John Dessauer Investments, Inc.

John Dessauer's market review and update as of Wednesday January 5, 2022

It's that time of year again, when market pundits of all types justify their forecasts for the new year. The stellar performance of stocks in 2021 makes forecasting for 2022 more difficult. The S&P 500 stock index gained 26.89% last year. Strong earnings and a remarkable economic recovery encouraged investors to take risks.

Last week I wrote about how passive investing in index funds provided support for stocks and likely prevented a major decline. Here is another interesting stock market phenomenon that also provided support for stocks. Last year options trading, which arguably is riskier than trading stocks, surpassed stock activity for the first time. In 2021 the daily average trading of single-stock options exceeded $467 billion compared with $410 billion for stocks.

Looking ahead, it seems likely to me that passive investing will remain popular and will continue to provide underlying support for stocks. However, experts at Bank of America disagree. They see the S&P 500 index falling from 4,766.18, at year end 2021 to 4,600 by year end 2022. They also see the probability of a 10% correction in the near term or over the next 12 months as "elevated".

Zacks investment research has a different outlook. "In fact, in the Fed's own words, the economy remains "really strong," "consumer demand is very strong," and "incomes are very strong." And that's why it looks like there's a lot more upside to go, not just for this year, but for next year as well."

Last year was the third straight year of double-digit gains for the S&P 500 stock index. Will the optimists be right again this year? Will this be the fourth straight year of gains, double-digit or less? The Bank of America outlook is not convincing because they see such a modest decline, a drop of 670 points or 3.5% on the S&P 500. That is not exactly a pessimistic outlook after three strong years of growth. They are basically saying that the stock market has already taken into account another strong year of economic recovery. In my opinion, the stock market's behavior will depend on the nature of the ongoing recovery.

The details on November consumer spending point to a change in consumer behavior. Overall consumer spending rose 0.6% in November. However, the main driver of that gain was a 0.9% increase in services expenditures. Spending on goods rose a more modest 0.1%. And, when adjusted for current inflation spending on services rose only 0.5% and spending on goods declined 0.8%. Clearly inflation is becoming a major factor in determining the outlook for consumer spending and therefore for the overall economy.

Consumer spending on goods was very strong early in the recovery. Probably some of the demand for goods has been satisfied. Add in the inflation driven price hikes and goods become less attractive to consumers. Fortunately, consumers still have plenty of cash and can spend it on travel, restaurants, or going out to a movie. Services, in other words.

The U.S. GDP growth came in at 2.3% in the third quarter of last year. The Federal Reserve Bank of Atlanta estimates fourth quarter growth at 7.2%. We will soon have the actual number. The Atlanta estimate may turn out to be on the high side because of the Omicron virus variant.

“But the Omicron surge won’t last forever—indeed, given its very speed, and the recent experience of other countries, it might not last very long. In its aftermath, the spending dynamics that were in place last month might well reassert themselves. Next year could be when demand for services really drives spending, and demand for goods moves to the passenger seat.” (Editors of the Wall Street Journal, on 12/28/2021)

Politics will likely play a major roll in determining the coming rate of inflation and economic growth. As we have seen the last several years, American politics is unpredictable and sometimes downright puzzling. The shift towards socialism, especially among some Democrats, is frightening. Fortunately, the polling shows that Capitalism is still favored by the majority of American voters. The coming November elections will determine which party has control of the House and Senate. A shift in either body would stop the runaway Biden spending plan. And, in my opinion, that would significantly cool inflation expectations.

Will inflation come down from the current highs? The answer is yes, but how it comes down is the bigger issue. If inflation cools thanks to politics and economics, the markets, including stocks, will celebrate. If it takes strong action by the Federal Reserve to counter excess government spending and bring inflation down, investors will fear recession and stocks would likely decline.

Which way will inflation come down? My opinion is that the Biden spending agenda is already under political attack. American voters understand how inflation punishes them. The Biden attack on fossil fuels has already pushed up the cost of gasoline. And that hits every voter when they have to fill up their car or truck. Likewise, the higher cost of food punishes every voter - especially those in the lower income brackets. The Biden Administration said that their policies would not result in higher inflation. But inflation is up, and the President and his supporters are wrong. Politics can change in a flash. But economic trends - including inflation - move in a much slower fashion. My conclusion is that the current high inflation has a political silver lining. The big spenders will be forced to back-off. The Federal Reserve will not have to do battle with inflation. Yes, the Fed will likely raise interest rates this year, but not very much. Interest rates will remain near their lows.

There could be a 10% stock market correction. That would be a normal event after last year's strong gains. But my view is that stocks will quickly recover from a correction and move on to end this year at higher levels. Stocks remain my favorite investment.

I will have the next market and update for you one week from today on Wednesday January 12, 2022

All the best,

John Dessauer