John Dessauer Investments, Inc.

John Dessauer's market review and update as of Wednesday February 26, 2020

A decade ago, economists were united in warning about too much government debt. They said that if government debt rose above 90% of GDP that growth would slow, and the risk of a financial crisis would increase. Today they are not so sure. In a world of very low interest rates some economists say that government debt levels above 90% of GDP are feasible, even desirable.

The United States is testing the new ideas with federal government debt rising at a trillion dollars a year rate. Our national debt is already above 105% of GDP. We are not alone. France, Italy, Spain and the UK are planning large budget deficits that will push debt levels above 100% of GDP in the next few years. Japan recently announced a $120 billion spending plan even though government debt is already 240% of GDP.

However, running up debts during a period of low inflation and interest rates may not be such a great idea after all.

Last month the IMF (International Monetary Fund) published a study showing that advanced economies with government debt owed to foreign investors above 70% of GDP face a substantially higher risk of suffering a financial crisis. For emerging economies, the threshold is 30% of GDP. The IMF study was based on 400 crisis episodes in 189 countries between 1980 and 2016.

Recent history lends support to the IMF warning. The two European countries with the slowest economic growth rates over the last decade, Italy and Greece, started out with the highest government debt levels. In contrast Ireland, which entered the crisis with low government debt, was quick to bounce back.

Carmen Reinhart and Kenneth Rogoff, both economists at Harvard University, published a paper in 2010 showing that countries with government debt above 90% of GDP typically had slower economic growth.

We know the U.S. economy has not been able to sustain growth above President Trump's 3% goal. Could our large government debt be the cause? Neither Democrats nor Republicans have so far made the budget/national debt a campaign issue. We can hope that changes and that some high-ranking politicians will admit that the greatest long-term risk to our economy and financial markets is the huge and growing national debt.

What we do hear, especially from Democrats, is the complaint that U.S. corporations are raking in huge profits as blue-collar jobs disappear. Their problem is that the economic reality is the exact opposite of their complaints. A Conference Board survey found that corporate profits have been declining as employers increase wages to hire scarce blue-collar workers. Wages for 20-to-24-year-olds are increasing twice as fast as for other workers. In 2018 overall job satisfaction was the highest since 1995.

Another thing we hear from Democrats is that we need higher taxes to support new programs. They talk as if raising taxes would have little to no adverse effect on the economy. Once again, the reality is quite the opposite. That is the clear lesson from Japan. Prime Minister Shinzo Abe raised Japan's consumption tax from 8% to 10% effective last October 1. Between October and December Japan's economy contracted on an annual basis by 6.3%. Consumer spending was the prime culprit, falling by 11.5%.

Do the Democrats who propose raising the payroll tax think there would not be a similar adverse impact on the U.S. economy? Just like Japan our economy is being supported by consumer spending. Raising the payroll tax would be a direct hit on consumer income. That would most likely result in a decline in U.S. consumer spending. Raising the consumption tax has pushed the Japanese economy to the brink of recession. The same could happen in the United States.

The editors of *The Wall Street Journal* had this to say about Japan's economic mess: "It's too late for Japan to avoid the costs of Mr. Abe's economic failures. But other governments can learn the lessons that Japan's leaders refuse to heed."

Let's hope that come November, American voters will prevent a lurch toward higher taxes, never-ending annual budget deficits and slower growth.

If the stock market is still a leading indicator, then the odds favor a rejection of socialism and all it stands for in November. Total earnings for companies in the S&P 500 index are expected to be down 1.5% in 2019 from 2018. But stocks went up. Are the pessimists right to warn of a coming stock market plunge? How can stock prices be up when earnings are down?

Zacks investment research has the following to say about stocks and earnings: "One of the main reasons that 2019 earnings looked so weak is that 2018 earnings were so strong, as a result of the tax cut. That made for very tough comparisons, and set a very high bar for corporations to reach.

But here's the kicker: when you zoom out and look at 2018 and 2019 earnings together, you find that earnings grew 23.2% in 2018 while declining 1.5% in 2019. Over that two-year stretch, the S&P 500 rose approximately 24% - a nice balance between stock price appreciation and corporate earnings growth.

The picture emerging from the Q4 2019 earnings season – which also marked a strong rally for the S&P 500 – is one of steady improvement, with earnings growth on track to turn positive and above-average proportion of companies beating the top-line expectations. Estimates for Q1 2020 have come down, but they still compare favorably to other recent periods despite the coronavirus impact.

For Q4 2019 as a whole, total earnings for the S&P 500 index are expected to be up 0.7% from the same period last year on +4.3% higher revenues. Better-than-expected earnings per share (EPS) performance is a good explaination for the market’s rally.

Earnings growth is expected to resume in 2020, with S&P 500 corporations projected to post +7.5% aggregate net income growth on +4.7% higher revenues.”

The Federal Reserve is expected to remain accommodative this year. Globally, the European Central Bank, the Bank of Japan and the People’s Bank of China are all implementing accommodative policies, providing a strong tailwind for stocks.

As for the DOW’s coronavirus panic attack, here is what Kevin Matras at Zacks has to say:

“Headlines point to continuing coronavirus concerns as the reason for the pullback. And while that's true on the surface, I think it's mostly being used as an excuse to pull profits after an auspicious start to the new year.

At the highest point this year, the Dow was up 3.6%, the S&P was up 5.0%, and the Nasdaq was up a whopping 9.6%, all in less than two short months. And that's on top of the spectacular finish to 2019. So, it was totally expected that at some point, we'd see some profit taking. And the coronavirus concerns gave traders the perfect opportunity to do just that.

Don't get me wrong, there will indeed be an economic impact. But so far, analysts are still only estimating that the virus will shave just two tenths of one percent off of Q1 GDP (and maybe another two tenths later in the year). And since S&P companies only get about 6% of their revenue from China, you can see why the impact to U.S. stocks is expected to be minimal.

Nonetheless, once it looks like the worst of the outbreak is over, and travel restrictions, which affect both people and goods, are lifted, stocks are expected to soar as pent-up demand is unleashed."

I will have the next market review and update one week from today on Wednesday March 4, 2020.

All the best,

John Dessauer