John Dessauer Investments, Inc.

John Dessauer's market review and update as of Wednesday November 16, 2022

The election is over, though there still are races too close to call. There was no red wave, except in Florida where Republicans did very well. As I write, it looks as if the Democrats will have a slim majority in the Senate and the House is still uncertain. The most disturbing news from the election was that AOC and other left-wing members of the Squad won their respective elections by wide margins. How can so many Americans vote for politicians who advocate radical, socialist changes? Socialism has never worked, and Venezuela is the current example of how elected socialists can ruin an economy.

The stock market went down a bit the day after the elections. But then came news that inflation dipped a bit in October, and that sent stocks soaring - the Dow was up more than 1,200 points. That was the best one-day performance in a very long time. Clearly investors are more concerned with inflation than politics. If inflation really has peaked and is now in a decline, stocks will remain strong.

There are differing views on the outlook for inflation. I found a recent study by Morningstar to be very encouraging. The study was published on November 11 and is titled: "Why We Expect Inflation to Fall in 2023. What could longer-term inflation look like? A deeper look at the data suggests less reason for concern."

"Inflation in 2022 is set to peak at its highest level in four decades, but we think there's less cause for concern about inflation in 2023 and beyond.

High demand has conspired with supply constraints to cause price surges in many industries, hitting energy and autos especially hard. But once these supply constraints eventually resolve, we expect the various price spikes to unwind in a deflationary rush. Combined with the effect of the Federal Reserve's interest rate hikes, we expect inflation to recede back to normal in 2023 and thereafter.

We forecast inflation to average 2.6% over 2022-26 as a whole (in terms of the personal consumption expenditure price index) only slightly above the Fed's 2% target. The year 2022 will deliver the worst inflation (6.1%), but over 2023-26, we expect inflation to average just 1.7%."

Wow! If Morningstar is correct, we could see stocks at new highs next year. Stocks usually do well after midterm elections. If in addition inflation comes down the outlook becomes even brighter. But is it likely that Morningstar is going to be correct. There are economists who think the Fed has waited too long to begin the inflation fight. They see a long, difficult inflation battle ahead. Fortunately, Morningstar backed up their inflation forecast with solid reasons for their outlook. Here are their reasons:

"Inflation Data Looks Alarming, but Details Are More Comforting.

Although the short-term inflation rate is striking, a deeper look at the data suggests less reason for panic around longer-term inflation.

For one thing, a handful of categories are responsible for today's high inflation, and we don't expect pricing pressure in these categories to persist. In a repeat of the 1970s' "Great Inflation," we should be witnessing broad, economywide inflation, but we haven’t seen it occurring. If inflation is attributable to specific issues in a few industries, then it is a problem that can be eventually fixed.

We Forecast Inflation for 2023-26 From a Bottom-Up Perspective

Given the role of industry-specific shocks, we forecast inflation using a bottom-up methodology.

We're projecting large deflation in prices for durable goods, food, and energy over 2023-26.

- For durable goods, resolution of the semiconductor shortage should play a large role in expanding supply. A normalization of consumer spending mix will also shift demand away from durables (and other goods) and back into services.
- For food and energy, prices should subside as these industries adjust to disruption from the Russia-Ukraine conflict and other factors.

We don't expect the price spikes in energy and durables to be replaced by new problems elsewhere in the economy. We expect moderate wage growth and the absence of any long-lasting supply disruptions to keep general inflation at restrained levels.

Fed tightening will cool off the overall economy substantially in 2023 and 2024, extinguishing the inflationary fire before it spreads to the broader economy.

Supply Chains Are Healing as Demand Normalizes and Capacity Expands

A broad array of production and logistical disruptions contributed to price inflation in durables and other parts of the economy. These are captured in the New York Fed’s Global Supply Chain Pressure Index, which peaked at extreme levels in late 2021.

However, it now appears to be normalizing. Supply chains are healing as demand normalizes and capacity catches up.

As one indicator on the logistics side, enough container ships are set to be delivered over 2022-25 to expand the current fleet by 30%. On the manufacturing side, capacity is also expanding in the United States and other major economies (most notably China). It will take time to fulfill the backlog of unfilled demand, but within a few years, we’re likely to be talking more about supply gluts than supply shortages.

Beyond these broad supply-chain disruptions, perhaps one half of the runup in durable goods prices looks be a result of the semiconductor shortage alone.

Semiconductor manufacturing capacity is frantically expanding, with 2022 capital expenditures expected to soar 90% above prepandemic levels. It takes a while to ramp up capacity, but it is now a question of when—not if—the semiconductor shortage will be cleared.

Inflation in 2023: This is not the 1970s’ oil-price shock

A key reason we’re sanguine about inflation is expected lower energy prices. Morningstar’s energy team forecasts oil prices to fall to $55 per barrel in 2025 (West Texas Intermediate) from an average $92 per barrel in 2022. This would make it about where prices were in 2019 before the pandemic.

Oil prices have skyrocketed as sanctions and boycotts have disrupted Russia's oil supply. Compensating for Russia will take some time, but we expect producers in the

U.S. and elsewhere to steadily ramp up production until prices fall back to the marginal cost of production, which we assess at $55.

The contrast with the 1970s' oil-price shock could not be greater. Oil prices first tripled in 1973 and ended the decade up 11 times versus 1970 levels. There were short-run disruptions that contributed to that surge, but the long-term story was the awakening of OPEC's market power, which never returned to the rapid production growth exhibited in the 1960s. Also, other cheap sources of crude had been tapped out by this time, necessitating a shift to offshore drilling and other, more-expensive sources."

In my opinion the Morningstar position is based on solid research and is likely to be correct. In addition, there is housing where prices are already coming down. The combination of soaring prices and rising interest rates has made housing considerably less affordable.

Hold on to your stock positions.

I will have the next market review and update for you one week from today on Wednesday, November 23, 2022.

All the best,

John Dessauer