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John Dessauer's Outlook

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The Sluggish Economy has been good for stocks, So Far. But, Real improvement is desperately needed

Special note: Fears of a government shutdown are overblown.

As Washington politicians once again fight over the federal budget and national debt ceiling, some economists are sounding an alarm, claiming that a federal government shutdown could trim 1.4% off the expected 2.4% fourth quarter growth rate. However, that is not likely to be the case. As one economist said, this is a political and not an economic maelstrom. Between 1977 and 1996 there have been 17 government shutdowns. In 1995 the government was shut down for five days. In 1996 as Newt Gingrich and President Bill Clinton continued to battle over the budget, the government was shut down from Dec 16 to January 6. Those back-to-back government shutdowns trimmed only 0.25% off the U.S. economic growth rate. And, the GDP loss was almost entirely due to federal employees being furloughed.

The idea of a government shutdown might scare investors, but history says stocks largely ignore the political turbulence. The average decline in the Standard & Poor's 500 stock index during government shutdowns of ten days or longer is a scant 2.5%. For shutdowns of five days or less the average decline is 1.4%.

History also tells us that shutting down the government does not stop the red ink or growth in the national debt. There were three consecutive government shutdowns during the Carter administration - 1977, 1978 and 1979. The national debt continued to grow after each shutdown and has continued to grow ever since. There has been only one year since 1976 when

the national debt declined - that was the final year of the Clinton administration and had nothing to do with a shutdown.

There is another lesson from the history of government shutdowns: In almost every case both sides lost political capital. Voters from all political affiliations understand that shutting down the government does nothing to help the fiscal mess in Washington.

Stocks are up and the debate over valuation goes on. One side says stocks are too highly priced. The other side says no, they are not. But neither side says stocks are bargains. Are stock heavy portfolios at great risk? Not likely. More likely, stocks will trade in a narrow range as underlying fundamentals continue to improve.

Yale professor Robert Shiller’s long term, cyclically-adjusted price to earnings ratio says stocks at 23.5 time earnings are far above their long term median valuation of 16. Pessimists use Shiller’s work to argue that stocks are headed for a steep decline. They point to Shiller’s analysis and argue that after almost five years of appreciation, stocks are overdue for a significant correction. University of Pennsylvania’s professor Jeremy Siegel says the Shiller data is distorted because of 1990s accounting changes and their impact during recessions. He says if you use NIPA (National Income and Product Accounts) earnings data instead of S&P 500 data, stocks are not overvalued. Morningstar has now waded into the debate with their valuation model. They find that the recent gains in the S&P 500 stocks have closed their valuation gap, which now stands at 102%, indicating mild overvaluation. However, Morningstar does not side with the pessimists. Their analysts see the modest overvaluation as a caution sign and advise focusing on the fundamentals of individual stocks.

The basic problem with this debate is that stocks can remain overvalued or undervalued for a long time. Whether stock prices stay the same, rise, or fall depends on a host of factors ranging from corporate balance sheet conditions, cash flows, earnings, dividends, inflation and interest rates, to investor sentiment and the amount of cash on the sidelines. Whether the broad stock averages, such as the S&P 500 or the Dow Jones Industrial Average, are headed for a major fall is extremely difficult to predict. Attempts at market timing have produced losses and missed opportunities for scores of investors over many decades. Few are psychologically flexible enough to both sell and then buy back after a

decline. Fewer still will admit to having made a mistake, and buy back after the stock or market moves higher.

Many investors get caught up in whatever is popular at the time. Back in the late 1990s it was popular to believe that technology had no growth limits. Cisco Systems' stock was bid up to $77.31 in early 2000. It is now, thirteen years later, $24.13. Microsoft was $58.38 and is now $32.75. Texas Instruments was $83.06 and - while up nicely this year, at $40.29 - is less than half of its price thirteen years ago. The crowd also can overreact in the opposite direction. The 2008 financial crisis terrified investors. They sold stocks, causing broad market averages to temporarily become deeply undervalued. Following the crowd in 1999 led to huge losses. Following the crowd in 2008 led to losses and lost opportunity. One logical lesson from history is that when an investment crowd develops and pushes stocks up or down, do the opposite, if you can. At the least, stay away.

