John Dessauer Investments, Inc.

John Dessauer's market review and update as of Wednesday October 27, 2021

The federal government's fiscal year ended on September 30, 2021. The final numbers are disappointing. The deficit did go down a little, as some of the pandemic spending ended. But the 2021 deficit still was $2.8 trillion. What I find most discouraging is that revenue increased 18% from fiscal 2020 to more than $4 trillion thanks to higher tax receipts from individuals and corporations. Taxes collected from both rose significantly more than government officials predicted. With tax receipts soaring, I would think the big spenders in Washington could have exercised more restraint and cut the deficit without damaging the economic recovery. Instead of showing restraint the Biden Administration wants to raise tax rates and boost spending. Thank goodness there are some moderate Democrats that object to the Biden proposed $3.5 trillion tax and spending plan. They are having some success. The *Wall Street Journal's* editors wrote on October 23 that "President Biden's corporate tax rate increase appears to be dead." However, that has not stopped the President, with the support of Treasury Secretary Janet Yellen, from trying to get around Congress by working with the OECD on a global tax reform that would raise taxes on U.S. corporations. Hopefully that will also fail.

Federal Reserve chair Jerome Powell recently said that supply-side constraints have worsened, creating more inflation risk. "The risks are clearly now to longer and more persistent bottlenecks, and thus to higher inflation." He added that the central bank will "need to make sure that our policy is positioned for a range of possible outcomes."

Federal Reserve policy makers will meet again on November 2-3. They are expected to announce the start of tapering, reducing the current bond buying by $15 billion a month, which would conclude the bond buying by next June.

“I do think it is time to taper. I don’t think it is time to raise interest rates.” Mr. Powell said ten days ago.

The Fed is in a tough spot. The Biden spending plan does have the potential to overheat the economy and boost inflation. Inflation has already perked up, rising above the Fed’s 2% target. Core prices, the Fed’s preferred inflation measure, rose 3.6% in August from a year earlier. That is why tapering is expected to begin soon. The Fed does not want to be providing a super stimulus at the same time the Biden Administration is flooding the economy with cash. The Fed has also said that inflation above their 2% target will be tolerated for a while, because inflation is expected to settle back down as supply-side and labor market shortages are resolved.

“We think we can be patient and allow the labor market to heal. But at the same time no one should doubt that we will use our tools to guide inflation back down to 2% if it looked like more persistent inflationary pressures were taking root.” (Jerome Powell)

“Successfully managing the economic exit from the pandemic remains the greatest challenge facing Fed policy makers.” Mr. Powell said and then added: “The virus essentially removed a piece of potential economic output—concentrated in high-contact service sectors, such as leisure, hospitality and entertainment industries. We want to give full time for that to come back before deliberately cooling demand for goods and services more broadly by raising interest rates" he said.

As a result of Powell's frank talk about the challenges facing Fed policy makers, the odds of at least two interest rate increases by the end of next year has risen above 75% according to futures market prices. Rising yields on bonds can make stocks less attractive. So far, the yield on the benchmark 10-year Treasury bond is still very low at 1.627%. It would take more than two modest interest rate hikes to tip the balance in favor of bonds over stocks.

The greatest risk for stocks is, as usual, an overheated economy and rising inflation. That would force the Fed to move interest rates significantly higher. The question is: did Biden's American Rescue Plan already boost inflation? Researchers at the Federal Reserve bank of San Francisco tackled that question. Critics say the plan, which included a third round of $1,400 stimulus checks, boosted unemployment benefits, and a one-year expansion of the child tax credit, flooded households with poorly targeted cash and overheated the economy. Supporters say the plan provided critical relief to families and small businesses.

The San Francisco Fed paper found that the American Rescue Plan played a role in contributing to the inflation spike but concluded the nearly $2 trillion plan will ultimately have a modest long-term effect on it. The researchers estimated the plan would add 0.3 percentage points to the Fed's preferred inflation gauge in 2021 and a bit more than 0.2 percentage points in 2022. The impact in 2023 will be negligible.

Each Federal Reserve Bank has its own team of researchers. I find that reading their reports, I especially like the Federal Reserve Bank of St. Louis. It provides an accurate look at monetary and economic conditions in the United States. Yes, I did check the velocity of money and it remains on the floor. Remember Liz Ann Sonders' article on inflation. She pointed out that with the velocity of money so low inflation is not a threat to the economy or the stock market.

Third quarter earnings continue to roll in and are well above expectations. Labor shortages, higher prices for raw materials and supply-chain issues have not eaten much into corporate profits. The strong recovery, on the other hand, has boosted revenue and profits. Stocks remain our best choice.

We will be traveling again next week. This time we will fly to Lisbon Portugal, stay a few days, and then board the Seabourn Ovation for a cruise back to Miami. Therefore, I will have the next market review and update for you two weeks from today on Wednesday November 10, 2021

All the best,

John Dessauer