John Dessauer Investments, Inc.

John Dessauer's market review and update as of Wednesday August 14, 2019

I opened my computer last Wednesday and found this scary article: "The Dow Plunges 500 Points Because Treasury Yields Might Be Sending a Recession Warning. The difference between the 10-year and three-month Treasuries has fallen further into negative territory, as the yield curve remains inverted. In the past, that has been a good sign that a recession was six to 18 months away."

Missing from that article was any mention that this applies uniquely to the United States. The yield curve has not been a useful predictor of recessions in other rich countries. Yet popular mainstream media and some market pundits are still promoting the yield curve/ recession connection.

Fortunately, others are focused on the data, which continue to show a strong U.S. economy. For example, Kevin Matras, EVP at Zacks Investment Research had this to say last Wednesday: "In other news, retail sales via the Redbook report showed y/y same store sales up 5.1% last week vs. the previous week's 4.5% snapshot. Analysts were quick to point out the report's consistently 'strong levels of demand.'

Of course, what the markets really want to know is what's going to happen with China and trade. But it doesn't look as if we'll get any answers on that until September.

In the meantime, the economy's strong, employment is at record levels, consumer confidence is near record highs, and corporate earnings continue to impress."

My conclusion is that when it comes to the yield curve the U.S. economy is no different from other rich countries. An inverted yield curve does not necessarily mean there is a recession coming in six to eighteen months.

Thomas Lee, head of Fundstrat Global Advisors, says "U.S. stocks are headed higher in the next six months." Lee doesn't feel he can overstate that point, noting in a research report last Friday that investors "ignore at your peril" bullish signs crystallizing in markets despite jitters about international trade conflicts between China and the U.S. that rocked the Dow Jones Industrial Average, the S&P 500 and the Nasdaq on Monday. Appearing on CNBC, Lee advised investors to 'back up the trucks and buy assets before they missed out on a big buying opportunity.' He sees at least 5 signs that have been triggered in the past week that have dependably generated an average return for the market of 12% in the last half of a year.

Among the signs he sees is the Fed's interest rate cut. Lee says that since 1971 a Fed rate cut has been followed by a six-month market gain. The American Association of Individual Investors (AAII) keeps track of investor sentiment. They say that optimism is below its historical average of 38.5% for the 24th time this year. That is a contrary indicator. Lee also watches the VIX - a measure of volatility - and futures contracts, both of which are sending bullish signals.

Lee's conclusions?

"In short these signals are saying the S&P 500 is set-up for a monster second half rally. We are not ignoring the negative signal of a plunge in interest rates, nor saying that a full-blown trade war is not a negative for the world. But, we believe the trifecta of

strong U.S. corporates, positive White House (towards biz) and dovish Fed, are major supports for the U.S. equity market."

When the U.S. and world economies pulled back during the 2008-2009 financial crisis, Ben Bernanke, then chairman of our Federal Reserve, slashed interest rates and pumped up the Fed's balance sheet to prevent a slide into a depression. His strategy worked. The U.S. economy recovered. Other central banks followed suit and the global economy recovered. Ever since central bankers have been concerned about the next downturn. Interest rates and inflation remain very low. The Fed's balance sheet is shrinking, but slowly. But neither interest rates nor the Fed's balance sheet are anywhere near the levels that preceded the 2008-2009 financial crisis. For a couple of years Federal Reserve board members argued about how to prepare for the next downturn. Some wanted to 'normalize interest rates,' meaning raise them to pre-2008 levels. But inflation did not cooperate. It is hard for the Fed to raise interest rates while inflation is so low. And now, the Fed has gone the opposite way and cut interest rates. While positive for the economy and stock market, this has highlighted the question…. Will the Fed and monetary policy be able to rescue the economy from the next downturn? It is against this background that MMT or Modern Monetary Theory has gained attention.

Economist Stephanie Kelton asserts that the federal government could spend freely for things like jobs guarantees or Green New Deal without risking runaway inflation, a debt default or a clubbing by global creditors. Mainstream economists have countered, calling her theory left-wing free lunchism. Larry Summers, former Treasury Secretary and advisor to both the Clinton and Obama administrations calls Kelton's theory "Voodoo Economics."

MMT's proposal that our politically divided Congress could take over the role of the Federal Reserve and both control inflation and support economic growth looks delusional. The nation's federal government debt is approaching $23 trillion. The federal government is running huge annual deficits. What if inflation reappears and interest rates rise? Interest costs on our national debt would also rise, out of control. Congress would then be faced with a fiscal crisis, struggling to pay interest on the debt and other essential programs like Medicare, social security and our military. You would think that the obvious risk of higher future interest rates would have killed MMT. Instead MMT is being looked at more seriously. The reason is concern about how the U.S. will counter the downward pull of the next recession.

However, there are good reasons why modern rich economies have independent central banks. Handing monetary policy over to elected politicians has never worked anywhere. In the 1970s when OPEC pushed up oil prices and we suffered rising inflation and unemployment, there was a compromise between the White House and the Fed. The result was a deep recession, the opposite of what was intended. And our recent history shows lots of unintended negative consequences after Congress or the White House tried to fix economic problems. I remember the 10% tax on yachts and expensive cars. The result was we lost the yacht building business and the thousands of jobs that went with it. Federal tax revenue declined as lost payroll taxes offset collections from wealthy buyers of yachts and cars.

My conclusion is that MMT and socialism are the biggest threats to the long-term health of our economy. Meanwhile let's stay invested in stocks to build up our personal wealth while we can.

I will have the next market review and update for you one week from today on Wednesday, August 21, 2019.

All the best,

John Dessauer

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