John Dessauer Investments, Inc.

John Dessauer's market review and update as of Wednesday January 29, 2020

I have company. Last week I wrote about the stock market's late 2018 decline and how that distorted the 2019 reported performance. On the 24th of this month a *Wall Street Journal* editorial quoted Lauren Goodwin, an economist and strategist for New York Life Investments. She had this to say about the stock market in 2019: "Obviously it was a great year for the markets. But if you take out the correction at the end of 2018, the S&P is up more like 10% rather than 30%. But that's still a great year."

The editorial went on to point out that investors last year poured money into bonds and out of stocks. In 2019 investors pulled a net $167.4 billion out of funds focused on U.S. stocks and pulled out $32.4 billion from international-stock funds. They poured a net $449.8 billion into bond-focused mutual funds and ETFs.

Ms. Goodwin added: "The flows reflect how wary investors have focused on generating income across asset classes, or moving to higher quality. It doesn't surprise me that flows have moved toward bond funds. Within those there is a big move up in the quality of bonds being bought."

The appetite for quality bonds has been a major force in helping to finance the huge federal government annual deficit. American investors have purchased two-thirds of the extra government borrowing since 2016. Foreign investors bought the rest, $800 billion worth of U.S. Treasuries.

That domestic investors have the cash to buy billions' worth of Treasuries may come as a surprise. Headlines have warned about the binge in corporate borrowing. But the fact is that American businesses are net suppliers of savings to the rest of the economy. Corporations have recycled much of their excess cash to investors through rising dividends and share buy-backs. All that cash had to be parked somewhere, and U.S. Treasuries are an obvious choice.

Foreign investors flock to U.S. Treasuries not only for the obvious liquidity and safety but also because low U.S. interest rates are higher than interest rates on other developed country liquid government securities.

No wonder financial markets have largely ignored the huge U.S. government annual deficits. However, the deficit is now 5.5% of GDP, raising the question: can the U.S. deficit remain so large much longer? Some economists worry that loose fiscal policy at a time of low unemployment will cause the economy to overheat, rousing inflation. That would force the Federal Reserve to raise interest rates, pushing up government borrowing costs. That is based on the old Keynesian economic thinking, namely that to counter recessionary forces, governments should increase spending even if that means borrowing to stimulate economic growth. When the economy is strong, as it is now, the opposite should be the case: governments should take advantage of economic growth to reduce national debts. The problem for the Keynesian economists is that current economic reality is not following the old script. The Federal Reserve cut interest rates three times last year because of concerns that in spite of loose fiscal policy the economy might be slowing too much.

The Fed now says interest rates are on hold. But the Fed is also adding liquidity to U.S. financial markets. The Federal Reserve Bank of New York has been purchasing large amounts of securities to keep overnight interest rates from spiking. The result is a $400 billion increase in the Fed’s balance sheet. Critics say this another QE (quantitative easing) and risks spiking inflation. Fed officials say no, this is very different from the days of the massive QE. To counter the downward pull of the 2008-2009 financial crisis the Fed bought trillions of dollars-worth of long-term securities. Current buying is of short-term securities that will mature within a year. Still - there is the combination of loose fiscal policy and an accommodative Federal Reserve. If this doesn't spike economic growth and inflation what will? The answer may be that fundamental changes in the underlying economy have shifted risks away from inflation and towards persistent slow growth and recession.

Dietrich Vollrath, professor at the University of Houston, says slow growth is here to stay and is a sign of policy success. Between 1950 and 2000, GDP per person in the United States grew at an average annual rate of 2.3%. In 2000-2018 that rate fell by roughly half. This slowdown, seen in other rich countries as well, is often taken as sign that economic policy has failed and that governments must inject stimulus or somehow restore capitalism's lost dynamism. Dietrich Vollrath argues that America's growth has slowed because so much has gone so well for so long.

For example, Dietrich points out that in 1910 only a tenth of Americans completed high school. By the 1970s four-fifths were graduating high school. This increase in the size and quality of the American workforce added nearly 1% to annual GDP growth from 1950-2000. Since then the "human capital" has shrunk, reducing annual GDP growth by 0.2%. The shrinking is due to an aging population and lower birth rate as families choose to have fewer children.

Vollrath adds that another reason for slowing growth is a shift in economic activity towards service industries, where productivity gains are more difficult. He says that while the shift is growth-inhibiting, it is a good thing. People buy more services as they get richer.

The bottom line from Vollrath's work is that slower growth is here to stay and that means low interest rates and low inflation are also here to stay. That is positive for both stocks and bonds. As Omar Aguilar, chief investment officer for Charles Schwab, says: "So yes, most individual investors are happy reading their 2019 statements. But the year we just had will be very hard to repeat under current circumstances, (meaning the near 30% headline gain). We're not near a recession, so people don't need to panic. Retail investors should just think the returns won't be as high this year."

I agree, but another 10% will be very welcome.

I will have the next market review and update one week from today on Wednesday February 5, 2020.

All the best,

John Dessauer