John Dessauer Investments, Inc.

John Dessauer's market review and update as of Wednesday October 9, 2019

Wow! What a week it was. Stock market volatility returned with a vengeance as October dawned. October is notorious for stock market volatility, but last week was out-of-bounds. By Wednesday afternoon the Dow Jones Industrial Average had lost roughly 1,000 points in just a few days. What scared investors and traders alike was a report from the Institute for Supply Management that their manufacturing index (PMI) dropped to 47.8 in September. Any reading below 50 indicates deteriorating conditions. Economists expected the September Index to be 50.2. The unexpected drop to well below 50 came as a shock, triggering the rush to get out of stocks. The selling continued on Thursday morning. As noon approached the selling subsided. In the afternoon there was a buying binge. By closing time the Dow Jones Industrial Average had gone from down to up, a 450 point one-day reversal. The reversal was started by traders who saw the selling as overdone. The rebound on Thursday was more for technical than fundamental reasons. On Friday the U.S. Labor Department reported that the U.S. added 136,000 non-farm jobs in September and that the unemployment rate had fallen to 3.5% - a fifty-year low. Even better, the Labor Department added that average hourly earnings rose 2.9% in September. Stocks continued to climb on Friday.

The editors of *The Wall Street Journal* had the following to say after the September jobs report:

"The labor market continues to be a bright-spot for the U.S. economy. While the pace of hiring is slowing, low unemployment and solid wage growth continue to give some analysts confidence that falling interest rates and a ceasefire on tariffs will boost economic growth and financial markets. "

The next questions are, will the Fed keep cutting interest rates and can President Trump make a trade deal with China?

John Williams, president of the New York Federal Reserve Bank, has this to say about interest rates: "While the U.S. economy looks to be in a "favorable place" when viewed through the rearview mirror, the outlook through the windshield ahead is "mixed." Trade uncertainty, geopolitical risks and other factors are creating "crosscurrents" that need to be navigated as the Fed tries to keep the U.S. economy in "roughly" the same place it is currently. The inverted yield curve shows negative investor sentiment about the outlook for U.S. economic growth." - a signal John Williams takes seriously.

Economists at Argus Research have a different view of the yield curve. They say: "Assuming an inverted yield curve equals recession may be old thinking." Still Williams is likely correct when he says the Fed wants to keep the economy in a "favorable place." The Fed may cut interest rates again at the next meeting.

President Trump has negotiated favorable trade agreements with Japan, Canada and Mexico. China is more difficult, but his track record says the odds are that he will negotiate a China deal. Beijing has paraded its military force in celebration of the 70th anniversary of Communism in China. Now the focus will shift back to the economy. Independent data say the real rate of growth in China is less than government reports. Instead of 6.4%, the Chinese economy may be growing at a 3%-4% rate. If so, China cannot afford an ongoing tariff battle with the United States.

The trade war has expanded. From the 2017 beginning, tariffs now encompass more than half of what we ship to China and what China ships to us – with the rest at risk of inclusion. The trade war is hurting the U.S. economy. Tariffs are blamed in-part for the decline in the PMI index. Argus Research thinks that if the trade war remains unresolved next year, U.S. GDP could slip to the 1.5% range for 2020. That means President Trump is also under pressure to get the China trade deal done. The two sides are still talking, and President Trump is still firm in wanting what he calls 25 years of abuse corrected. For now, trade uncertainty hangs over the economy and the stock market. Fortunately, the outlook for corporate profits is strong enough to make U.S. stocks look moderately undervalued.

Argus Research has a 2019 estimate of $171 for the S&P 500 stock index. Currently the S&P Index is trading at 17.3 times that earnings estimate. For next year Argus estimates earnings of $185. The current P/E based on that estimate is 16.

Another, perhaps better way of looking at earnings and stock prices is to measure the earnings yield instead of the Price to Earnings ratio. Bonds are always measured by their yield. Earnings from stocks may not be exactly the same as interest on bonds. But the measure is useful in assessing stock valuations. The earnings yield on the S&P 500 based the Argus 2019 estimate is 5.8%. If Argus is right about earnings next year the forward earnings yield becomes 6.3%. In this time of record low interest rates both earnings yields make stocks look far more attractive than bonds. Yes, the interest paid on bonds goes straight to the bond holder's pocket. In the case of stocks, the board of directors decides how much to pay out in dividends and how much of the earnings will be retained for investment and other purposes. However, in the case of stocks the dividend payout will rise with earnings. The interest paid on bonds stays the same, no matter whether interest rates generally rise or fall. This means that the earnings yield test for stocks is a valuable way of measuring whether stocks are over or undervalued. Argus says that based on standard P/E measures, stocks are moderately undervalued. The earnings yield confirms that opinion.

Hold on to your stocks and pay close attention to the news on a China trade deal.

I will have the next market review and update for you one week from today on Wednesday, October 16, 2019.

All the best,

John Dessauer