John Dessauer Investments, Inc.

John Dessauer's market review and update as of Wednesday June 22, 2022

Stocks are down. Investors are frightened by record inflation and the President's blame game. He could help bring inflation down by admitting his fiscal mistakes, reversing his energy policies, and stopping the talk of raising taxes. Instead, he blames Putin's war, supply side shortages and attacks energy companies. He must know that his attack on energy has caused widespread inflation. My grandson is a commercial fisherman. He called the other day. I asked and he said the fishing is great. There is no supply side shortage of seafood. But the price of diesel fuel has skyrocketed. He said even with a boatload of squid he is just making it and is thankful the price of squid went up. Farmers are in a similar position - their main costs are diesel fuel for tractors and other equipment, and fertilizer, which needs natural gas to produce.

Biden's efforts to bring energy prices down make the climate situation worse. He wants more oil from Venezuela and Saudi Arabia. Why give the money to them? The XL pipeline was to bring light crude to us from Canada. Why not give the money to Canada instead of Venezuela? And the oil from Canada is lighter requiring less energy to refine into gasoline and diesel. Then there is the bottom line - why is drilling in the USA bad for the climate while drilling in Venezuela is not? Biden ignores the question.

This means he is leaving it to the Federal Reserve to bring inflation down. Looking back at past inflation challenges the Fed had no choice but to tighten monetary policy so much that a recession followed.

This time the underlying inflation has some different root causes than in the 1970s and in other past high inflation times. A recession is not a given. There is a chance for a soft landing. Inflation is a supply versus demand phenomenon. In this case the supply of energy has been artificially restrained by Biden's energy policies. He cut supply but did nothing to cut demand. So demand kept growing as the supply side shrank. The best solution would be to increase supply so prices would come down without the Fed raising interest rates. The Fed cannot help on the supply side. Only the President and Congress can do that, and they refuse. The Fed therefore has to try and kill off demand. They do that by discouraging borrowing with rising interest rates. And that exposes the first big difference this time. Past inflation periods were fueled by credit bubbles, too much borrowing thanks to easy money and low interest rates. This time there is no credit bubble. Credit demand was depressed by the pandemic and still remains at low levels.

Economists and investors worry that sluggish demand for credit will mean the Fed has to get really tough to stop inflation.

The Fed gets part of the blame for the inflation. Total Fed assets increased from $1.5 trillion in 2008 to $8.9 trillion today. That boosted the money supply and surely caused some inflation. But it is wrong to put very much blame on the Fed. Banks and certain other institutions keep large sums parked in accounts with the Fed. Remember the Quantitative easing under Ben Bernanke? Pessimists were sure that would result in soaring inflation. It didn't happen because the Fed pays interest on the accounts it holds for banks and other institutions. The Fed is paying interest on $3.3 trillion in bank reserves and on an additional $2.3 trillion in cash parked at the Fed through reverse

purchase agreements conducted with money market investors. That’s $5.6 trillion that never made it out into the open economy.

By raising interest rates, the Fed is making it more attractive to keep cash parked at the Fed. This will also discourage borrowing. The unknown is whether this will kill off enough demand to bring inflation down without having to go through a recession.

Are stocks at the bottom of this cycle? Jeremy Siegel is a professor of finance at the prestigious Wharton School at the University of Pennsylvania. He is also a market commentator with an astounding record. On CNBC a week ago, he said: “We’re closer to the lows than the highs. I actually think that the market is already discounting a recession – it’s being priced to that.”

He pointed out that the S&P 500 is now trading at roughly 17 times forward per share earnings, and if you exclude tech stocks the figure is even more impressive at just 13 times earnings. To put the current valuation in perspective, the five-year average for the earnings ratio is roughly 18.6.

Looking at current valuations, Siegel said: “You rarely see it that low.”

During the interview Siegel acknowledged that his own research showed that markets correct on average 31% during a recession – but he said this was likely skewed by outsized downturns in 2000 and 2008. He went on to explain that despite the recent increase in interest rates in many countries, the global economy remains in a much lower interest rate environment than was seen in the past, and typically, lower interest rates

favor higher valuations. So, even though the market's current price-to-earnings ratio is near historic norms, it is evidence that investors are predicting a recession.

Siegel also questioned if the Fed rate hikes will be enough to discourage investing in stocks. "Even if the Fed's interest rate is at 3% or 3.5%, is that real competition for the real asset that is stocks? History shows that dividends move with inflation, so you're getting a real return."

We know the Fed does not want to cause a recession. We also know that the Biden administration is making the Fed's job difficult, and that inflation plus recession fear is affecting more than stock prices. According to one poll the President's approval rating is down to 39%. Democrats are desperate. It looks as if the Republicans will be a majority in the House after the November elections. They could also take the Senate. So we are finally seeing a few Democrats addressing inflation reality and attacking the President's energy and spending policies. The November election is the best bet for reversing course. Meanwhile stocks look undervalued.

I will have the next market review and update for you one week from today on Wednesday June 29, 2022

All the best,

John Dessauer

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