John Dessauer Investments, Inc.

John Dessauer's Outlook

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Stocks, Politics, and the Current Limits to Growth

Slow growth has been the norm throughout this recovery. The negatives are obvious: millions without a good job, millions laboring at jobs below their skill level, and millions more on the sidelines with no job at all. The positive is that with slow growth it takes a long time for the usual cycle-ending conditions - inflation and high interest rates - to develop. Business has shown its ability to grow profits faster than the underlying rate of economic growth. The opening quarter of this year shows that continues to be the case. The bottom line is that profits and stock prices are likely to keep growing this year and next, perhaps longer.

Decades ago the Club of Rome and a gaggle of pessimists declared there were physical limits to economic growth. Chief among their list was energy. Supposedly we were close to exhausting the world's supply of oil and natural gas. We now know that was completely wrong. If anything, there is a developing global glut of oil and gas. Next on their list was starvation. They calculated the world's population was growing so fast that supplies of food could not keep up. That too turned out to be completely false. These forecasting failures do not mean there are no limits to growth. There are, but the source is human rather than nature. Russia's brutal annexation of the Crimea and ugly threats against the rest of the Ukraine is a current clear example.

Vladimir Putin has used military power to grab valuable assets in the Ukraine. In response, the United States is threatening sanctions. Governments in Europe like that idea. Sanctions might actually work, not because they are by themselves effective, but because they would come on top of brutal free market responses to Putin's aggression. Badly needed

capital has been flowing out of Russia. That has driven Russia's currency, the ruble, down, forcing the central bank to raise interest rates. S&P has cut the rating on Russian debt to one notch above junk. Inflation is rising as the cost of imports is driven higher by the falling ruble. Russia's economy is slowing and economists are reducing their expectations. Putin's power grab may look like a good idea on paper, but it is turning out to be a huge mistake for Russia's economy. Russia has plenty of natural resources. Given an accommodative political climate, Russia could enjoy the benefits of robust economic growth. Instead, the economy faces severe limits on growth imposed by political ambition and military aggression. This sort of limit to growth was not part of the thesis for the Club of Rome's work. They relied on false, or at least premature, ideas about the limits of natural resources. Where the club of Rome went terribly wrong is not just underestimating the size of the earth's pool of natural resources; it was ignoring the greatest of all of earth's resources - people. Humans have imaginations, ambitions and the ability to adapt. We are innovators, designers and organizers. Optimists countered the Club of Rome with tales of how people adapt and often overcome what may seem like insurmountable natural barriers. We have been to the moon and back. We can fly and communicate over long distances instantly. Where the optimists went wrong was in not recognizing the human ability to impose unnecessary limits on growth that are against their own basic interests. Russia may be the clearest current example of that at work, but other countries are not innocent.

The United States

If there was any doubt the United States has imposed unnecessary limits to economic growth the recent data on growth in 2013 and the opening quarter of this year settles the issue. The recession officially ended in June 2009. Historically the U.S. economy has bounced back and delivered robust growth within two, three at the most, years. Not this time. The growth rate in 2013 was an anemic 1.9%. The opening quarter of this year was worse. The economy barely budged with an annual growth rate of 0.1%. And that looks like a statistical conclusion. An annual rate of 0.1% is about the same as saying the growth in the quarter was zero. Yes, it was a brutal winter. But we have been through tough winters before and not seen the economy stop growing. I lived in New England for twenty years. There were two or three winters that were brutal and seemed to never end with heavy snow all the way into April. But the economy did not stall. Government supporters can say all they want about the weather, but it is obvious that the main reason for

no growth in the first quarter is that the economy was limping along all through 2013.

Apologists argue that this recovery is especially difficult because the 2008 financial crisis resulted in an unusually deep and difficult recession. They obviously did not live through the 1970s and the brutal recession of the early 1980s. Every recession is different from others. That is because we make changes after each deep recession in hopes of preventing the next. Being different however, does not explain why this recovery has been so weak. I say that because this time we have in place all sorts of new conditions, especially new technologies, that should not only overcome the difficulties, but make the recovery stronger than others in the past. In addition, businesses have been gaining strength financially.