With stocks up, a correction is possible. But beyond that, from here on, economic and business fundamentals will determine if stocks rise, fall, or stay the same.

The flood of third quarter earnings reports will start soon. The rate of growth will most likely be slower than in previous quarters, but good enough to support stocks at current levels. Pessimists will surely argue that the slower pace of earnings growth marks the end of this growth cycle and that from here on, earnings will stay flat or decline. For stocks to move up another 10%-20%, analysts and investors need to have solid reasons to expect that earnings will keep growing at a decent rate. Some individual companies will be able to do better than that, thanks to their specific circumstances. But for earnings growth to continue for a long list of stocks there will have to be fundamental changes. Chief executive officers (CEOs) as well as analysts will have to become optimistic about final demand in many markets. That means an increase in the growth rate for the world's largest economy - the United States.

To be sure there is some good news. For example, thanks to higher stock prices and rising home prices, U.S. household net worth rose $1.34 trillion in the second quarter to $74.8 trillion - a new record high. According to the wealth effect theory, that gives consumers more confidence to spend and borrow. The problem is consumers know that both stock and home prices can go down. With the economy still sluggish and unemployment

relatively high, the wealth effect is likely to be modest. What the U.S., economy desperately needs is significant improvement in the core economy, especially job creation.

Could the Fed be wrong?

Last month the Fed lowered its expectations for the U.S. economy. The Fed now sees 2013 growth of 2.0%-2.3%. That is down from earlier expectations of 2.3%-2.6% and far less than what is needed to change analysts' and CEOs' outlooks. William Dudley, president of the New York Fed, has been quite specific in diagnosing the U.S. economic problems. In a speech on September 22 he said there is an "unusually high degree" of drag stemming from the government's fiscal policies. He said tax and spending policies are making it just that much harder for the economy to grow, and this situation is likely to continue to affect the outlook for some time to come. The Fed isn't always right. The board members adjust their forecasts as data on the economy develop. Could their next revision be an increase in the expected growth rate? There are some powerful developments that will benefit the U.S. economy. They include an American energy boom, continued growth in housing, a shift in the cost equation that is bringing manufacturing back to America, a recovery in U.S. household net worth, a significant drop in new claims for unemployment, and a solid recovery in the global economy.

One of the greatest threats to the U.S. economy - "peak oil" - is not just gone; the U.S is producing more oil than anyone ever expected, and has enormous amounts of natural gas as well.

Oil, once the greatest threat, has become an economic blessing that few fully appreciate. In the 1970s, the U.S. economy and stock market suffered for years. U.S. oil production fell short and Middle Eastern suppliers raised prices. Oil forced the U.S.to cut the link between the paper dollar and gold. High oil prices pushed inflation and interest rates up. Stocks plunged, and by the end of the decade the U.S. economy was headed for a deep recession. Experts studied the oil fields of Saudi Arabia. They monitored every move by the major oil companies and concluded that we were at or past "peak oil," meaning that slowly but surely the U.S. and global economies were running out of oil. Fear of another oil shortage has persisted to the present day, even though "gusher" rather than "peak oil" looks like the better description of oil production in the United States.

Texas produced an average of 2.625 million barrels of oil per day in July - 30% more than in July 2012, and almost double the daily production just two years ago.

"The exponential increase in Texas's oil production over the last several years is nothing short of phenomenal, and is a direct result of America's "petropreneurs" who developed game-changing drilling technologies that have now revolutionized the nation's production of shale oil. For oil output in Texas to almost double in only two years, and increase so dramatically that the state produced 35% of all US crude oil in July, is undoubtedly one of the most remarkable energy success stories in US history – and it's just getting started. At the current pace of annual increases of 30% or more, Texas oil production will likely surpass 3 million bpd by early 2014, and then surpass 4 million bpd by early 2015. Welcome to "Saudi Texas," the shining star of **The Great American Energy Boom."** Mark J. Perry - University of Michigan professor of economics. (See his blog site at: http://www.aei-ideas.org/channel/carpe-diem/)

North Dakota is another oil gushing state. In July North Dakota produced 874,460 barrels of oil per day, up 6.4% from June. The state's chief minerals regulator says oil production in North Dakota will double by 2017.

