John Dessauer Investments, Inc.

John Dessauer's market review and update as of Wednesday February 5, 2020

Marilynn and I are in Barcelona, Spain. On Thursday we will board a new cruise ship and sail back to Miami. The new ship belongs to Regent Seven Seas and is called the Splendor. It is not a large ship with 700 passengers. Some of the new cruise ships hold 6,000 passengers. This will be our first time on a new ship. My point is that the cruise business is booming, with many new ships being built, several with 6,000 or more passengers. Cruising is now a major business. And it is threatened by the outbreak of the coronavirus. Regent sent an email saying that passengers who had been to China 30 days before would not be allowed on the ship. There is one large ship from the Costa cruise line that was quarantined in the port for Rome, Italy with 6,000 passengers. One, a woman from Macau, became sick. If she tests positive for the coronavirus the entire ship will be quarantined for two weeks. Imagine the cost to Costa to take care of 6,000 passengers for two weeks and having to refund passengers on the missed cruises. This virus is a serious threat to every cruise line.

This shows how something can develop suddenly, with no warning and threaten not just cruise lines, but entire economies. The virus is already slowing the Chinese economy and scaring investors around the world.

The virus will also likely have an impact on some politicians, including some of the presidential hopefuls. They have been highly critical of the big, profitable pharmaceutical companies. Those profitable companies have the scientists, the facilities and the resources to develop a vaccine for the coronavirus. And several have formed a coalition, joining forces to do just that. There are reports that they may have a vaccine for

human testing by April. If they do then the threat from this virus will be significantly reduced saving billions of dollars and tens of millions of jobs. Instead of attacking the big pharmaceutical companies, wise politicians should praise them for having the ability to stop medical threats to the U.S. and global economies.

The U.S. economy grew at a 2.1% annual rate in the fourth quarter of last year. That is far below President Trump's 3% or better target. The President blames the Federal Reserve. However, the Federal Reserve quickly reversed course after raising interest rates and selling bonds at the end of 2018. Federal Reserve policy has been accommodative for the last several months. The big policy shift that caused the slower growth was trade. President Trump started a trader with China in early 2018 by imposing tariffs on solar panels and washing machines. Then he added tariffs on steel and aluminum, made threats about Nafta and generally scared businesses at home and abroad. Businesses have pulled back investment because they can't be sure of supply chains or input costs. The global economy took a hit as the Chinese economy slowed. Private investment in the United States fell to 1.8% for 2019 well down from 5.1% in 2018.

Fortunately, there has been a pause in the trade war. The redone Nafta accord will reduce uncertainty about North American supply chains. The trade deal with Mexico and Canada will boost jobs in all three countries. And the President has concluded a phase one trade deal with China.

Reducing trade tensions will go a long way towards boosting U.S. economic activity this year. In addition, there are signs of improvement here at home. Inventories knocked 1.09 points off U.S. GDP growth in the fourth quarter of 2019. Put another way, the economy would have grown at 3.2% rate in the fourth quarter if inventories been flat.

Jobless claims keep declining, which means the labor market remains very strong. The Federal Reserve is accommodative, adding liquidity when needed.

Most economists predict the U.S. economy will slow this year to a growth rate less than 2%. That is good enough to ward off a recession. And that may also turn out to be too pessimistic. We may not get all the way back to 3% this year. But a rate of 2.5%-3% is possible.

As far as the stock market is concerned just about everyone agrees that stock prices are elevated. According to FactSet the twelve-month price/earnings ratio (P/E) is at around 18.6, well above the five-year average of 16.7 and the ten-year average of 14.9.

Federal Reserve Chair Jerome Powell said “We do see asset valuations as being somewhat elevated. P/Es, they’re high.” But he added that “It’s ill advised to consider valuation metrics like P/Es in a vacuum. One way to think about equity prices is what’s the premium you’re getting paid to own equities rather than risk-free debt. That’s also at fairly low levels, but not at extremely low levels. Valuations are high, but not at extremes.”

During her term as Federal Reserve Chair, Janet Yellen had this to say about equities: “The fact that stock market valuations are high doesn’t mean that they’re necessarily overvalued. For starters, high valuations don’t portend lackluster returns in the near term. History shows that valuations provide no reliable signal as to what will happen in the next 12 months. We are in a low interest rate environment. Lower than we’ve had in past decades. That’s a factor that supports higher valuations.”

Warren Buffet agrees. “Everything in valuation gets back to interest rates. Sometimes valuations can be almost totally unimportant. It’s just not quite as simple as having one or two formulas and then saying the market is undervalued or overvalued.”

The pessimistic chicken littles pay no attention to the broader economic environment. They focus on high P/Es and claim the stock market is about to come tumbling down. The opposite is more likely, namely that earnings and other fundamentals grow enough during this low interest rate environment to support stocks when the environment changes and interest rates rise.

Stocks remain attractive.

I will have the next market review and update one week from today on Wednesday February 12, 2020.

All the best,

John Dessauer

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