John Dessauer Investments, Inc.

John Dessauer's market review and update as of Wednesday October 26, 2022

Many thanks to Mitch from Zacks Investment Management for the following:

"Equity investors looking for positive signs on the horizon may find one in an unlikely place: the U.S. midterm elections.

The first point worth mentioning is that the lead-up to midterm elections has historically proven very volatile for the stock market, a pattern that matches what we've seen in 2022. Going back the last 60 years, the average drawdown for the S&P 500 in the leadup to a midterm has been a stout -19% – a sizable correction close to in line with 2022's declines.

It is also true, however, that stocks have staged strong rebounds in the months and years following a midterm election, with positive performance far more than just a seasonal or statistical quirk. Case-in-point: since 1950, there have been 18 midterm elections, and stocks have gone up the following year 100% of the time. And not only do stocks go up, but they also tend to go up by a lot."

Mitch does not say that the post midterm gains depend on which party wins. The market has gone up no matter which party wins. The really good news is that over the six months after elections the S&P 500 rose 35%. A rebound of that magnitude would put the stock market at new highs. Also note that interest rates and inflation did not matter, the post-election rebound happened under all sorts of monetary conditions.

Having said that, midterm elections have a reputation for being a referendum on the President and his policies. In my opinion that will be the case next month. The economy was growing at a 6+% rate when President Biden took office. Inflation was less than 2% and interest rates were low. Now the economy is technically in recession, inflation is at a 40 year high and interest rates are rising fast. Clearly, economic conditions today are dismal compared with two years ago.

The Labor Department's recent report shows that real (after inflation) wages have declined in nine out of the last twelve months, and 3% overall.

With respect to the coming elections the editors of the Wall Street Journal had this to say a week ago: "The main legacy of the 117th Congress is a decline in living standards." The polls show that the economy is the number one issue with voters. That is likely to mean a significant turnover in the members of Congress. A red wave may be coming. If there is a significant change in the make-up of Congress, enough to block any further unwelcome policies, the stock market will likely repeat history and rebound sharply higher. We may see new highs on stocks by early next year.

Reinforcing that is the issue of lags when it comes to the Federal Reserve tightening by raising interest rates. Interest rates have now been pushed up from zero to 4%, the steepest tightening in 40 years. Ben Bernanke, former Fed chair, estimates that it can take two years before the full effect of tightening can be seen in the broad economy. The concern is that the Fed may have now done all that is necessary to dampen demand and bring inflation down. Milton Friedman introduced the idea of lags when raising interest rates, he coined the phrase "long and variable lags" meaning there is a lack of predictable interval between raising interest rates and seeing the result. In addition, markets can anticipate expected Fed tightening. For example, mortgage rates in the United States rose a full 1% before the Fed had started raising interest rates. As a result, American housing has been reacting to higher interest rates for at least six months, and sure enough, home sales, prices and new construction have all started to fall.

These interest rate lags have some economists worried that the Fed will go too far and create a nasty recession. Others worry that if the Fed stops or slows down on tightening, inflation will continue to rise and damage the underlying economy. My guess is that the Fed will keep raising interest rates until there are convincing signs that inflation is coming down. This will increase the risk of a recession, but underlying economic strength will provide a counterbalance that should keep any recession from becoming nasty.

A couple of weeks ago I wrote about our now huge national debt and how rising interest rates are increasing the cost of paying interest on that debt. That is worrisome, but the market for Treasuries has grown to a huge size. Today there are $640 billion worth of treasuries traded every day - that is double the amount traded ten years ago. For now, it seems that the U.S. Treasury will be able to sell new debt, thanks to the size of the market for treasuries. However, everything has its limits. The politicians in Washington need to rein in the spending and stop running deficits year after year.

As far as our portfolios are concerned the post midterm election history says the best strategy is to hold on to our stock positions.

I will have the next market review and update for you one week from today on Wednesday, November 2, 2022.

All the best,

John Dessauer