In addition to oil, the United States is producing record amounts of natural gas, so much that there is a ship building boom in several American shipyards. (See: **Closing Thoughts.)** Gas producers need ships capable of moving the gas to market.

The benefits of rising gas and oil production are not to be underestimated. Not only does this mean lower energy prices for manufacturers and consumers; it means dollars will stay at home rather than going to Saudi Arabia and other foreign oil producers. These dollars will provide tax revenues, jobs and capital for productive investment.

Closer to home the data, while mixed, points to a coming increase in the rate of GDP growth.

In August, sales of existing homes rose 1.7% to a 5.48 million annual rate, the highest since February 2007. Existing home sales are counted when

the sale closes. The August deals were made a month or two ago, when mortgage interest rates were lower. Now that interest rates have come up from their lows, the monthly sales numbers may pull back. But, they will be pulling back from a high number. Economists expected the August sales rate to be 4.95 to 5.41 million. At 5.48 million August exceeded the most optimistic forecast. Because of the delay between signing and closing, the September existing home sales number may also be above expectations. In any case, housing remains a driver for the U.S. economy.

Manufacturing jobs are coming back to America.

A decade or more ago when manufacturing jobs were leaving the U.S. for China, the numbers went something like this: for every 100 jobs lost there were 250 jobs created in China. The reason for the increase was that Chinese wages were low and the infrastructure was far less efficient. Because of China's economic success, wages have risen, making China a much less attractive location for manufacturing. It takes time to build new factories and make the transition, but more and more firms are cutting back in China and increasing their presence in the United States. The number of new jobs per factory is roughly 60-70, less than what was lost decades ago. Still, multiply that by hundreds of new factories and the total could be 5 million new American jobs over the next five years.

Household net worth has fully recovered.

Thanks to higher stock and home prices U.S. household net worth rose to $74.8 trillion in the second quarter. That is $6.7 trillion better than the $68.1 trillion peak before the 2008 recession. While net worth does not directly boost GDP growth or jobs, it is an important economic indicator. It is far better to have household net worth at a record high than at a record low.

New claims for unemployment are dropping.

While there are 2.82 million American on unemployment, the number of new claims unexpectedly fell to 305,000 in the week ended September 21, 2013. This means that one strong headwind - job losses - is changing for the better.

The global economy is doing better than appreciated.

World industrial output and merchandise trade reached new record monthly highs in July. Both are now above their pre-recession highs. Industrial production is 7%, and merchandise trade is 8%, above their pre-recession highs. Contrary to some media claims, annual growth in trade over the last twelve months was led by emerging markets. The data support a conclusion that - in spite of slow U.S. growth and a long recession in the euro region - the global economy has fully recovered from the 2008 financial crisis and recession.

Conclusion: There is more than enough good news on the U.S. and global economies to support optimism on future earnings growth.

The American energy boom, by itself, is an economic game changer. The benefits are just beginning to show in the growth rate and job creation numbers. The change from a huge energy importer to a self sufficient economy will have long lasting benefits that will boost economic growth for decades. Once past the political bickering over the debt ceiling, the rate of U.S. growth is likely to increase. The 3% target of economists like Richard Hoey of BNY Mellon still looks achievable.

Odds are that stocks will have the underlying support they need to move higher in 2014.

