John Dessauer Investments, Inc.

John Dessauer's market review and update as of Wednesday January 18, 2023

California is a budget lesson for all politicians, state and federal. In its last fiscal year California had a $100 billion budget surplus. That was thanks to the state's tax the rich policies and a booming stock market. The top 0.5% of taxpayers pay 40% of the state income taxes. California taxes the capital gains of millionaires at a 13.3% rate, on top of the federal 23.8% top rate. Imagine have to pay 37% of any capital gains in taxes. That discourages investment and encourages wealthy taxpayers to leave for states like Texas and Florida where the tax burden is far less onerous.

The California tax the rich policy resulted in a huge gain in tax revenues last year. Tax collections soared to $210.5 billion up from $146 billion the previous year. California politicians did not resist the temptation to increase spending rather than accumulates the surplus for a day when the economy slowed down. They expanded Medicaid to undocumented immigrants over the age of 50, enacted universal pre-school and school lunches, extended paid family leave by two weeks, and boosted climate spending by $10 billion. Now the stock and bond markets are down and California's tax revenues are also down. The governor has sadly announced a $22.5 billion budget deficit for the coming year. Not only is California hurting because of the spending increase it is also suffering as thousands of taxpayers leave because the tax burden is just too high.

Politicians in Washington do not worry about Americans leaving for lower tax countries but, like California, they do have to worry about the cost of financing ongoing deficits. California's fiscal mess will make it more difficult and more expensive to sell

municipal bonds. Likewise, Washington is facing rising interest rates on a ballooning national debt. Cutting back on spending is always painful for politicians. But both California and Washington will suffer far more if they don't start restraining spending soon. Allowing the debt burden to keep rising will eventually result in a financial crisis that will force large cuts in spending.

The good news for Washington is that there are signs the Fed is succeeding in bringing the rate of inflation down. The rate of growth in the money supply has fallen sharply. That is due to the increase in the fed-funds rate which has increased from near zero to 4.25% - 4.5%. And the Fed continues to shrink its balance sheet by allowing bonds to mature and not be replaced.

The Consumer Price Index or CPI declined for the sixth straight month in December. The CPI was down 0.1% last month. That pushed the CPI down to 6.5% over the last twelve months. While that annual rate is still too high, it is down from the 9.1% peak in June. This data is solid evidence that the Federal Reserve's monetary policy is working and is not pushing the economy off a cliff. The chance of a soft landing is looking much better than it did a few months ago.

The financial markets also liked it when Fed chair Powell said: "We are not, and will not be, a 'climate policymaker."

After all monetary policy is difficult enough with the two Congressional mandates of price stability and full employment. Add on political goals like climate and the risk of a monetary error multiplies.

Not everyone agrees that the inflation outlook is improving. Some worry about the consequences of reopening in Europe and China after Covid lockdowns. They are concerned that demand will increase as economic activity picks up. In my opinion those are legitimate concerns but even if there are difficult pockets of inflation in other countries that will not automatically be exported to the United States. Our inflation will respond to Fed actions and the money supply. Higher U.S. interest rates along with progress on inflation will mean a strong dollar that keeps imports cheap.

Stocks liked the December inflation news and will likely remain strong as inflation news continues to improve. We will soon be in fourth quarter earnings season. Analysts are mixed on the earnings outlook but generally have modest expectations. That could mean that actual results will be better than expected. If so, the single digit gains for this year would be revised upward.

Stocks remain attractive.

I will have the next market review and update for you one week from today on Wednesday, January 25, 2022.

All the best,

John Dessauer