John Dessauer Investments, Inc.

John Dessauer's market review and update as of Wednesday April 27, 2022

It was a very rough week for stocks. Fed Chair Powell confirmed that the May interest rate hike will be 50 basis points rather than the usual 25. Stocks and bonds promptly went sharply down Thursday and again on Friday.

There have been concerns about a recession as inflation soared and the yield curve tightened. But stocks and bonds held their ground because of hope for a soft landing or at worst a modest recession. Fannie Mae, the mortgage lender, in a new economic and housing forecast said that the economy faces a "modest recession" in 2023 as a result of the Fed's aggressive monetary policy tightening trajectory, fallout from the Russian war in Ukraine, and the worst inflation in a generation. They explained that thanks to the current state of the housing market, including a mortgage credit quality that is "far superior" and mortgage lenders that are better equipped than they were a decade ago, the coming recession will not be worse than the one seen in 2008 in the wake of the financial crisis.

During the Fed's March meeting Powell said: "The probability of a recession in the next year is not particularly elevated. All signs are that this is a strong economy, and one that will be able to flourish in the face of less accommodative monetary policy,"

If the outlook isn't so bad, why did stocks and bonds suddenly plunge? Part of the reason is the popularity of the "yield curve recession indicator."

Investors looking for recession indicators typically focus on the relation between yields on the two-year and 10-year Treasury notes, called the 2/10 or the "twos-10s spread." As of the market close on March 25, the two-year note was yielding 2.30%, while the 10-year note was yielding 2.48%. That margin of 18 basis points (bps) was 150 bps a year ago. The long-term average is 90 bps; since 2017 the average has been 60 bps.

Normally investors expect higher yields on longer term notes. When short term yield rise, as in the last year, investors take that as an early indicator of a coming recession because when short-term yields rose above the 10-year yield in the past, the economy subsequently slowed or slipped into a recession.

When Powell spoke about the Fed's resolve to bring inflation down, and the intended 50 bps rate hike next month, stock and bond traders immediately assumed that short-term rates were going a lot higher and that would cause a yield curve inversion, a strong indication of a coming recession. So, traders sold stocks and bonds to raise cash and get ahead of a recession.

In my opinion the stock market plunge is an overreaction. I say that for two reasons. First as the market was collapsing, Kimberly Clark's stock price soared, up $10 a share. Management reported a strong quarter and gave an upbeat outlook for the rest of this year. Several other stocks, while down, were off only slightly. I did not see broad based panic selling as we had in 2008. Second, the economy is remarkably strong. The labor market in particular is solid. And as Fannie Mae points out, bank and household balance sheets are better than they have been in a decade. Stock market pull-backs are always disturbing. But selling into a pull back is seldom a good idea.

Remember 2017 and the Democrats' claims that the Trump tax reform would slash Treasury tax receipts, especially the corporate income tax cut to 21% from 35%? According to them, corporate tax revenue was supposed to fall to historic lows as a share of the economy. Big business supposedly got a windfall and government was robbed.

You wouldn't know it from the Democrats or the popular media, but it hasn't turned out that way. Corporate tax revenue declined in the immediate wake of reform as the rates fell. But the big news is that more corporate tax revenue is flowing into the Treasury at record levels even with the lower rates.

"In June 2017, before tax reform passed, Congressional Budget Office (CBO) predicted corporate tax revenue of $383 billion in fiscal 2021. But in April 2018, after reform passed, CBO lowered its estimate to $327 billion. Actual corporate income tax revenue in 2021 was $372 billion- nearly as much at a 21% rate as CBO expected at the 35% rate that was among the highest in the world.

Fiscal 2022 is turning out to be even better for the Treasury. Corporate tax revenue for the first six months was up 22% from a year earlier to $127 billion. William Mc Bride of the Tax Foundation estimates that if the pace of the first half continues, corporate tax revenue will hit a new record of $454 billion in fiscal 2022.

That compares to CBO's estimate after tax reform of only $353 billion.

What accounts for this windfall for Uncle Sam and a comparable one for state coffers? Corporate profits have been very strong, and government is sharing in the

wealth, even at a lower rate. Inflation in the last year has also increased nominal corporate profits, though CBO's estimates did include some inflation.

But the Occam's razor policy answer is that corporate tax reform worked as its sponsors predicted: Lowering rates while broadening the base by eliminating loopholes created incentives for more efficient investment decisions that paid off for shareholders, workers, and the government.

By the way, individual income-tax revenue rose by $300 billion, or 36%, in the fiscal year through March from the same period in 2021. Washington is having a very good year and doesn't need more money to spend." (*The Wall Street Journal,* 4/20)

I will have the next market review and update for you one week from today on Wednesday May 4, 2022

All the best,

John Dessauer

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