Until the recession of 2008 the United States was the envy of the world when it comes to creating new well-paying jobs. We are creating jobs, but the rate is well below past recoveries and there are far too many low wage and temporary jobs in the mix. The April jobs number was cheered. The U.S. added 288,000 new jobs last month. But the cheering was subdued because average hourly earnings were flat and the length of the workweek held steady at 34.5 hours. The official unemployment rate fell to 6.3%, but that was partly, if not mostly, due to 806,000 Americans dropping out of the labor force. Before 2008, our labor force was steadily growing and the unemployment rate stayed low because we were creating plenty of good, well-paying new jobs. Somehow our enviable job creating ability has been stunted.

With little in the way of hard economic data to support claims of success following the recession of 2008, some point to the stock market and talk about that amazing recovery. Stocks have finally recovered. But more than five years after the recession, the Dow Jones Industrial Average is just now inching above its old high. Five years after the recession of 1982 the Dow Jones Industrial Average was 2.7 times its pre recession high. The Dow climbed from a 1980 high of 1,000 to a 1987 high of 2,722. To match that the Dow Jones Industrial Average today would need to be above 40,000. This brief look back shows the stock market has also been held back by the sluggish recovery and the barriers to growth.

Don’t blame the Fed

Shortly after taking the reins, Chair Janet Yellen said the Fed's first concern is to "do no harm." If only the executive and legislative branches of government had the same principle. The Fed has applied innovative ideas to provide the banking system and economy overall with badly needed liquidity following the financial crisis of 2008. But at every turn, the potential of harmful, unintended consequences was considered. Thanks to those efforts, our banking system dealt with mountains of bad loans and not only survived, but recovered. Our banking system today is well capitalized and profitable. The executive and legislative branches on the other hand have been focused on health insurance reform, climate change, balancing the budget and debt reduction, without regard for unintended consequences. As a result, the economy and millions of Americans are needlessly suffering.

The Good News

Thanks to the Fed's efforts, our nation's banks are making more loans to businesses and consumers. Liquidity that has been bottled up in bank accounts at the Fed is slowly making its way into the broad economy. Now that spring has sprung we are likely to see GDP growth increase. Whether or not we make it to a 4% rate remains to be seen. However, growth between 2% and 3% in the next few quarters is a reasonable expectation. While that is good news, the better news is that the long, slow recovery leaves lots of room for improvement. It will likely be several years before growth picks up enough - or the cumulative benefits of a long period of slow growth run their cyclical course - and we begin to see rising inflation and significantly higher interest rates. Pessimists talk about the "Bull stock market" being old, long in the tooth and ready for a decline. That ignores basic cyclical forces. Stock markets are driven primarily by earnings. Earnings are growing, but slowly. That dampens investor expectations and keeps stock prices in reasonable bounds. When will this stock market run come to its cyclical end? While anything can happen in the short run, it will take time - a lot of time - to develop the fundamentals for a stock market peak and decline.

The Risk

The greatest long term risk for investors is an economic setback large enough to tip the U.S. economy back into recession. With growth so anemic that might seem like a big risk. Actually, a new recession is highly unlikely any time soon. The Fed is ready and able to provide more stimulus if needed. And recession is a politician's greatest fear. Washington is on hold

with the election coming this fall, and will remain recession-scared until at least 2016. The economy has survived all the Washington political spitballs and kept growing. That tells us there is at least enough underlying strength to keep growth alive for the coming year or more.

Europe

Russia is not the only example of politicians obstructing opportunities for economic growth. Much of Europe has suffered under populist political ideas from France's 35 hour work week to Germany's extensive union involvement in managing businesses. Unemployment was high and growth was low in Europe before the 2008 financial crisis. The world-wide recession took an enormous toll on the economies of Europe. We know about the suffering in Greece and the punishing high interest rates that threatened economies like Italy, Portugal, Spain and Ireland. What is not so well known is that in spite of high government debts, oppressive tax rates and still high unemployment a recovery took hold in Europe last spring and looks to be gaining strength. Germany is the primary growth engine for the euro region, but growth, albeit slow, has expanded to Italy and Spain. The peripheral euro economies are definitely being helped by lower interest rates. Here is news that may seem unbelievable. Interest rates on Irish debt have fallen to the lowest level since the euro started 15 years ago. And the euro region has a new member. Latvia joined in January.

Challenges remain for the euro region. Prices are falling. Japanese style deflation is the chief concern. The strengthening euro versus the U.S. dollar does not help. A stronger euro makes imports cheaper, putting downward pressure on prices and makes exports more expensive slowing growth in that sector. However, the euro central bank has room to provide more stimulus through lower interest rates and bond buying. Odds are the euro central bank, like the U.S. Federal Reserve, will do all it can to keep growth alive and well. Europe is no longer a drag on the global economy.

