John Dessauer Investments, Inc.

John Dessauer's market review and update as of Wednesday June 3, 2020

The pessimists are having a field day. They are using the massive COVID-19 spending as the basis for their siren calls about a coming financial disaster. I have seen teaser headlines like: "The Biggest Wealth Transfer in History is About to Take Place," "Your Savings, even Your IRA are at Risk." And of course, if you buy their publications, they will tell you the five steps you have to take now to save your wealth. The common thread in all these scary predictions is the massive spending and borrowing the federal government is undertaking to soften the economic blow from COVID-19.

There are serious errors in the pessimists' assumptions. The first has to do with the debt itself. The Federal Reserve has, so far, financed most of the new borrowing. The Fed has, once again, swollen its balance sheet by buying trillions of dollars worth of U.S. Treasury securities. U.S. Treasury debt held by the Federal Reserve is far different from debt held by American or foreign individuals and institutions. The Fed pays for the debt by printing money, expanding the money supply. Everyone else has to have dollars earned, or saved, in private sector enterprises to pay for the securities.

When the pessimists write about the massive accumulation of new debt, they rely on misleading government accounting rules. Believe it or not, the government debt held by the Federal Reserve is included in official figures showing how much debt is "held by the public." Congress does not have to raise taxes to pay for the securities held by the Federal Reserve. The Fed can hold those securities for a very long time, selling only when economic conditions are solid and sound.

Just like the reaction to the Fed's quantitative easing in response to the 2008-2009 financial crisis, some are predicting an outbreak of inflation because of the Fed flooding the economy with money. The inflation hawkers were wrong then and will be wrong again.

The Personal Consumption Expenditures (PCE) index fell 0.4% in April, following an unchanged reading in March. April was the weakest reading since September 2001. The Federal Reserve board members are openly worried about deflation and are ready to adopt policies to prevent that from happening. Inflation may become a serious concern, but not as a result of the COVID-19 rescue efforts.

Another reason the pessimists are wrong is misunderstanding what actually happens when Congress raises taxes on high earners and cuts taxes on low-income earners. The intention is to reduce the income inequality gap by making the tax structure more progressive. This is sure to be on Congress's agenda in the post-election COVID-19 recovery planning.

Three economic scholars recently joined forces and submitted a paper to the St. Louis Federal Reserve Bank. The title is: "Could More Progressive Taxes Increase Income Inequality?" They concluded: "We found that an increase in tax progressivity actually increases income inequality. At first, this result seems counterintuitive. Lowering taxes on low-income individuals and raising taxes on high-income individuals should make low-income individuals relatively better off. Disposable income for low-income individuals increases, thus allowing them to increase consumption.

How then, would income inequality rise? Consider the standard fiscal multiplier story: Taxes decrease, consumption rises. But this consumption results in new income for others."

The logical next question is, who benefits when low-income individuals increase their spending? The answer is the businesses and individuals that provide the goods and services the low-income individuals want. And that process is what results in consequences never even imagined by the pro-tax-the-rich politicians.

Here is more from the St. Louis Fed paper: "We conjecture that inequality can rise if low-income agents work for (relatively) fixed wages but high-income agents own the stores and capital. When low-income agents' taxes go down, they increase consumption at the stores owned by high-income agents. Even though these high-income agents saw an initial decline in their disposable income from the tax shock, they see a countervailing rise in income from the new spending by the low-income agents.

If the high-income agents, in turn, increase their spending, they go to the stores owned by other high-income agents. The result is a multiplier effect that occurs only for the high-income agents and a single, one-time increase that occurs for the low-income agents. The net effect is that output rises, but the increase in income may trickle up to the top."

When I first read this paper, I was astounded. No wonder the stock market has continued its long-term upward trend even when tax-the-rich politics result in higher taxes on us. The paper is available on the St. Louis Federal Reserve Bank's website, along with supporting research. But please do not pass this along to the tax-the-rich supporters. Let us continue to benefit from these unintended consequences.

It seems that some of our political leaders are trying to use the COVID-19 disaster to their political advantage. The theory being, that if the economy stays in a deep recession through October their chances of defeating President Trump will be better. This may be the reason the Blue State governors are keeping the lock-downs effective while the Red states have mostly partially reopened their economies. If so, this is a very high-risk policy.

Kevin Matras of Zacks Investment Research thinks there is pent-up demand that is being unleashed even in the Blue states and points out that top analysts are calling for a third quarter GDP rebound to be the biggest in history (likely 20% or more), with another double-digit growth rate in the fourth quarter.

In my opinion the President's opponents would be far better positioned if they were supporters of the recovery rather than hoping for a continued recession. But we shall see, come November. And we will be watching the performance of the S&P 500 Index at the end of October. As I wrote last week, that index has been a very good predictor of a President's reelection prospects. If the index is higher at the end of October than at the beginning of August, President Trump will be the likely winner.

For a full post-COVID-19 recovery the economy will need new investment and the risk-taking known as American animal spirits. Far better in the long run to adopt policies that encourage new investment and reward animal spirits than to wish for more economic suffering in hopes of winning an election.

I will have the next market review and update one week from today on Wednesday June 10, 2020.

All the best,

John Dessauer

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