John Dessauer Investments, Inc.

John Dessauer's market review and update as of Wednesday January 4, 2023

I found the following from the editorial board of the Wall Street Journal to be an excellent description of what happened in 2022.

"Reality has rudely but helpfully taught some hard economic lessons in 2022. To wit, excessive government spending has negative consequences such as inflation; modern monetary theory is a fraud; renewable energy can't keep the lights on without fossil fuels; and (most cruelly) free money can't last forever.

The last of those is the reality that financial markets brought home in 2022 as U.S. stocks finally fell back to earth after being inflated for years by the Federal Reserve's detour into monetary illusion. Asset prices soared as the Fed showered the economy with money that cost essentially nothing, as real interest rates stayed negative. Investors dug for gold in the Klondike of crypto assets and the NFTs of memorabilia from pro athletes. Sam Bankman-Fried was hailed as a man who saw the future—and it was crypto.

This couldn't last and in 2022 it didn't. As inflation took off, and the Fed raised interest rates, asset prices have inevitably adjusted. U.S. stocks had their worst year since 2008, the year of financial panic. The S&P 500 fell 19%, while high-flying tech shares fell even more. In the revenge of the financial nerds, value shares outperformed growth funds. Mr. Bankman-Fried stands accused of fraud.

The surprise, if there is one, is that there haven't been even more financial casualties as the Fed has tightened money. Perhaps the financial system is sturdier now

than in 2008, or perhaps the debt dominoes have yet to fall. But the end of free money always does harm that is unanticipated during the mania.

Unhappily, corrections are sometimes necessary to teach the eternal truth summed up by legendary stock trader Ace Greenberg after the 1987 stock-market crash: “Stocks fluctuate, next question.”

Of course, the question now is what is likely this year. The experts at Argus Research think this year will be a normal year for the stock market. They see stocks as represented by the S&P 500 up in high single digits to low double digits, or 8%-12%. That would be a welcome result after 2022’s decline. Then there is history. This is year 3 in the President’s term. Over the past 50 years, year three has been the best every time. The 50-year average gain for the year after midterm elections has been 18.6%.

But history was not on our side last month. We did not get the usual year-end Santa Claus rally. Will history continue to disappoint?

The greatest challenge to history is today’s inflation. This is not a repeat of the 1970s. We are not going to see soaring interest rates. This was inflation initially created by federal government spending and energy regulation. It remains difficult because the Biden administration refuses to change and join the Fed in fighting inflation. Never-the-less progress is being made in the battle against inflation. Here is what Mitch at Zack’s Investment Research has to say:

“There is strong data indicating that goods inflation has peaked. Supply constraints like closed factories, higher shipping costs, and snarled supply chains

have largely faded. Falling housing prices and lower prices on new rental leases indicate that the sticky “shelter and owners’ equivalent rent” component of inflation will come down. The impact of higher prices for used cars, semiconductors, and airfares appears to have run its course, and energy prices have also retreated from peaks.

That’s all-positive news. The problem today is that services inflation has not come down alongside goods inflation, and in fact may be trending in the wrong direction. A big factor driving services inflation is the tight labor market, where labor scarcity continues to drive up wages. As wages move higher, the cost of doing business rises, which filters through to higher prices charged for services.”

No wonder economists give so much attention to labor market conditions. We have seen an uptick in applications for unemployment insurance. What we need to see now is stabilizing wages. The upward pressure on wages came largely from two factors: a widespread shortage of employable workers and rising prices for goods. Workers wanted higher wages so they could afford to buy goods from groceries to gasoline. That pressure has subsided. In addition, we have seen notices from some large companies about large layoffs. The layoffs have not been so widespread as to trigger a sharp rise in the unemployment rate. There are still many unfilled jobs. But the layoffs will change the balance in the supply and demand for workers. And that could be enough to slow, if not stop, the rise in wages.

The Fed’s interest rates increases have been enough to change the balance of supply and demand in housing. What was a sellers’ market where prices rose rapidly has become a buyers’ market with prices coming back down. The shift occurred as interest rates on mortgages rose. High prices plus higher mortgage rates made buying a house too expensive for many buyers. As a result, housing prices peaked and started back down.

Likewise higher interest rates will have an impact on the labor market. With goods prices stalled businesses will have to watch their costs more carefully. Labor is their biggest expense. Businesses will slow down or stop expansion and otherwise take steps to reduce the need for new employees. That will stop the upward pressure on wages. I suspect this process is farther advanced than we know. Business managers try to anticipate future demand. We may see better news on wage inflation in coming weeks.

In any case, as we can see in housing, the Fed is winning the battle against inflation. Hold on to your stock positions.

I will have the next market review and update for you one week from today on Wednesday, January 11, 2022.

All the best,

John Dessauer

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