Emerging Markets

There is a lot of media coverage and investor chatter about emerging markets. It is widely accepted that there are more investment opportunities in emerging markets than in developed markets. While these assumptions are basically correct, it is still important to keep emerging markets in perspective. The two largest emerging markets by population and GDP are

China and India. China has grown to become the world's second largest economy with a GDP of $8.23 trillion. India has passed Japan to become the world's third largest economy, but is far behind China at $1.87 trillion. The United States, by comparison, is still the world's largest economy with a GDP of approaching $16 trillion. Size is obviously important. China is growing much faster than the United States. If the two growth trends were to continue China would become the world's largest economy in slightly more than a decade. That frightens politicians in Europe and the United States. It also frightens economists who don't know what such a huge change would mean for the global economy.

Several years ago I visited a manufacturing plant in Pudong, just across the river from Shanghai. I brought up the fear that China would one day overtake the United States. The company's CEO laughed. He said China is, and for at least 50 years will be far behind the United States because China has so many more mouths to feed. He is right. According to data from the IMF (International Monetary Fund), China's GDP per capita was $9,844 in 2011, far behind the U.S. with $53,101. This shows not only how much further China has to go to reach living standards now enjoyed by Americans, it also shows why the Chinese economy can keep growing at a fast pace. Size can be a limit to growth. Size is a major reason the U.S. economy does not grow at a rate approaching China's. However, when it comes to economic activity, people are the best measure. At $9.844 per person, China can keep growing at a 7% or better rate for a lot longer.

India, being far behind China in both size and GDP per capita, has an even greater opportunity for growth, but at the moment is not reaching its potential. India's economy is growing at an annual rate of 4.7%. That is less than it looks because of an 8% inflation rate. The parliamentary election process will conclude on May 16. Hopefully the new government will focus on India's economic needs, build roads, improve water and sewage, cut back military spending, and reduce corruption. Time will tell, but my recent trip to India has convinced me that India is already on the way to improving its economy, increasing the growth rate and bringing down inflation. It may be another trickledown effect from China's success. India has had a good educational system. Many people are well educated and speak good English. They are well aware of China's economic successes and believe strongly that India can do the same. India is not suddenly going to start growing at a 7% real rate. There is too much basic infrastructure foundation lacking for

that to happen. But change is happening and India's growth rate is likely to rise and inflation is likely to come down.

In the 1990s on one of my early trips to China, I flew from Hong Kong to Hangzhou. After landing I looked out the window. The taxiway was lined with neat piles of bombs and other ordinance as well as Chinese fighter planes. The airport obviously was a military facility being converted to commercial use. China had lots of military airports, which made developing a nationwide commercial air traffic system much easier. Last month I flew from Goa in India to Delhi. Goa has been a military airport and it is just now being fully opened for commercial traffic. India, like China, has lots of military facilities that can be opened or converted to commercial use. With this comparison I don't mean to imply that India's path to faster economic growth will be quick or easy. I simply want to show that it is possible.

Bumps in the Road

Growth, even in emerging markets, is never a smooth, continuous process. There have been and still are major challenges for all emerging markets. China's economy is going through yet another transition. The biggest current transition is away from export dependence toward domestic growth. China has created a huge middle class, one that will keep growing for many years. The downside is that as wages rise in China, it becomes cheaper to make things elsewhere, causing jobs to leave China. I saw that in Malaysia. Malaysia is enjoying an increase in manufacturing jobs because wages are lower than in China. That puts pressure on China to create higher paying jobs to make up for those that are lost to lower labor cost countries. In India the current challenge is to bring inflation down without killing economic growth. Critics always say that these challenges are economy killers. I have heard that ever since the 1990s. I saw popular books in store windows in Hong Kong ten and fifteen years ago claiming that China's economy was about to implode. China has survived the past challenges and continued to grow. China has also become an economic model for others, especially India. Over the last several decades the economies of the Pacific Rim have developed. Growth in the region, led by China, is now self-sustaining.

The **Vanguard Emerging Markets EFT, NYSE, VWO, $41.24** has reflected the volatility in emerging market stock prices over the last year. The stock price was about $44 a year ago. It fell to $36 and has now largely

recovered. During the year Vanguard made a major change, dropping South Korea and increasing holdings in other markets. Vanguard management decided that South Korea was now a developed market. After visiting Thailand, Malaysia and India I agree with Vanguard. When you compare the economy of Malaysia with South Korea, the latter looks very developed. I regard this fund as more attractive than before and rate the shares as a buy.

