John Dessauer Investments, Inc.

John Dessauer's market review and update as of Wednesday August 5, 2020

Forget the polls, we now have the starting point for an election predictor with an excellent record. Since 1928 the S&P 500 stock index has been right about a president's reelection 87% of the time. If the S&P 500 index is higher on October 31 than it was on July 31, President Trump will be reelected. If the S&P 500 index is lower come October 31, he will lose. The measure technically is from August 1. But this year that was a Saturday when the stock market was closed. The S&P 500 index closed at 3,271.12 on Friday July 31. That now becomes the point to beat for a Trump second term.

Because of the pandemic, the tools usually used to predict future stock market behavior are not much help. Second quarter earnings are very mixed. Some companies are doing quite well, even reporting better sales and earnings growth than expected. Others have been hit hard by the lockdowns and travel bans. Overall, S&P 500 second quarter earnings will likely be down more than 30% from the second quarter of 2019. And analysts do not expect earnings to grow again until next year. If that is not depressing enough, the U.S. economy contracted at a 32.9% rate in the second quarter. The eurozone was even worse, down 40.3%.

In anticipation of the dismal earnings and economic news, stocks plunged - down more than 30% in March. If stocks had stayed down, a gain in coming months would have been an easier call. But stocks have come roaring back. The S&P 500 is close to its all time high. The tech-heavy Nasdaq has done even better, reaching new highs. With stocks having recovered and the earnings and economic outlook so uncertain, can the S&P 500 climb between now and the end of October? While possible, that is far from a sure bet. We will have to be patient. We will get the S&P index answer, but most likely not until a few days before the election.

Just what we didn't need is another source of long-term concern emanating from our Federal Reserve. The Federal Reserve board is considering adopting "yield-curve control" to regulate interest rates. That may not sound ominous, but it would be a major shift in monetary policy. For the past forty years the Fed has "set" short-term interest rates by expanding or contracting the money supply, in other words guiding supply and demand for credit, leaving open markets to agree or disagree. The important aspect of the past policy is that it preserved open market influence. Investors were the final determining force when it came to interest rates. As the *Wall Street Journal* editorial board said: "Yield-curve control muzzles investors. The world needs a market price for the ten-year Treasury yield, and Mr. Powell is threatening to take that away."

The last time the Fed experimented with yield-curve control was in the 1940s. The U.S. had borrowed heavily to finance World War II. All of Washington was terrified that interest rates might rise, increasing the amount needed to pay interest on the debt. Today we are once again dealing with a soaring federal government deficit and rising national debt. The possibility of open market interest rates rising, just as in the 1940s, is frightening the Treasury, Congress and Chairman Powell. Inflation became an issue after World War II as the economy transitioned back to a peace time basis. Economic reality soon drifted away from the Fed's interest rate regime. In addition to its own policy determination, the Fed had opened itself to political pressure from the Treasury to keep interest rates low. The conflict between Fed policy and economic reality was finally resolved in the 1951 Accord, when the Fed wrestled back its independence from the

Treasury. But the Fed maintained what was called “even keel” operations to facilitate government borrowing into the 1970s. The terrible inflation of the 1970s finally compelled the Fed to fully separate and let interest rates rise. Arguably the economic and financial market jolts of the 1970s and into the 1980s would have been much milder had the Fed never adopted yield-curve control, or at least fully abandoned it shortly after the war.

Perhaps Fed policy makers believe that “this time is different.” Inflation is very low, and at the moment, there is no sign that it will rise any time soon. As long as inflation stays low there will be no conflict between economic reality and Fed yield-curve control. Of course, the yield-curve would no longer be a useful indicator of underlying economic conditions. Inflation could sneak up on us, introducing financial market and economic distortions. No doubt, just as in post war times, there would be severe political pressure on the Fed to keep interest rates low. A repeat of the 1970s would be disastrous given the monstrous amount of debt being accumulated by the U.S. and other governments. Imagine a flood of government bond defaults as the cost of servicing the debts rose.

“We don’t know what price the global economy would pay for such a policy in economic distortions or financial instability. The Fed doesn’t know either. No one should be eager to find out.” (*Wall Street Journal* editorial board July 28)

The United States is not alone when it comes to yield-curve control. The Bank of Japan has been dictating interest rates since 2016. One result is that the open market for Japanese government debt has all but dried up. Otherwise the penalty for the policy have been tolerable. Because of concerns about the long-term financing of pandemic debts, Australia adopted yield-curve control in March. Reportedly our Fed is watching Australia to see what happens. So far both Japan and Australia have been dealing with low inflation. Combine political pressure to stay in control of the yield-curve with rising inflation and the result would likely be financial market and economic pain.

For now, our best strategy is to hold on to our stocks and pay close attention to inflation indicators.

I will have the next market review and update one week from today on Wednesday August 12, 2020.

All the best,

John Dessauer