COMPANY NEWS AND VIEWS

BP, NYSE, BP, $42.29, reported a decline in second quarter net income to $2.7 billion, from $3.6 billion last year. Analysts were looking for $3.4 billion, so the miss was significant. The explanation is a higher than usual 45% tax rate and low oil prices. The disappointing second quarter has some investors turning away from the stock. That is a mistake. Yes, BP is still struggling with issues arising from the Gulf oil spill, but it has made real progress repairing the damage. BP's ROE (Return on Equity) is 21.4% - well above the industry average of 13%. The stock is trading at only 1.4 times tangible book value and the current dividend yield is 5.2%. BP owns a 19.7% stake in Russia's Rosneft, a highly profitable venture. BP has a major discovery in deep water in India and has won major blocks in waters off Brazil. Analysts at Argus Research and Standard & Poor's rate the stock a hold. Argus has a 2014 earnings estimate of $5.60 a share. Standard & Poor's thinks the 2014 result will be $5.40 a share. Split the difference and the stock is currently trading at 7.7 times the 2014 estimate. BP is a buy.

Nokia, NYSE, NOK, $6.58, is up 68% since Microsoft agreed to pay $7.2 billion for Nokia's device business. The deal is a game changer for Nokia. For example, Nokia has immediate access to 1.5 billion euros in short-term financing. That could be used to buy Siemens' interest in NSN, the Nokia-Siemens networking joint venture. According to Nokia management, the Microsoft deal is expected to be significantly accretive to earnings; will significantly strengthen Nokia's cash and net cash positions; and provides a solid basis for future investment in its continuing business. Post deal, Nokia could become a very attractive long-term investment. However, there are plenty of unknowns. There is a slight risk that regulators will not approve the deal. And, all that can be done now is make logical assumptions about what Nokia's management will do with the cash. There could be a one-time cash dividend coming. It seems almost certain that management will use the cash for acquisitions. The best strategy is to be patient, wait for the deal to close and for management to decide on a new business plan. Nokia is a hold.

Rite Aid, NYSE, RAD, $4.67, reported a profit in its fiscal second quarter that was much better than analysts expected. Earnings in the quarter were $0.03 per share, a dramatic change from last year's $0.05 per share loss. Analysts were expecting Rite Aid to suffer another loss. The consensus was a loss of $0.04 a share. Likewise, Rite Aid beat expectations on the top line. Revenues in the quarter were $6.28 billion. Analysts were looking for $6.27 billion. Management now expects revenue of $25.1-$25.3 billion and a profit of $0.18-$0.27 a share for the full fiscal year. The stock surged on the news.

Advice on Rite Aid is mixed. Some analysts say hold because of the stock's surge and the still enormous debt on the balance sheet. Others, such as Standard & Poor's, say buy, but have modest further stock price expectations. Standard & Poor's stock price target is $5.00. The last few quarters say that Rite Aid has turned the corner on cash flow and profits. Both are likely to keep growing and beating expectations. The increase in cash flow will allow more debt reduction. I am delighted to see the stock up, but am not ready to buy more. There still is above average risk because of the huge debt. My advice continues to be to hold on to your shares in Rite Aid.

Texas Instruments, NYSE, TXN, $40.31, raised the dividend and narrowed guidance for the third quarter. Management now expects sales of $3.15 billion to $3.29 billion, and earnings of $0.51-$0.55 a share. The new guidance is in line with analysts' expectations. Texas Instruments' stock price is up 41% this year. That is an excellent performance, especially considering that many analysts had very low expectations for this year. Argus Research rates the stock as hold with earnings estimates of $1.78 for this year and $2.10 for 2014. Standard & Poor's analysts say buy with a $42 stock price target. Their earnings estimates are $1.76 for this year and $2.29 for 2014. The differing 2014 estimates reflect respective opinions on 2014 profit margins and sales. Here is what analysts at Standard & Poor's have to say: "Our buy opinion reflects our confidence in TXN's transformation to a predominantly analog-based company. We think this transition will generate higher margins, cash flow, and returns to shareholders. TXN is shedding its money-losing wireless business that will wind down this year. Its analog products should deliver gross margins in the high 50% to low 60% area, by our analysis - above its current gross margin of 52%. The company has laid out a strategy whereby it should generate a sustainable percentage of free cash flow of 20%-25% of revenue that it intends to use for share repurchases and higher dividends. Given the low customer and product risk we see, we find the business model attractive."

