John Dessauer Investments, Inc.

John Dessauer's market review and update as of Wednesday August 10, 2022

In July the U.S. economy added 528,000 jobs. By any measure that is good news. More Americans working, earning a wage, contributing to economic growth. Only economic pessimists can spin this in a negative way. And they are doing just that. Their argument is that the job growth shows the economy to be quite strong and that might mean a more aggressive Fed to combat inflation. On the other hand, wages were up 5.2% year-over-year in July. That is far less than the 9% inflation rate. In my view that means job growth is not contributing to the current high inflation. Real wages are declining. Workers are losing buying power. One further point is that with the July data, the labor market is finally back at the pre-pandemic level. We have recovered all the jobs lost to Covid.

Will we keep adding jobs at a high rate? There are some areas that have not fully recovered from the pandemic, but most have. The unemployment rate is at its low, 3.5%. And there are fewer people looking for work. Odds are that we are seeing the peak in job creation. Fear that the Fed will become much more aggressive is premature at best.

This isn't the first time the nation has faced destructive inflation. By 1973 inflation was running at 8.7% and rising. Inflation averaged 9.2% a year for nine years. In 1981 when Reagan took office the inflation rate was 12.5%. Forty years ago this month the fiscal policy of President Reagan and the monetary policy of Federal Reserve Chairman Paul Volcker broke the back of the 20th century's most destructive inflation, ushered in an economic expansion that effectively lasted a quarter of a century, and banished inflation—until now.

Much like today, that period of inflation began in 1966 when Congress, at the urging of the Johnson Administration, expanded funding for both the war in Vietnam and the War on Poverty. The combination of “guns and butter” produced a double-digit surge in federal spending. That money flood is what increased demand and ignited inflation. The supply side attack on oil prices by OPEC made inflation worse.

How did Reagan and Volcker stop 12.5% inflation from rising further and how did they bring inflation down? The answer is by doing the opposite of what the Biden Administration is doing today. The Federal Reserve pushed up interest rates. The Powell Fed is doing the same but so far has not had to push interest rates anywhere near as high as Volcker did. By 1981 Volcker had prime lending rates at 20.5%. President Reagan cut federal spending, lowered taxes, lightened the regulatory burden and supported supply side increases. His efforts cut the cost of moving people and products by 50% and gave America the world’s most efficient supply chain.

As far as the stock market was concerned, investors did not immediately understand what the Reagan policies would mean. They understood 20% interest rates and in the mid-1970s the stock market collapsed. There was a recovery in the 1980s, but that was marked by a short-lived plunge in 1987. In those days I was writing a monthly newsletter. In a letter in the 1980s I wrote that the Dow Jones Industrial Average was headed to 1,000, where it once was in the mid-1960s. That did not impress my subscribers. The popular wisdom at the time was that stocks were down and would stay down for many years. The pessimists were wrong. The Dow did rise to 1,000 and kept on growing. A Dow above 30,000 was not even imaginable in the 1980s.

When I say the Biden administration is doing the opposite of what Reagan did, I am not alone. More than 230 economists wrote a letter to the President explaining why his “Inflation Reduction Act” will do just the opposite and make inflation worse. The President and his supporters claim the act will reduce the federal deficit by $300 billion over ten years and that will bring inflation down. Last year the Democrats in Congress - with the President’s support - passed a law that increased the deficit by $1.7 trillion. Perhaps that law should be renamed “The inflation Acceleration Act.” The other problem is that the deficit will first go up under the “Inflation Reduction Act.” It won’t start coming down until 2027, five years from now. Does anyone believe politicians can predict what the inflation rate will be in five years? Leave it to the President and it will most likely be higher than today. Pumping up demand by increasing federal spending while at the same time hindering the supply side with taxes and regulations clearly is a formula for higher inflation. This means the Federal Reserve is alone in the battle against inflation. Not only will the Fed have to tighten monetary policy enough to combat current inflation - it will also have to take additional measures to counter the President’s pro-inflation policies.

The Fed is now expected to raise interest rates by 0.5% next month. Thanks to the strong labor market a soft-landing is still possible, but the President and his fellow Democrats are making that more difficult to achieve.

The combination of bad fiscal policies and a Fed left alone to fight inflation is discouraging investors. Rising interest rates make cash more attractive. Fortunately, corporate profits are coming in better than expected. That provides basic, fundamental support for stocks. The bottom line is that a full stock market recovery has been delayed. Moderate volatility is likely to be the case until there are convincing signs that inflation is coming down.

I will have the next market review and update for you one week from today on Wednesday August 17, 2022

All the best,

John Dessauer