John Dessauer Investments, Inc.

John Dessauer's market review and update as of Wednesday May 4, 2022

A slowdown in the rate of recovery was expected. But from a growth rate of plus 6.9% in the fourth quarter of last year to a 1.4% decline in this year's opening quarter was a shock. That's right - the U.S. economy contracted 1.4% in the opening quarter of this year. That was the first decline since the pandemic wrecked the economy in the second quarter of 2020. Economists had expected growth of 1%-2% in the first quarter.

As you would expect the pessimists are using the decline to bolster their forecasts of stagflation and recession. But they are going to be wrong again. Consumer spending grew at a 2.7% rate in the first quarter. Overall spending, including spending by businesses and other private purchasers grew at a 3.7% rate in the first quarter.

With spending growing, why did the GDP shrink? The answer is that the U.S. trade deficit expanded, meaning that a lot of U.S. demand was met by imports from other countries rather than domestic production. And that is not likely to continue, at least not at the first quarter rate. Because of the pandemic, ships piled up at U.S. ports, waiting at anchor to be unloaded. There was a surge in the first quarter as conditions at American ports improved. For example, in the first quarter, the ports of Los Angeles and Long Beach took in 31% more loaded shipping containers than in the same period of 2019, while in the fourth quarter they took in 3% fewer than three years earlier. That was a dramatic shift. The surging trade deficit alone shaved 3.2 points off GDP growth. In other words, if our ports were behaving as they did before the pandemic the GDP would have grown in the first quarter.

The editors of *The Wall Street Journal* called the first quarter report "The GDP Mirage," and they concluded: "For now, the stage seems set for robust growth in the quarters ahead." They also warned: "On the other hand, the economy is bound to slow at some point, if only because the Federal Reserve wants it to. The negative first-quarter GDP print will hardly keep the central bank at bay; rather the firming of demand the details of the report showed might only steel its determination to keep raising rates until both inflation and the job market cool off."

Speaking of inflation, you will not believe what some policy makers in Washington are promoting. Democrats are desperate, their poll numbers are falling, the Biden Build Back Better agenda has failed, and inflation has become a serious concern of voters from both parties. Senate majority leader Chuck Schumer is now pitching a tax increase as a cure for inflation.

"If you want to get rid of inflation, the only way to do it is to undo a lot of the Trump tax cuts and raise rates," said Mr. Schumer a week ago. This idea comes from Modern Monetary Theory school. MMT proponents argue that taking money away from taxpayers will cool demand and bring inflation down. The problem is that raising taxes only shifts spending from taxpayers to the government. As can be seen from the recent Biden budget there is no limit to the government's desire to spend.

Tax increases would actually make inflation worse. That is the lesson from the 1960s and 1970s. Higher taxes on corporate profits and individuals depressed investment and productivity growth. In other words, higher taxes reduced the supply side of the economy, but demand remained strong. That contributed to inflation just like the Biden attack on American energy production did recently.

In the 1980s inflation was finally defeated by a policy mix of tighter money to target inflation and tax cuts to re-ignite animal spirits and faster growth. What followed was the Reagan economic boom.

There is one way that tax increases could bring inflation down and that is by raising taxes so high that the economy falls into a nasty recession. I doubt that is what Mr. Schumer wants. He is just casting around looking for an angle that might fool voters and keep Democrats' spending plans alive. He and his fellow Democrats are losing support because their massive pandemic spending has resulted in the highest inflation in 40 years.

Democrats and other apologists point to 7.5% inflation in the euro region and 7% in the UK as evidence that U.S. inflation is part of a global phenomenon. The problem is that when you strip out food and energy, the euro zone's inflation rate falls to 3% while American inflation is 6.5%. That makes it clear that America has its own inflation problem.

"Uncle Sam has been on a unique path because of Mr. Biden's excessive $1.9 trillion fiscal stimulus, which passed in March 2021. It added extra oomph to an economy that was already recovering fast after multiple rounds of spending, and brought the total pandemic stimulus to 25% of GDP--the highest in the rich world." (*The Economist*, April 29)

Yes, the Federal Reserve bears part of the blame for the high inflation. It arguably kept monetary policy to easy for too long. But unlike the Biden Administration, the Fed has changed course and is now raising interest rates and shrinking its balance sheet. The question is: can the Fed, by itself, orchestrate a soft landing or is a recession inevitable? In the last 60 years there were three times when the Fed managed to bring inflation down without causing a recession. So, it is possible. And the good news is that inflation may have peaked and will start coming down thanks to the economy returning to pre-pandemic growth rates.

Investors are clearly worried that the Fed won't be able to orchestrate a soft landing and that we are headed for a recession. I see the stock market's decline as overdone because the economy is fundamentally strong, and a recession is not a sure thing.

I will have the next market review and update for you one week from today on Wednesday May 11, 2022

All the best,

John Dessauer