John Dessauer Investments, Inc.

John Dessauer's market review and update as of Wednesday May 15, 2019

It is remarkable, if not incredible for all who lived through the 1970s. It is almost ten years since the recovery from a near depression began. The U.S. economy is growing faster, unemployment is extremely low, wages are rising, but there is no sign of the old, classic economy killer - inflation. The legendary, late economist Milton Friedman described inflation as too much money chasing too few goods. The Federal Reserve, starting under Ben Bernanke, has printed trillions of new dollars and is now struggling to rebalance its balance sheet. Many thought that the Bernanke money flood fulfilled the main part of Milton Friedman's inflation formula - namely too much money - and that inflation would soar. But inflation stayed low, below the Fed's target of 2% a year. The reason was sluggish demand. Banks had the cash, but too few wanted to borrow. Most of the new money went straight back to the Fed as deposits by member banks. It never chased anything. Recently that has changed. Final demand has improved significantly. There is demand for credit. At least some of the new cash is chasing goods and services but inflation refuses to rise, staying comfortably below 2%. What is going on? Is inflation dead? Or as some predict, is it temporarily in remission and will soon rise to become a threat to the economy?

Zacks Investment Management recently published an article explaining that there are at least two reasons inflation is so low. Zacks says they are likely to keep inflation low for a long time. The first is technology. Moore's law says the number of transistors on a micro chip doubles every two years and that keeps the cost of technology down. For example, calculators that once cost thousands of dollars now cost less than a hundred. Technology also increases productivity. For every 3% increase in productivity inflation goes down by 2%. Technology has also resulted in the production of vast new sources of oil. And the price of oil has come down. The second reason inflation is low is the complex global supply chain. Years ago, it was “made in Japan” that drove down the cost of everything from cars to sweatshirts. Then “made in Korea” and “made in Malaysia” and in recent years “made in China” and “made in Vietnam” developed with similar anti-inflation pressures. Today there are intense global competitive pressures keeping the quality of goods and services up and prices down. And both technology and global competition are likely to keep inflation in check for a long time.

At the start of this year stocks were under pressure, the yield curve inverted and an economic model by JPMorgan Chase put the odds of a recession in twelve months at 65%. Perceptions have changed dramatically. The JPMorgan Chase model now puts the recession odds at 15%. Consumer sentiment has rebounded. Job growth has recovered from a hiccup in February. And, even better, Federal Reserve chairman Jerome Powell on May 1, said: “We don’t see any evidence at all of overheating.” The net result is that the economy can continue growing without concern about inflation or Federal Reserve interest rate hikes.

Investors have become more cautious, selling stocks again because of concerns about trade relations between the U.S. and China. Apparently, a broad reaching trade deal was struck between China’s and Washington’s negotiators. When higher-ups in Beijing looked at the deal, they made significant changes, which infuriated President Trump. He responded by increasing tariffs on a long list of Chinese imports. Stocks went down in response to bad news on trade.

Professor Jeremy Siegel, normally an optimist on the stock market, recently warned that stocks could fall 10%-20% if China and the US ‘dig in’ on a trade war. China and the US are back at the table working on a trade deal. Professor Siegel added: “The strongest thing that Donald Trump has going for him in next year’s election is the economy and the stock market. He cannot afford that to falter.”

In addition, there is pressure on Xi Jinping to keep China’s economy growing so the October first celebration of seventy years of Communist Rule will not be marred by economic troubles.

There is precedent for a trade deal. In the 1980s trade tensions between Japan and the U.S. were, if anything, worse than the current China U.S. trade tensions. Japan kept its currency deeply undervalued for decades. “Made in Japan” became a political target. The pressures were resolved by a broad trade agreement called the Plaza Accord. After that, Japan made major changes including building cars in the United States.

China’s economic model, state capitalism, is very different from Japan’s in the 1980s. It is unlikely that Chinese firms will follow Japan and move production to the United States. Not that Beijing isn’t feeling a similar pressure - there used to be a flood of businesses leaving Taiwan for mainland China. In the last couple of years that has stopped and a trickle of businesses coming back to Taiwan has developed.

The bottom line is that there are significant pressures - political and economic - on both sides to settle the trade tensions. A trade deal in coming weeks remains highly likely.

Abby Joseph Cohen, senior investment strategist at Goldman Sachs spoke at a Barron's roundtable in New York last week. She lamented the havoc on U.S. and world markets caused by the U.S.-China trade tensions. However, she added: "Fundamentals of the economy and financial markets remain solid, and he S&P 500 stock index is not overvalued."

My conclusion is that Abby Joseph Cohen is right. Stock market volatility is back, but stocks have been quite resilient, refusing to cave in to selling pressures. Zacks thinks stocks will surge once a trade deal is announced. Morgan Stanley thinks a trade deal will mark the start of a 10% correction. I think the reality will fall in between, no surge, no correction, just a reduction in volatility.

I will have the next market review and update for you one week from today on Wednesday, May 22, 2019.

All the best,

John Dessauer

© May 2019