John Dessauer Investments, Inc.

John Dessauer's market review and update as of Wednesday August 4, 2021

As I wrote last week, the debate over inflation has become intense. But remember that Liz Ann Sonders emphasized that inflation cannot gain traction until the velocity of money picks up. So I keep checking, and while the velocity of M-2 has stopped declining, it is still on the floor and is not rising. That doesn't mean it will stay forever on the floor. It simply means that there is no current threat of soaring inflation. It also means that the current rise in inflation is being driven by something other than an increase in the velocity of money. That something else is of course the pandemic. The PCE (Personal Consumption Expenditures price index) rose 6.4% in the second quarter after rising 3.8% in the first. These are high numbers leading some to conclude that flooding the economy with money has led to a mismatch, boosting demand while businesses are having trouble getting the goods and employees to meet the rising demand. The Federal Reserve says this will be transitory and that inflation will settle down as the supply side issues are resolved. The very low velocity of money indicates that the Fed is right. The money flood resulted in a surge in personal savings, and businesses also increased their cash holdings. The personal savings rate has started to come down but at 10.9% is still very high. And domestic investment fell by 3.5% in the second quarter. This means that businesses are still holding on to their cash rather than making new investments. I believe that Liz Ann is right. The inflation hawks may turn out to be correct, but not until the velocity of money picks up. Looking at the details of economic growth in the second quarter tells me that M-2 velocity is not likely to pick up significantly this year.

First of all, the rate of growth in the second quarter came in below expectations. Economists expected the economy to grow at an 8.4% rate. The actual annualized rate for the second quarter was 6.4%. While that is respectable, it was far below expectations. On the positive side, 6.4% was enough to lift U.S. GDP above its pre-pandemic peak to $22.72 trillion. The optimists were right - the V shaped recovery has come true.

Second, consumption has been the driving force behind the recovery. Consumption rose by 11.8% in the second quarter after rising 11.4% in the first. The reason second quarter growth came in below expectations is that domestic investment fell 3.5% in the quarter after falling 2.3% in the first quarter. Businesses are having a hard time keeping up with demand. This means they have been drawing down inventories to satisfy demand. Hopefully, this will mean a sharp increase in investment once the current shortages of raw materials, semiconductors and labor are resolved. Rising investment would boost growth but not inflation.

The welcome surge in growth is not expected to be sustainable. Economists surveyed by *The Wall Street Journal* expect the economy to grow at an annual rate of 7% in the third quarter and then drift down to 3.3% by the second quarter of 2022. A growth rate of 3% or better would be welcome. It would create jobs and provide fundamental support for stocks without aggravating inflation.

"On the horizon is more of the President Biden – Bernie Sanders agenda of trillions of dollars in more spending and the largest tax increase as a share of the economy since 1968. Washington is applauding itself for the new $1 trillion infrastructure deal, but that's merely the down payment on what Democrats want.

This pandemic recovery year should be the best for growth since 1984. But Washington simply won't let the economy grow on its own. The best economic medicine, other than more Covid vaccinations, would be if the Biden agenda stalls on Capital Hill and there are no tax increases or new entitlements. We wish we could say that is our prediction." (The editorial board of *The Wall Street Journal*)

As for stocks, second quarter earnings are coming in well ahead of expectations. Overall S&P 500 second quarter earnings are expected to be up 78.1% year-over-year. That is according to data from Rifinitiv, a financial data company. This will be the best earnings quarter since the fourth quarter of 2009, when profits rebounded from the financial crisis and recession.

Of S&P 500 companies reporting, 88% have beaten expectations. So far 125 or a quarter of the 500 have reported. There is more good earnings news every business day.

The Delta variant of the Covid virus is causing more infections. There has been a spike in cases here in Florida. The new cases are among adults who have not been vaccinated. The answer to the Delta variant is more vaccinations. I am shocked at the organized resistance to the vaccines. There can be problems with any vaccine. Some people get sick from a flu shot. But most people benefit from the vaccines. Take the new shingles vaccine. Shingles is a very painful illness. The answer is the new vaccine. I haven't seen any resistance to the shingles vaccine. The resistance seems focused on the Covid vaccines. And that, in my view, is tragic. Hopefully most people will get vaccinated and ignore the anti-vax idiots.

Meanwhile enjoy the strong quarterly earnings reports and the consequent stock price increases.

I will have the next market review and update one week from today on August 11, 2021.

All the best,

John Dessauer