth and stock markets in particular. Odd are that Global Warming alarms will be no more correct than "The Population Bomb" or "The Limits to Growth." Calmer researchers like Professor Lindzen are likely the Julian Simons of our time.

P.S. For more about Julian Simon, Paul Ehrlich and Global Warming, read *The Bet* by Paul Sabin.

Final note: I booked the trips before the political turbulence made headlines. Now I am glad I did. On April 3 I will fly to Bangkok. After a few days in the city I will take a cruise that stops in several ports in Thailand. I hope to get a first hand view of the political situation in that now divided country. In August I will take another cruise - around the Black Sea, with stops in ports in the Ukraine and Russia, including Sochi. Of course, I will let you know what I see and learn during these trips.

Next issue: The April issue of *John Dessauer's Outlook* will be ready on Wednesday April 2, 2014.

Next weekly market review and update: Wednesday March 12, 2014

All the best,
John Dessauer

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