John Dessauer Investments, Inc.

John Dessauer's market review and update as of Wednesday July 15, 2020

Over the course of my working life I have been through several recessions, a few of which were very nasty. For example, in the 1970s, skyrocketing oil prices triggered a deep recession and a massive stock market plunge. The driving force behind those past recessions was inflation. As prices rose, interest rates followed. High and rising interest rates crushed borrowers and depressed economic activity. Recessions cleansed the economy of the inflation virus and paved the way for a return to growth.

Recession history taught economists and investors to be very sensitive to inflation - so sensitive that both groups focused on every monetary detail. The mantra was that inflation was caused by too much money chasing too few goods. When then Federal Reserve chair Bernanke launched Quantitative Easing to fend off a depression in 2008, there was an outcry, shrill warnings of high inflation to come. Pessimists were positive the money flood would soon be followed by rising inflation. They were wrong. The money flood simply provided needed liquidity to support the post-financial crisis economy. A decade later, as the economy gained strength, inflation remained so low that the Federal Reserve worried about deflation. Early this year, before the COVID-19 pandemic, the economy was strong, unemployment was at record lows and inflation was nowhere to be seen. There was talk about a future recession but no sign of inflation or rising interest rates. This recession is therefore different, unprecedented, and history is no help. But governments around the world have responded with massive fiscal and monetary stimulus. When all the numbers are counted the stimulus comes to 28% of global GDP. This time - the money flood being both massive and world-wide – the stimulus is prompting some to predict a rise in inflation.

Because the virus is affecting so many supply chains it is possible that there will be some pockets of inflation. Demand for some products could be so strong as to drive those specific prices higher. But if the United States is any guide, this money flood will, like 2008-2009, provide needed liquidity but not drive up inflation.

Last Friday we learned that the Producer Price Index (PPI) missed forecasts by a wide margin. Economists expected a 0.4% **increase** in producer prices. Instead the PPI was **minus** 0.2%. When volatile food and energy prices are excluded, the PPI, year-over-year, was in negative territory, -0.1%. The problem is not just supply chains; final demand was -0.8% in June. Instead of inflation, the Federal Reserve and other economists are on alert for other signs of *deflation*. Deflation caused by depressed demand can prolong a recession. There are plenty of uncertainties because of the virus. But one thing seems clear: we do not have to worry about inflation or rising interest rates. Both are likely to remain low for this year, next and likely well into 2022.

Rising inflation and interest rates have, historically, been bad news for stock prices. By default, that makes the current whiff of deflation good news. But it also raises questions about the outlook for earnings and dividends. Some businesses - cruise lines, for example - have been devastated by the virus. Others, including technology, have been doing very well. The sharp divide between winners and losers makes it difficult for analysts to calculate likely future results. Making analysts' jobs more difficult is that 40% of companies in the S&P 500 index have withdrawn their guidance on future earnings. Difficulties have not stopped analysts from doing their jobs. For the last several weeks analysts surveyed by Bloomberg have held their 12-month forward earnings estimates for the S&P 500 at $129 a share. Just recently that has changed and for the better. Analysts now expect the S&P 500 to report earnings of $142.51 a share in the coming 12-months. The good news on future earnings estimates leaves some still worried about stock market valuations. I found it interesting to read Zacks Investment Management reaction to those concerns. The article is entitled “4 Reasons the S&P 500 is Not Overvalued.”

“1. The Fed Model Suggests Stocks Can Go Higher”

“The Fed Model is a way of assessing stock valuations by comparing the earnings yield of stocks with the 10-year U.S. Treasury bond. “For illustrative purposes, let’s say the yield on the 10-year U.S. Treasury bond is 5%, and the forward earnings yield on the S&P 500 is 6%. In this case, an investor might do better with stocks, but may ultimately decide that the 1% difference is not worth the additional risk. If the yield on the 10-year Treasury is 1% and the earnings yield on the S&P 500 is 5%, investors usually choose stocks.”

Today, the forward earnings yield of the S&P 500 is over 4% and the 10-year U.S. Treasury bond closed the second quarter with a yield of 0.66%,” making stocks look fare more attractive by comparison.

“2. Tech Companies Make Money – Lots of It. The last time the S&P 500 traded over 20x forward earnings for a substantial period was 1997-1999, with the index topping out at around 25x. But looking back, we now know there were basically no earnings supporting tech’s astronomical rise. Today, tech companies are leading the way with sales growth, earnings growth, and arguably reshaping the modern economy as we know it in the process.”

“3. The Very Worst of the Crisis is Behind Us. Cases of Covid-19 are rising, so there is no argument to say that the spread of the pandemic is improving. What has changed between April and today, however, is a better understanding of how to test, treat and care for patients who become infected.

From an economic standpoint, I agree that the longer this crisis drags on, the longer and more difficult the economic road to recovery will be. But at the end of the day, recessions end when economic growth begins – even if that growth is merely a trickle at first. In my view, the very worst of the economic crisis is behind us, and markets are looking ahead to what the economy could look like at this time next year.”

“4. You Really Cannot Fight the Fed and Fiscal Stimulus. The world has never seen this type of liquidity event before. It is difficult to make a bearish case when this ‘wall of liquidity’ looms in the backdrop.”

Stocks can be volatile, swinging up or down on the latest virus news. And it may be early next year before we have a vaccine and effective treatments. But the best bet, in my view, is that we will defeat this virus and there will be future earnings and dividend growth.

I will have the next market review and update one week from today on Wednesday July 22, 2020.

All the best,

John Dessauer