John Dessauer Investments, Inc.

John Dessauer's market review and update as of Wednesday June 10, 2020

The May jobs report is a shock to optimists as well as pessimists. Leading Democrats are especially troubled by the report. Their concern is the coming election. They see economic good news as helping President Trump. So, they hope for bad news until after the election. No wonder Speaker Pelosi and Senator Schumer are upset and trying to find bad news buried somewhere in the details of the May report. However, their bigger problem is that the news on the labor market is likely to keep getting better. The May report included data up to the 12th of the month. This means that the May report included only the very early stages of the reopening in some parts of the U.S. More recent surveys show that new claims for unemployment are declining sharply.

The top line jobs numbers for May are so much better than anyone expected that both optimists and pessimists were surprised. The change in non-farm payrolls through May 12 showed an increase of 2.509 million jobs. Economists expected a loss of 7.5 million jobs. And May compared with April is mind-blowing. The economy lost 20.687 million jobs in the April report. To go from such a huge loss to a solid gain in just a few weeks is astounding. The sharp turn-around in the labor market indicates that the U.S. economy is stronger and more resilient than most expected. The developing recovery may also turn out to be stronger than now expected, maybe not a sharp V, but a short-lived bottoming out followed by a return to solid growth.

The strong May jobs report has provided fuel for a debate about the future for inflation in the United States and other developed markets. As *The Economist* says in the June 6 issue: "Never before have central banks created so much money in so little time.

In the past three months America's monetary base has grown by $1.7 trillion as the Federal Reserve has hoovered up assets using new money……It is no surprise, therefore, that a vocal minority of investors and economists predict an inflation surge, including researchers at Morgan Stanley."

I have Morgan Stanley's June "On the Markets" report and sure enough here is what they say: "The great COVID-19 recession has unleashed forces that will alter inflation dynamics. We expect inflation to reemerge in the developed markets, particularly the U.S., in a way that will be different from the previous three cycles……. We expect inflation to be structurally higher than in the previous three cycles and see the US as most exposed to this risk."

The Morgan Stanley researchers admit that the near-term effects from COVID-19 are deflationary. "In the near term, the shock (from COVID-19) will likely be disinflationary, given the hit to household and corporate income." They go on to explain when they see things changing. "As growth recovers, reflation will take hold, driven by the narrowing of the output gap and normalization in the labor market. We expect DM (developed market) output to reach pre-COVID-19 levels by the fourth quarter of 2021.

After this normalization takes place, we think that inflation dynamics will gain momentum. Assuming DM economies reach their prerecession output levels by 2021's fourth quarter we expect this phase to kick in starting in the second half of 2022 thanks to policymakers' renewed monetary and fiscal activism and coordinated easing."

In other words, the Morgan Stanley researchers do not think a resurgence of inflation is inevitable. They think it will be the result of politicians' attempts at dealing with income inequality and central banks continuing to feed the renewed growth with

excess money. In my view they will likely be wrong about how our Federal Reserve handles the recovery. But the political risks are real and could be exaggerated in the coming election.

Here is the view of the Editorial Board at *The Wall Street Journal* on June 6: “The worst intervention would be for Congress to extend the unemployment benefit of $600 a week that is giving workers an incentive not to return to work. The Congressional Budget Office this week said five out of every six workers would receive more benefits than they would in wages, and employment later this year would be *lower*, if the $600 benefit is extended into 2021.

The U.S. economy is a dynamic engine that left to its own devices will grow, as consenting adults commit multiple acts of commerce. Let’s give it a chance to recover before Congress spends another trillion dollars that sooner or later will come out of the private economy.”

I met Liz Ann Sonders many years ago when we both were panelists on *Wall Street Week*. She is now Chief Investment Strategist at Charles Schwab and recently wrote an article including a clear and understandable piece about inflation.

“The growth rate in M2 money supply has gone parabolic. At the same time, the velocity of money continues to shrink—which is why “real economy” inflation has been in check. “Money printing” by the Fed (not quite an accurate description of what the Fed’s doing) only becomes inflationary if the liquidity pumped into the financial system comes out via the lending channel and picks up velocity in the economy. Without that velocity, inflation tends to be absent in the real economy.”

In the past I have written about a "credit bubble" as the necessary predecessor to an inflation surge. That is consistent with Liz Ann's "lending channel" explanation.

The next question is: where has all that liquidity gone? Liz Ann answers: "The surge in money supply is reflected on Main street as well; with the personal savings rate surging a whopping 33% of disposable personal income; while at the same time, household net worth remain historically high."

In addition, households and many businesses have been deleveraging since the global financial crisis of 2008-2009.

There were similar inflation warnings after the 2008-2009 financial crisis when the Fed pumped several trillion dollars into the economy. They were wrong, because business and consumers used the extra liquidity to build up savings. They are doing the same today, which means the inflation hawks will likely be wrong again. In any case inflation will not become a risk until the US and developed market economies have fully recovered and are growing again.

I will have the next market review and update one week from today on Wednesday June 17, 2020.

All the best,

John Dessauer

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