John Dessauer Investments, Inc.

John Dessauer's market review and update as of Wednesday January 27, 2021

With stock market indices making new highs, the question everyone is asking is: are stock prices so high that a major decline is inevitable? Robert Shiller of Yale University is well known for his CAPE ratio (Cyclically Adjusted Price-Earnings ratio). That ratio has only twice been higher than it is now—in the late 1920s and the early 2000s. In both cases a major stock market crash soon followed. Further, in the past Shiller has been quick to sound an alarm when his CAPE ratio rose above historic norms. This time, however, he is singing a different tune. A recent study by Robert Shiller, Laurence Black and Farouk Jivra suggests that today's steep stock prices may be still warranted, because interest rates are so low. The real yield on risk free government bonds is so low that stocks by comparison look quite attractive.

An empirical study by Robert Shiller and John Campbell in 1988 found that yields on stocks help predict long-term returns. The dividend yield and three different measures of earnings yield all show some forecasting power. Back in the time before the dot-com stock market bust of 2000, real interest rates were an attractive 4%. Today interest rates are so low that real yields are negative, meaning that current very low inflation at an annual rate of about 1.4% is still higher than the 1% yield on a ten-year government bond. Shiller and his colleagues conclude that despite high prices, stocks are attractively priced relative to bonds.

This raises the next question: if inflation rises, as some expect, will the Federal Reserve raise interest rates high enough to make stocks look unattractive relative to bonds? Jon Sindreu, writing for the *Wall Street Journal* says: "While a return to 1970s-

style inflation is unlikely, prices are almost certain to rise faster than normal this year, because they were artificially depressed by the pandemic. If the market is reading the Fed correctly, though, that needn't stop the party."

Yields on 10-year U.S. government bonds have risen to 1.1%, up from 0.9% at the end of 2020. That indicates bond traders believe we are headed for a rise in inflation. The problem with that view is that TIPS (inflation-protected Treasurys) have not sold off. Put the two together and what we see is a rise of inflation expectations among bond traders which is not shared by longer-term bond investors.

We have been getting quarterly results from major banks. They are mixed. Some, like Goldman Sachs are enjoying profit growth thanks to successful trading operations. Others are suffering from a wealth of deposits and depressed loan demand. There has been a surge in existing home sales but otherwise loan demand remains depressed. Banks are buying government securities to get some yield on the cash deposits. But traditional bank profits from loans will stay low until loan demand improves. With so many small businesses closed, it will take time to get loan demand back to pre-pandemic levels. Even then loan demand will not be fueling a credit bubble. And that is good news on inflation and interest rates. A credit bubble is what precedes an outbreak of unwanted inflation.

Fed Chair Powell has made it clear that interest rates are going to stay low for a long time, most likely all this year and into 2022 as well. The best conclusion is that even if the Fed raises interest rates later this year it will do so by less than the inflation rate, keeping real interest rates negative. And that would leave stocks as attractive relative to bonds. If there is a bounce in consumer prices during the recovery, that would simply

bring them back to pre-pandemic levels and not necessarily lead to sustained higher future inflation rates.

Another plus for the economy and the stock market was the quick confirmation by the Senate of Janet Yellen's appointment as Secretary of the Treasury. Stocks rose on that news. Yellen served as chair of the Federal Reserve from 2014-2018. During her confirmation hearing she told the Senate Finance Committee that Congress must "act big" on the next coronavirus relief package. She pointed out that low interest rates make such a spending plan affordable. Clearly President Biden agrees. He has unveiled a $1.9 trillion relief package.

Yellen added: "Economists don't always agree, but I think there is a consensus now: Without further action, we risk a longer, more painful recession now-and long-term scarring of the economy later. Over the next few months, we are going to need more aid to distribute the vaccine; to reopen schools; to help states keep firefighters and teachers on the job."

There was one troubling development by President Biden. Within minutes of being sworn in he told Peter Robb, general counsel of the National Labor Relations Board, that he had ten minutes to resign or he would be fired.

The general-counsel position is a Senate-confirmed four-year appointment at an independent agency. Robb had ten months left on his term. No NLRB general counsel had ever been fired, and Biden provided no cause for the firing.

"For four years, the media and Democrats cast every action of the Trump administration as something law-breaking or verging on a constitutional crisis. This

week's headlines, by contrast, were a mass media celebration of the return to "normalcy." Mr. Biden ran on, and won on, a promise to restore norms to Washington.

The Robb firing illustrates the falsehood of both narratives. For all Mr. Trump's bad manners, his administration's actions were largely by the book. Mr. Trump never fired Richard Griffin, Barak Obama's NLRB general counsel, who served nine months to the end of his term in 2017. For all the talk of Mr. Biden as the embodiment of gentlemanly politics, Democrats have no intention of playing by the rules. They intend to impose an agenda and won't let a little thing like a 70-year-old precedent, or embarrassment over double standards, get in their way.

The Robb firing is an early indicator of Mr. Biden's top priorities. Democrats rely on unions to get elected, and unions are therefore first in line to get rewarded. The most effective vehicle for that is the NLRB, which has sweeping power to enforce labor practices on companies across America."

Raising taxes on corporations has made headlines and is a threat to corporate profits, but the NLRB situation will likely have equal or even more severe consequences on business bottom lines. The media will certainly keep us informed about taxes, but it may take a little more digging to follow the consequences of NLRB developments.

I will have the next market review and update one week from today on Wednesday February 3, 2021.

All the best,

John Dessauer

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