John Dessauer Investments, Inc.

John Dessauer's market review and update as of Wednesday June 1, 2022

Investors are afraid the pessimists might be right this time. Their record is not very good. Predictions of doom and gloom have never materialized. Look back at the 1970s and the beginning of Earth Day. Experts predicted all sorts of tragedies. One said the world would be starving by 1985. Others said we were running out of oil. Pollution was the global warming of its day. Supposedly pollution would kill off billions of people and might make mankind extinct by the end of the 1990s. At the time those pessimistic prognostications were widely believed. Some wrote books explaining their gloom and doom outlook. Several of the books made the best seller list. None proved correct. Looking back most of the forecasts look silly and unrealistic.

Today's economic pessimists are not as drastic as the 1970s - they are calling for a recession, not the end of the world. Still, history tells us that recessions are just about impossible to predict. There is one thing that strikes me as a major difference from the high inflation of the 1970s. I wrote about it last week. The dollar is strong, up 8% so far this year. In the 1970s the dollar was sinking. The global currency market is huge, most likely the largest market on earth. Living and working in Switzerland in the 1970s taught me that the currency market should be watched and respected. If the Fed was truly behind the curve, doing too little too late to stop inflation, and the U.S. really was heading for a recession the dollar would be going down. Foreign currency traders would not want to take the risk of losing first to inflation and then to a recession. The fact that the dollar is up and rising says currency traders think they will enjoy a profit on dollars bought today.

They see the U.S. economy growing this year and next, with inflation coming down so they will have a real return on their dollar investments.

In the past when the Federal Reserve set out to cool the economy and slow inflation it counted on the housing market to lead the way. By raising interest rates, it made taking out a mortgage to buy a home less affordable. Buyers backed off and home sales declined. Home prices stabilized and then went down a bit. The economy slowed and inflation came down. There is no doubt that housing has been a contributor to inflation. The average house price has soared, up 14.8% in April compared with a year ago. And home prices rose 18.8% last year. The average price is now $391,200. That alone makes housing more expensive and reduces the number of buyers who can afford that cost. In addition, the Fed's action has already pushed up interest rates on home mortgages. Mortgage rates have risen about 2.3% since last November to 5.25%. That is the fastest six-month rise in decades. The Fed is set to raise interest rates at coming meetings. That could push interest rates up another 1%-1.5% this year. Mortgage interest rates could edge up above 6% and that is widely believed to be a breaking point for housing affordability.

Some economists worry that home prices might go still higher before peaking and settling down. If that happened, then the Fed would have to be more aggressive in tightening monetary policy. Interest rates then might rise enough to increase the recession risk. Their point is that the demand for a home remains strong and the supply is restricted. Based on that supply-demand analysis they see home prices going still higher. However, housing is different. First, a home is a major investment, one that costs money to keep.

There are local real-estate taxes, insurance and the principal and interest on a mortgage. Demand for housing is dependent on affordability. With home prices sky high and mortgage interest rates rising I expect to see demand decline and prices stabilize. That will be a major help in cooling inflation. Pending home sales, a good indicator, fell in April. That is the sixth month in a row that pending sales have declined. Housing is cooling off.

The stock market's decline has encouraged one group of investors. Companies that repurchase their shares are getting more bang for their buck. Depressed prices are encouraging stock buybacks which are expected to reach a new record high at $1 trillion this year.

Buybacks reached a new peak at $972 billion during the 12-month period ended in March. That is up from $499 billion in the same period a year ago. The buybacks are financed from free cash flow. Cisco, for example, generates about $12-$14 billion in free cash every year. Dividends account for $6 billion. The rest can be used to make investment in the business or for stock buybacks. Cisco's chief financial officer, Scott Herren recently said: "looking at where our share price is, it feels like there will be an opportunity to do that more aggressively." Cisco's stock price has fallen about 40% during the stock market decline. That makes stock buybacks very attractive. Cisco can retire more shares with the free cash. Buybacks reduce the number of shares outstanding. That in-turn increases the earnings per share, making the remaining outstanding shares more attractive.

The stock market's decline therefore has a silver lining, at least for companies that have sufficient free cash flow. Which, by the way includes about all of the major tech companies, whose shares have been particularly hard hit. Share buybacks are one reason stocks, especially tech stocks, will come roaring back.

I will have the next market review and update for you one week from today on Wednesday June 8, 2022

All the best,

John Dessauer

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