John Dessauer Investments, Inc.

John Dessauer's market review and update as of Wednesday May 20, 2020

The economic contraction from COVID-19 is sure to set records. It already has been the fastest on record and may soon be the deepest since 1930. However, it also is showing signs of a potential recovery. Greg Ip, writing for the *Wall Street Journal* on May 16 pointed out: "There are signs the economic contraction caused by the pandemic, the steepest since the Great Depression, has bottomed out and a tentative recovery may be under way.

Official data may not show much, if any recovery, in May from April, but a rise in June is quite plausible. If that growth is sustained, this economic contraction could go on record as the deepest since the 1930s, yet also the shortest, lasting as little as two or three months. Postwar recessions have lasted six to 18 months."

The signs of a nascent recovery that Greg is writing about come from private rather than government data. They include reports from Apple that map requests have steadily climbed since April 9. Home-buyer demand as measured by customers contacting affiliated agents, after plummeting by one-third, is now above pre-pandemic levels. Uber Technologies says rides have been rising for three straight weeks. Wendy's reported same-store sales were down just 2% from a year ago in the week ended May 3.

The nascent recovery is still fragile. COVID-19 could surge again, wiping out these early signs of a recovery. But there are, at least, indications that the economy has enough strength to recover as the shutdown eases. That is thanks to the enormous monetary and fiscal stimulus that has provided badly-needed liquidity. However, the pessimists have been busy looking for ways to scare the unwary and warn that the stimulus is setting the stage for another, but worse, financial crisis.

We are currently watching prices decline. Consumer prices fell 0.8% in April from May. That is the largest monthly decline since 2008. The Consumer Price Index is now up just 0.3% from a year ago. The possibility of a period of deflation is a major worry for the Federal Reserve. When prices fall, it is even harder for borrowers to pay down existing debts, leading to rising defaults and banks raising credit standards. With credit challenged, the economy would struggle to grow, making a recovery hard to sustain.

Pessimists are saying, wait a minute - central banks, including the U.S. Federal Reserve, are buying bonds and flooding the world with cash. That, they argue, is sure to be inflationary. And rising inflation will mean rising interest rates - something heavily indebted governments cannot afford.

Alan Blinder is a professor of economics and public affairs at Princeton University and a former vice chairman of the Federal Reserve. Here is his analysis of the stimulus and inflation:

“But what about all that money created by the Fed’s actions? Don’t we know that huge increases in the money supply cause inflation? Actually, we don’t.

Identical questions arose over the Fed’s unprecedented responses to the financial crisis in 2008-09. Since then, however, monetary-policy makers have worried about inflation being too low than too high. Here’s what actually happened:

Over the seven years from August 2008 (the month before the Lehman catastrophe) to August 2015 (after quantitative easing had ended) the Fed’s balance sheet soared by a factor of five. Bank reserves ballooned from a negligible sum (roughly $10 billion) to a mind-blowing $2.8 trillion -roughly, a 280-fold increase. Huge fodder for inflation, right?

Apparently not. The M2 money supply did rise, but only by 54% over those seven years- during which time the Consumer Price Index rose less than 9%.

Can we be sure this aspect of history will repeat itself? Well, not *sure*, but I'm not very worried. If inflation storm clouds gather, the Fed will shrink its balance sheet gradually. Indeed, it was doing precisely that from March 2018 to August 2019, when it reduced its asset holdings by roughly 14% in 17 months. It wasn't hard."

The Fed is right. Deflation - not inflation - is the greatest threat to the recovery. Another question is: how much can the U.S. borrow at these very low interest rates? So far, the Fed has purchased about $1.5 trillion in U.S. treasury securities, effectively financing all of the additional borrowing to date. In this quarter, however, the Treasury will need to borrow an additional $3 trillion, a quarterly record and considerably more than last fiscal year's total. Treasury Secretary Steven Mnuchin says he plans to borrow money long-term to lock in low interest rates. And the Treasury has launched a new 20-year bond to extend maturities. In the last and most recent auction the Treasury sold $32 billion of ten-year bonds at a record low 0.70% interest rate. And there was strong demand for the bonds. So, it appears that, for now, the U.S. can keep borrowing, thanks to the combination of Fed purchases and widespread demand.

Given the COVID-19 disaster, all the government borrowing, and the need for more stimulus, it is clear that the economic stakes have never been higher than in the coming November elections. A Democratic sweep would surely mean new, draconian taxes that would blunt the recovery. The only effective long-term answer to our growing national debt is to have the economy grow in future years at a rate faster than the growth in debt. That is what happened in the 28 years after World War II, when the debt to GDP ratio fell from 100% to 22%.

Last week I had the privilege of listening to an interview of Dan Clifton, a Washington based partner and head of policy research at Strategas, an institutional brokerage and research firm serving clients in 20 countries.

Dan explained why he thought there would be one more stimulus bill from Congress, but at $1 trillion, not the proposed $3 trillion. For example, the 50 states are losing about $180 billion in tax revenue because of COVID-19. They are asking for $500 billion, will likely get far less, but enough to cover the current year's lost tax revenue.

He also explained his favorite indicator for Presidential reelection prospects. The indicator is the S&P 500 stock index. It has been correct 87% of the time since 1928. If the index is higher on October 31 than it was on August 1, President Trump will win. If it is lower at the end of October he will lose. With that indicator, we will at least know the likely result before the poll watchers and the media.

I will have the next market review and update one week from today on Wednesday May 27, 2020.

All the best,

John Dessauer