John Dessauer Investments, Inc.

John Dessauer's market review and update as of Wednesday February 10, 2021

During her confirmation hearing in the Senate Janet Yellen urged Congress to "go big" on the next stimulus spending bill. Janet Yellen is an accomplished economist who served as Fed chair from 2014 to 2018. The Biden administration is taking her advice with another $1.9 trillion spending plan. However, there are highly respected economists who disagree. Larry Summers and Phil Gramm warn that the big spending plan may carry more risks than benefits. Last week the editorial board of the *Wall Street Journal* published an article titled: "Wrong Stimulus, Wrong Time." Proponents of the new spending plan point to the December decline in consumer spending, the second consecutive monthly decline. Summers, Gramm and the *Wall Street Journal* point to the low unemployment and current economic growth as evidence that what is needed is not more cash but an end to the state lockdowns.

Morgan Stanley points out that the lost income from unemployment is roughly $400 billion and the amount of cash already injected in the economy is $1.1 trillion. The household savings rate has come down from the 33% last April to about 13% currently. Still, that is much higher than it was before the pandemic. Investors are hanging on to their cash. Some are using the extra cash to speculate in the stock market. The "go big" $1.9 trillion new spending plan will likely add to the already huge pile of savings and add more fuel for speculating in the stock market.

There is one point of agreement when it comes to the need for more stimulus. Money for vaccines and aid to low-income workers who are suffering the most is justified by even the sharpest critics of the new mega stimulus spending plan.

Melvin Capital Management was founded by a star portfolio manager, Gabe Plotkin. Because of the extraordinary run-up in GameStop and other hot stocks, Melvin Capital lost 53% in January. Yes, Melvin was short GameStop and others. In dollars the Melvin January loss was in the billions. As I guessed last week Melvin and other hedge funds have significantly reduced risk and repositioned the portfolio to be more liquid. So we are not likely to see more huge hedge fund losses. But the story of hot stocks and big hedge fund losses shows that putting trillions of dollars in individual pockets carries unintended risks.

Where do we go from here? Morgan Stanley was right a year ago. Last spring the consensus among economists was that the U.S. economy was headed for the deepest recession in a generation. Morgan Stanley did not agree. Morgan's experts predicted a sharp but short recession. And, that is precisely what has happened. Now the consensus forecasts slow growth and persistent low inflation. Once again Morgan Stanley disagrees.

Morgan Stanley sees the huge and growing excess savings as the fuel for a release of pent-up demand once the economy fully reopens. They expect economic growth this year to be 6.5%. That is 2% higher than the consensus forecast.

The roll-out of vaccines is rather slow right now. However, Moderna, Pfizer and now Johnson & Johnson are increasing production capacity and vaccine volumes are expected to rise sharply in the next few months. The economy is not likely to fully reopen until the vaccine is widely available and many more have been vaccinated. Putting vaccine expectations together with the Morgan Stanley full year 6.5% growth forecast seems to mean that there is an economic growth surge coming later this year. And both history and logic suggest that if that happens inflation will wake up and begin to rise.

Ellen Zentner, chief U.S. economist at Morgan Stanley forecasts U.S. PCE inflation to end this year at 2% and higher on a sustained basis from 2022 onward. The PCE measure of inflation is the favorite of the members of the Fed board of governors.

A growth surge would be welcome and provide a fundamental basis for rising corporate profits. Michael Wilson, chief US equity strategist at Morgan Stanley sees profits for the S&P 500 companies rising 26.8% this year to $175 a share. That would be positive for stock prices. The question is: will rising inflation push interest rates so high that stocks would suffer? The answer is no, if the Morgan Stanley interest rate forecast is anywhere near right. Matthew Hornbach, global head of macro strategy at Morgan Stanley, sees the yield on a 10-year US Treasury rising from the current 1% to 1.45% by the end of this year. That is not likely to have much of an impact on stock prices because corporate cash flows, that support dividends, remain strong. Corporate cash flows grew 4% through the first three quarters of last year. When fourth quarter data becomes available it will likely show cash flow growth at 4% or better. With dividends well covered by cash flow, stocks will remain more attractive than bonds even if interest rates rise as expected. Growing earnings and cash flows point to dividend increases, rising yields on stocks, something that never happens with bonds.

The S&P 500 is currently trading at about 22 times this year's expected profits. That is high by historical standards. However, the earnings yield, another measure of valuation, is currently about 4.5%, considerably higher than yields on safe government securities. As Robert Shiller and others point out that is because interest rates are so low, the relatively high P/E does not mean that stocks are overvalued.

Will there be a stock market setback? I expect so, but when it comes it will be mild and short. Where stocks will be at year end depends on how soon the economy fully reopens and how all the excess savings are deployed. If job creation gains strength and consumer confidence improves, we could see strong economic growth continue into 2022. That would provide the basis for continued strong earnings growth and higher stock prices. For now, be patient and wait for the vaccine rollout to gain strength.

I will have the next market review and update one week from today on Wednesday February 17, 2021.

All the best,

John Dessauer

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