For the second time this year Texas Instruments has raised the dividend. This time the raise is to $0.39 per share per quarter, up from $0.28. In the quarter Texas Instruments spent $721 million buying back stock and $301 million on dividends. Texas Instruments is financially very strong and is an attractive long term investment, with only moderate risk. The $1.20 annual dividend provides a yield of 3.0%. Buy Texas Instruments on any temporary market weakness to $38 or lower.

CLOSING THOUGHTS

Ship building in the United States is booming thanks to an old 1920s law that is still on our books.

The American energy boom is having a major effect on the ship building industry. There are ten supertankers currently under construction in American shipyards with orders for another 15. Consider that there are only 75 supertankers now sailing in American waters and the new construction

plus new orders is a genuine shipbuilding boom. Each one of these ships is more than 600 feet long, almost 200 feet wide and costs roughly $100 million.

It would be much cheaper to build these new ships in foreign shipyards. Not a single one of the new cruise ships that will soon be seen in American ports like New York and Miami is being built in an American shipyard. You might ask, how can the companies building these new supertankers justify the additional cost of building in America? The answer is the combination of the American gas and oil boom and the Jones Act.

In the gold rush days there was an outcry by American ship owners. They objected to the flood of foreign owned ships that appeared in ports in California and Washington State to carry Americans and their equipment to the gold fields in Alaska. Our Congress responded by passing the Jones Act. The Jones Act says that only an American made, owned and manned ship can carry American passengers or supplies between two American ports.

Yes, the Jones Act applies to cruise ships. I remember the early days of investment seminars at sea. A group of passionate individual investors would be gathered together for a real treat: a cruise with Louis Rukeyser. The typical cruise would leave from Ft. Lauderdale and sail the Caribbean. Lou Rukeyser always had a very busy schedule and could not stay for the whole cruise. Having boarded in Ft. Lauderdale, he could not get off in another American port, but he could get off in a foreign port in the Caribbean. A cruise with Lou would always be selected carefully so there was a foreign port two days after leaving Ft. Lauderdale. Once Lou left, the audience was stuck with speakers like me and other market pundits.

Take a look at cruise ship schedules and you will see they either do round trips from and back to the same port or they sail from an American to a foreign port. Taking American passengers on a cruise that starts and ends in Miami, for example, is not a violation of the Jones Act. The Jones Act applies only if the passage is between **two** American ports.

We are now producing enormous amounts of oil and natural gas in states like Texas and North Dakota. This is thanks to new technologies that allow us to extract these natural resources from shale and difficult under-earth locations. The oil and gas qualify as American supplies under the Jones Act. Some of the oil and gas is being exported. But most is being shipped

from one American port to another. There are currently 3.3 million barrels of oil a day being shipped from Gulf ports to ports along the east and west coasts. The demand for more ships to comply with the Jones Act is the explanation for the shipbuilding boom in the United States.

Domestic energy production is creating jobs in ways not anticipated even by the oil and gas enthusiasts. In Philadelphia, for example, at the Aker Shipyard there are plans to spend $115 million to construct tanks that can hold oil and gas. I am sure there will be more such plans announced at other U.S. ports, thanks to our domestic energy boom.

A side benefit from the shipbuilding boom will be American ports with facilities capable of handling the new larger ships that will be coming through the expanded Panama Canal.

Keep in mind that this energy boom and all the jobs it is creating has happened during a time when politicians in Washington have been trying to prevent exploration and production of oil and gas. The message is clear: Washington can try, Washington can even hurt some, but Washington cannot stop Americans from pursuing prosperity.

Next issue: The November issue of *John Dessauer's Outlook* will be ready on Wednesday November 6, 2013.

Next weekly hotline: Wednesday October 9, 2013

All the best,

John Dessauer
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