NEWS AND VIEWS ON OUR COMPANIES

First quarter earnings reports have been mostly better than expected, showing that businesses continue to grow sales and profits at rates better than the underlying economy. There also has been some exciting news. Take a look at General Electric, Pfizer (in Closing Thoughts) and Bank of America.

Bank of America, NYSE, BAC, $15.25, reported first quarter results that looked good. There was a small loss of $0.05 a share, but earnings from operations were $0.35 a share, well above last year's $0.10 a share. The stock moved higher after that news. However, in the closing days of last month, BAC fell sharply on news of a capital adjustment. The issue has to do with cumulative losses on structured notes at Merrill Lynch that matured or were redeemed before Bank of America bought Merrill. This is all about very complicated Bank accounting and new, overly severe bank regulations including Dodd Frank. To its credit, Bank of America's management found the mistake and took immediate action. The effect of correcting the mistake is to reduce Bank of America's tier-1 capital to $130.1 billion from $134.2 billion. That is still 9% of common equity, better than the 8.5% required under the latest international Basel committee rules.

Bank of America was planning on raising the dividend and allocating $4 billion for share buybacks. Both were immediately suspended following discovery of the error. The share buyback plans are most likely gone for now. However, the dividend increase is still being pursued by management. Bank of America earned more than $10 billion last year. The dividend proposal is for $1.68 billion. Bank of America has to re-submit its calculations for the Fed's stress test. The dividend increase is likely to be in the resubmission.

The decline in the stock is an overreaction to an accounting issue. Bank of America is on track to deliver consistent growth in profits. My advice is to buy Bank of America below $16.

General Electric, NYSE, GE, $26.68, reported a strong first quarter. Earnings per share were $0.33, a penny better than analysts expected. The quarter was down from last year, but that was because GE sold NBC. Oil and Gas related revenues were up 7%. Industrial revenue was up 8%. GE is successfully transforming its business to focus on higher growth industrial products and services. Finance is shrinking and media (NBC) is gone. Now GE wants to increase its industrial base by acquiring France's Alstom, a maker of railroad equipment and engines for a wide variety of products. GE has plenty of cash outside the United States. It makes sense to invest that cash overseas rather than subjecting it to high U.S. taxes. The problem is Siemens also wants to acquire Alstom and has a competing offer. The French government says it will not object to a GE acquisition. Hopefully, GE's offer will prevail. In any case GE is an attractive long term investment. My advice is to buy GE below $25. My twelve month stock price target is $30.

Nokia, NYSE. NOK, $7.35, has completed the sale of its mobile device business to Microsoft and received the $7.5 billion cash payment. Management has initiated a $6.9 billion capital restructuring program. That includes a $1.725 billion stock buyback program and a $0.36 per share special dividend. The balance will be used to pay down debt. Nokia also reported quarterly results for the remaining continuing operations. Earnings, excluding special items, were $0.06 a share, well ahead of the $0.04 analysts expected. Revenues on the other hand fell short of expectations. Nokia gets high marks for completing the sale, but some analysts are waiting to see more results from the continuing operations. Nokia is now a mobile network infrastructure company. The first quarter was encouraging. S&P Capital rates Nokia a buy with a 2014 earnings estimate of $0.37 a share and a $9.50 stock price target. I am on the side of those who want to see more results. I rate Nokia as a hold.

Pepsico, NYSE, PEP, $85.52, delivered an outstanding opening quarter of 2014. Earnings per share were $0.83, $0.08 better than analysts' calculations. Sales were $12.62 billion, also beating analysts' expectations which were $12.40 billion. The excellent results came in the face of currency headwinds, challenges in emerging markets, and investments in

marketing programs. Management is delivering on profit margin and organic revenue goals. For all of 2014 Argus Research estimates earnings at $4.55 a share. S&P Capital has an estimate of $4.54 a share. There is a bigger difference in stock price expectations. Argus looks for a stock price of $98 while S&P more modestly looks for $89. The $2.62 a share dividend provides a current yield of 3%. Pepsico is likely to raise the dividend in years to come. I expect Pepsico's stock will reach $100 and the dividend will likely be raised to $2.70 a share. However, it may take two years to reach those goals. I would buy Pepsico below $85.

