John Dessauer Investments, Inc.

John Dessauer's market review and update as of Wednesday March 15, 2023

Stocks have been drifting lower because investors are afraid the Federal Reserve will have to keep raising interest rates. The benchmark federal funds rate is now pegged at 4.5% - 4.75%. The still strong economy may mean that the federal funds rate will have to go above 5% to cool inflation. Looking back to the 1980s and 1990s the Dow Jones Industrial stock average rose from 1,000 to 10,000 while interest rates were much higher than today and higher than the 5% rate investors are worried about. The primary driver of rising stocks was growth in earnings. On that score the resilient economy is a positive. The rate of earnings growth may vary, but a strong economy provides the fundamentals for corporate earnings growth. Based on history, stocks remain very attractive. Uncertainty is the basic issue that is bothering investors. How long will it be, and how high will interest rates go, before inflation comes back down enough to satisfy Fed officials?

Back in the 1980s and 1990s the CPI rate of inflation fluctuated, at times rising above 3%, without alarming Fed officials. That history tells us that inflation doesn't have to be beaten back below 2% for the Fed to stop raising interest rates.

In February the U.S. economy added 311,000 new jobs and the unemployment rate rose to 3.6%. That was a much slower pace than in January when 504,000 new jobs were created. What bothered investors was the 4.6% growth in hourly wages. That was down from January but still above the pre-pandemic pace. Never-the-less the January to February trend is in the right direction. If that continues it may take only another month or two to get inflation down to acceptable levels.

Fed chair Powell is not letting up when he talks about inflation. In testimony before Congress, he recently said: “If the totality of the data were to indicate that faster tightening is warranted, we would be prepared to increase the pace of rate hikes.”

But he knows that monetary policy works with long and variable legs. It could be that interest rates have already risen enough to get the inflation job done. Interest rates have climbed from near zero to nearly 5%, a very rapid pace.

The collapse of the Silicon Valley Bank is another reason to think the Fed will be very cautious about raising interest rates. Silicon Valley Bank had plenty of capital, but it was invested in long-term treasury bonds. That is fine if the bonds can be held to maturity. But Silicon Valley Bank had significant deposit withdrawals that forced it to sell bonds. When interest rates go up the value of long-term bonds go down. So, Silicon Valley bank had large losses on the bonds sold to cover the deposit withdrawals. The clear lesson is that raising interest rates introduces a potential bank crisis.

President Biden has released his 2024 budget. The plan raises taxes by nearly $4.7 trillion and would increase revenue and spending to unprecedented plateaus as a share of the economy. This is a political document. Similar proposals failed to pass when Democrats controlled both the House and the Senate. Now that Republicans control the House there is no chance that his proposals will be approved. So, what is the purpose of proposing things that he knows will never pass? The editors of the Wall Street Journal say that he is telling us about his campaign when he runs for re-election.

“Even with all the taxes, deficits over the next decade would total $17 trillion, and debt held by the public as a share of GDP would rise to 109.8% in 2033 from 97% last year, Mr. Biden's budget is a recipe for an economically and militarily weaker America, but at least he's warning voters of his intentions—unlike in 2020."

The details in his budget are terrifying. When his tax proposals for individuals are added to state taxes, high earners would pay a combined rate of 55%. That would be higher than the oppressive taxes in some European countries. And, in my opinion, that would be a wealth and investment killer. Hopefully, come next year's elections, voters will solidly reject his tax and spend proposals.

In the short term there will be negotiations about raising the nation's debt ceiling. Republicans want to use the debt ceiling issue to force the Democrats to back off from their spending plans. Hopefully that will be the case. If so, that will reduce some of the fear that is bothering the financial markets.

Meanwhile I expect the stock market to remain soft, no big moves in either direction.

I will have the next market review and update for you one week from today on Wednesday, March 22, 2023.

All the best,

John Dessauer