John Dessauer Investments, Inc.

John Dessauer's market review and update as of Wednesday December 9, 2020

The Dow Jones Industrial Average has reached 30,000 and a familiar pattern of pessimism has developed. Stock market pundits warn that such a high number cannot be sustained, it is just too high. In the 1980s with the economy struggling to recover from a nasty recession, my analysis pointed to a rising stock market. I wrote that the Dow was likely to rise above 1,000 within a few months. There was an unexpected response to that prediction. The general consensus was that a Dow 1,000 was just not possible - that was just too high. The number itself was the underlying reason. Well, as we know now the Dow went past 1,000 to 5,000 and then 10,000. And, as you can guess the number 10,000 was greeted with more intense pessimism. The number 10,000 seemed to be way too high to many market prognosticators. Then a few short years later the pessimists had Dow 20,000 to deal with. Once again, without looking back, the gloomsters were absolutely sure that Dow 20,000 was the end of the road and that a big decline was coming. Now here we are at Dow 30,000 and we have serious concerns about the future for stocks simply because of the number 30,000. U.S. stocks had a very good November, up about 11%. Will there be a near-term temporary pull back? Probably. Stocks often pull back a bit after a strong rise. But is 30,000 the upper limit for the Dow? History says the answer is absolutely not. In the long run stock prices respond to two things: earnings and interest rates. Someday interest rates will rise. Morgan Stanley thinks that will be late next year and in 2022. Rising interest rates will dampen stock valuations. But the coming interest rate rise is expected to be modest and therefore not a major threat to stock valuations. Morgan Stanley also sees earnings gaining strength as the recovery unfolds. They see sales rising strongly as the arrival of vaccines allows a full reopening of the U.S. and global economies. In response to the Covid-19 recession, business managers cut back costs to survive. Morgan Stanley thinks costs will not recover as quickly as sales, meaning that profit margins are likely to expand in coming months giving earnings a big boost. They see rising earnings benefiting stocks more than the downward valuation pull from rising interest rates harms them.

As for the strong November gains, that was a response to good vaccine news and a market-friendly election, meaning a divided federal government. Of course, the latter is still dependent on the Georgia runoff early next month when two Senate seats will be decided. Current poling favors Republicans in both contests. However, Republicans need to win only one of the seats to maintain control of the Senate.

Looking at the details makes the ongoing economic recovery look quite different from past recoveries. Manufacturing is looking like the economic bright spot. Services, on the other hand, are lagging. Last week the Institute for Supply Management (ISM) said that its index of manufacturing activity came in at 57.5 in November. While slightly below October's two-year high of 59.3, that is a sign that manufacturing is on a solid recovery track. Anything above 50 indicates an increase in manufacturing activity.

The ISM's manufacturing gauge is a diffusion index, based on how many manufacturers say activity is expanding versus contracting, so it doesn't directly measure manufacturing output. A separate Federal Reserve index does, however, and it shows that as of October manufacturing production was about 4.6% below its level before the pandemic struck in February. That is somewhat puzzling because according to the Commerce Department, consumer spending in October was only 2.2% shy of its

February mark. The likely explanation is that manufacturers were allowing inventories to be drawn down to meet current demand. I can confirm that because of my searching for a computer and printer. I found that many were “out of stock” with more expected in 2-4 weeks.

Some economists are expecting a modest contraction in the first quarter of 2021, that would follow a modest, single digit final quarter 2020 growth. But even if consumer demand softens in the near-term, manufacturers will still need to step up output to bring inventories back into balance.

Services on the other hand will likely continue to struggle until the benefits from the vaccines take full effect. Even then we don’t know how consumers will behave after the devastation caused by the virus. Restaurants, theaters and shopping malls may not see pre-pandemic activity for a quarter or two after the vaccines are available to the general public.

After taking all this into account Morgan Stanley analysts see the S&P 500 stock index up 10% twelve months from now. That would make stocks far more attractive than bonds. Rising interest rates are bad news for bond prices. But the really good news from Morgan Stanley is their longer-term outlook, “New bull markets that coincide with a new economic cycle last for years, and the business cycle tends to override the political one.”

If Morgan Stanley is anywhere near right about the longer-term, the pessimists will have to prepare for a new round number - Dow 40,000. Thanks to modern medical technology the U.S. and global economies are heading for a recovery far sooner than in past pandemics. Once the vaccines have taken effect, we are likely heading for a synchronous global economic growth cycle like 2017. The pessimists may have more than DOW 40,000 to worry about.

I will have the next market review and update one week from today on Wednesday December 16, 2020.

All the best,

John Dessauer