CLOSING THOUGHTS

If it weren't clear before, it should be after the news on first quarter U.S. economic growth. The U.S economy barely budged in the first quarter. The U.S. economy needs all the help it can get. The high U.S. corporate income tax rates are keeping almost $2 trillion in needed investment capital bottled up abroad. Perhaps the Pfizer move to acquire U.K.'s AstraZenica will be a political wake-up call.

The United States is alone among developed economies when it comes to income taxes. Our taxes are based on citizenship for individuals. Other countries use residence as the basis for income taxes. Sean Connery, for example, lives in Nassau where taxes are low and therefore he does not have to pay the high income taxes in the U.K. The situation in the U.S. is even worse for corporations. They are taxed in the U.S. on profits worldwide. The U.S. tax is due and payable when the money is brought back to the United States. In Pfizer's case the combination of state and federal taxes impose a 40% marginal tax rate. Imagine, New York State collects taxes from Pfizer on profits earned in India, China and elsewhere when the cash is brought back to the United States. That may make sense to New York politicians, but looked at in the context of global competition it is downright silly.

Accountants at KPMG surveyed more than 130 countries, looking at corporate tax rates. They found one jurisdiction with a tax rate higher than the United States - the United Arab Emirates (UAE). The top corporate rate there is 55%, but that applies only to foreign oil companies. So that is not really a tax at all. The UAE is using their tax code as a trade barrier to keep competing oil companies away from their domestic oil and gas fields.

Therefore, as a practical matter, the United States has the highest corporate tax rate. And, intended or not, it too acts as a barrier, blocking the return of profits earned overseas. It also acts as an incentive for American companies to find ways of neutralizing high U.S. corporate taxes. Pfizer is an American company, but has more than 70% of its cash - or $35 billion - in accounts overseas. Bringing that cash back to the United States would mean paying those high U.S. income taxes. It makes more sense to invest the cash overseas where the full amount can be invested in attractive opportunities.

While there are solid business reasons for Pfizer to acquire AstraZenica, there also are significant tax advantages that would follow after the acquisition. Pfizer's Chairman and CEO, Ian Read, emphasized that "improved growth prospects" were the "primary drivers" behind the proposed merger. After **Pfizer's, NYSE, PFE, $30.35,** first quarter results, the proposed acquisition looks even more attractive on a business basis. Excluding special items, Pfizer earned $0.57 a share in the opening quarter. While that was $0.02 better than analysts expected, revenues at $11.35 billion were well short of the $12.08 expected. Pfizer is still struggling with stiff competition from generics. Merging with AstraZenica would improve future growth prospects. For all of 2014 management says earnings will be between $2.20 and $2.30 a share. At less than 15 times current earnings Pfizer's stock is attractive without AstraZenica. I rate the stock as a buy and hope the AstraZenica deal can be completed at a reasonable price.

Coming back to the AstraZenica deal details, CEO Read also said the deal would be "structured to achieve an efficient tax structure." He pointed out the "negative impact" of the U.S. tax code, which would be "problematical" if applied to the money AstraZenica now earns in the UK.

Pfizer's CEO plans on domiciling the combined holding company in the UK, where the marginal corporate tax rate is 21%, far less than the 40% in the United States. In public documents he said over the last twelve months Pfizer paid $4.3 billion in income taxes. No wonder taxes are an issue for Pfizer's management. Pfizer would keep its headquarters in New York.

The Pfizer case shows that shareholders and the U.S. economy are paying a high price under the current U.S. tax code. The President and his supporters argue that if the tax were reduced, companies would use the money to pay dividends or invest rather than creating jobs. They cite statistics to show that in the past, only part of the tax reduction benefits came

back as new jobs. That sort of myopic thinking is destructive. Bring the cash back. Let it benefit Americans any way that corporate managements think best. Paying dividends enriches American shareholders and boosts income tax collections. And to the extent the cash creates jobs we are all better off. This economy needs all the new jobs we can get.

Pfizer is not alone. Scores of American companies are sitting on cash in overseas accounts. If our politicians continue to refuse to reform our corporate income tax code, then more and more companies will use their cash to invest overseas to the benefit of other economies. While that is not all bad, you would expect U.S. politicians to put American interests first. Hopefully the Pfizer deal will startle stubborn politicians and start the process of serious U.S. corporate tax reform.

Next issue: The June issue of *John Dessauer's Outlook* will be ready on Wednesday June 4, 2014.

Next weekly hotline: Wednesday May 14, 2014

All the best,

John Dessauer
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