John Dessauer Investments, Inc.

John Dessauer's market review and update as of Wednesday September 1, 2021

The United States Navy irritated the Chinese by recently sending several ships through disputed water near Taiwan. This was a demonstration of national power. China's population is four times that of the United States and China's economy has been growing much faster than the U.S. Today the U.S. is the largest economy in the world. How long will this last? When will China be the world's largest economy and also become the dominant global power? Until the covid-19 pandemic, China's economy was growing at double digit rates, much faster than the U.S. However, that has changed. In the second quarter the U.S. economy rose 12.2% year over year, much faster than China's 7.9% gain. There is some disagreement about how much longer this will continue. Some economists think the U.S. rate of growth will exceed China's for the next five quarters. Others think that will be the case for three quarters. In any case the better U.S. growth sets back the time when China will be the world's largest economy. U.S. Oxford Economics expects China to become number one by 2030. Moody's figures that will not happen until 2038. Becoming the world's largest economy isn't simply a matter of bragging rights. "The world's largest economy sets business and consumer trends globally; it also has more resources to pour into technology and project power overseas." (*The Wall Street Journal*, Aug 28)

Derek Scissors, an American Enterprise Institute economist, says that GDP is one way to measure national power, but is not the best measure. Wealth is a much better gauge of national power. He says that aircraft carriers and overseas investments are paid out of a country's wealth, not its GDP. On that score China has much further to go to catch up with the United States.

"It's the wealth of nations, not the production of nations that matters," said Mr. Scissors.

For now, the U.S. economy is living up to expectations, although consumer spending in July, while up 0.3%, was less than a third of June's gain. Household income, on the other hand, rose a robust 1.1% in July. The gain in income was far bigger than analysts expected. That suggests the economy could be primed for stronger than expected growth in coming quarters. And inflation pressures eased. Consumer prices rose 0.4% last month, down from 0.5% in June. For this quarter, economists now expect growth at a 5.4% rate. In the first quarter the economy grew at a 6.3% rate. The second quarter growth rate has been revised slightly upward to 6.6% from the 6.5% reported earlier. Given the robust increase in income in July it is possible that the actual growth rate this quarter will be better than the 5.4% now expected.

The Federal Reserve is impressed with the economy's performance.

"At the FOMC's recent July meeting, I was of the view, as were most participants, that if the economy evolved broadly as anticipated, it could be appropriate to start reducing the pace of asset purchases this year. The intervening month has brought more progress in the form of a strong employment report for July, but also the further spread of the Delta variant. We will be carefully assessing incoming data and the evolving risk," said Fed chair Jerome Powell.

The minutes from that July Fed meeting show that while most participants are prepared to reduce asset purchases this year, some think it best to wait until 2022. If third quarter growth exceeds the current 5.4% estimate, then the Fed will likely start reducing purchases this year. My guess is that they would cut purchases by $10 billion a month. Then, if the economy remains strong, we could see quarterly reductions of $10 billion a month next year. That would reduce monthly purchases by $50 billion to $70 billion a month - still a strong economic stimulus. And chairman Powell made it clear that raising interest rates is a separate consideration. He feels that interest rate increases are still a long way away.

The bottom line is that while the recovery is strong, the Fed will remain a source of stimulus this year and next. Tapering, meaning reducing the amount of asset purchases, is a far cry from selling bonds or raising interest rates. And you can be sure the Fed will pay close attention to how the financial markets react when tapering begins.

For those who need something to worry about there is the U.S. housing bubble. In May home prices soared by a record 16.6% year over year. According to the Case Shiller index, home prices are now 38.1% above their 2006 peak. The surge has made home prices 25% overvalued compared with residential rents, almost 50% above normalized levels when factoring in inflation and more than 25% overvalued versus income measures like the employment cost index, according to David Rosenberg, chief economist at Toronto-based Rosenberg Research. High prices make homes out of reach for many. Mortgage applications to buy a home have fallen for several weeks and were down 19%

year-over-year in the week ending August 13. Housing starts fell to a three-month low in July.

Are home prices set to collapse? High prices are clearly dampening demand. But the supply of homes for sale is very, very low, said Odeta Kushi, deputy chief economist at First American Financial Corp. She went on to say, “It’s like going from an extremely hot market to just a hot market, it’s still a seller’s market.”

Yes, the high home prices are something to watch and worry about, but they are not likely to become a threat to the economy or financial markets.

I will have the next market review and update one week from today on September 8, 2021.

All the best,

John Dessauer