John Dessauer Investments, Inc.

www.johndessauerinvestments.com

John Dessauer's market review and update as of Wednesday January 13, 2016

The U.S. Federal Reserve raised interest rates for the first time in nine years. The global stock selling stampede that followed must have come as a shock to Federal Reserve chair Janet Yellen and her fellow board members. The stampede raises a serious question: has the Federal Reserve already done more harm than good by raising interest rates?

There is disagreement, even among members of the board of the Federal Reserve. Some are so confident the economy is gaining strength that they predict a series of interest rate increases this year, lifting short-term rates to 1.5% by year end. Others worry that the economy is caught in a "liquidity trap," where banks have plenty of money to lend, but too few sound borrowers to lend to. They argue that massive Quantitative Easing (QE) programs used by U.S. and European central banks are no help in this situation. They add liquidity, but do nothing to improve the financial circumstances of potential borrowers.

The common concern among both optimists and pessimists is that the global economy has been stuck with near zero interest rates so long. Both sides are searching for an explanation. It is, after all, quite unusual for an economy the size of the United States to go so long with so much liquidity and not have higher inflation and interest rates.

Interest rate hawks see applying the power of the Federal Reserve as the answer. They are the "normalizers," who persuaded all the FMOC members to vote for higher

interest rates last month. Recent data on economies in the United States and Europe are providing support for the "normalizers."

According to ADP, a payroll processing firm, the U.S. added 257,000 private sector jobs last month, the largest monthly gain since December 2014. Plus, ADP says the U.S. added 211,000 private sector jobs in November. The U.S. is adding private sector jobs at a robust pace, even while a strong dollar is stunting manufacturing, and energy firms are slashing capital spending and reducing payrolls. In a separate report, the Institute for Supply Management (ISM) said its nonmanufacturing index stood at 55.3 in December. A reading above 50 indicates expansion in the services sector, which accounts for more than two-thirds of the economy. The December reading was slightly down from November's 55.9, but that did not cause concern because there were signs of strength in the details. ISM said that comments from the majority of industries "remain positive about business conditions and the overall economy."

On January 6 Reuters published this headline: **"Euro zone surveys solid at end-2015; Germany, Italy shine."**

Business growth in Germany and Italy accelerated to multi-year highs as 2015 drew to a close. Economic activity across the 19-country bloc reached a four-month high in December and businesses added employees at the fastest pace in almost five years. Western Europe is not alone. The plunge in oil prices is benefiting economies in Central and Eastern Europe. Capital Economics said that its weighted PMI (Purchasing Managers Index) for Eastern and Central European economies stood at 52.5 at year-end, indicating industrial production growth at about a 5% annual pace.

These signs of growth are encouraging, but even with the recent improvements, growth rates are still far from what would be expected this many years into a recovery. If the past were being repeated, we would have much higher inflation and interest rates by now. The lack of inflation pressures is puzzling even to "normalizers" and interest rate hawks. Former U.S. Treasury Secretary and Professor, Larry Summers has a theory. He says the problem is a global savings glut. He is not alone. Former Federal Reserve chair Bernanke wrote about a global savings glut years before the 2008 recession. While savings might not seem threatening, the problem is too much excess savings, meaning too few attractive opportunities for investing the savings at a decent return with reasonable risk. Summers argues that the savings-investment imbalance has relentlessly driven interest rates to near zero. He might add that it is also causing unexpected problems, including China's slumping currency and wild stock market.

China has one of the world's highest savings rates. Plus, Chinese have a well-deserved reputation for enjoying high risk, including gambling. In the 1990s and early 2000s, I traveled extensively in China. It was an eye-opening experience to see Chinese people industriously using their new freedoms to start businesses and make money. Recent data from the cruise industry prove that the Chinese version of capitalism continues to lift millions of people up to a middle class standard of living. The cruise industry calculates that it takes a household income of $35,000 a year before travel, including cruising, becomes affordable. According to Oxford Economics, the number of Chinese households with that level of income has grown from 6 million to 27 million in the past decade. The number of Chinese taking cruises for their holiday is growing at 80% a year and is expected to keep growing at that rate despite signs of overall economic

growth rates slowing. Cruise companies have taken notice. No longer do they send their old castoff ships to serve the Chinese market. Now they send their newest and best. Royal Caribbean, for example, has based their 4,180 passenger, state-of-the-art *Quantum of the Seas* in Shanghai since last June. The Chinese cruise market is very profitable. There are two main reasons. First, the Chinese take short, four-to-six day cruises. Second, and more important, Chinese cruisers spend more while on the ship, not for alcohol, or spa treatments like Americans, but for gambling, which brings us back to the savings glut and Chinese stock market volatility. China does not have a long history of industrial successes. On the contrary, there have been scores of stock market tales of failure, due to incompetent management and poor business practices. I remember the collapse of shares in a major Chinese brewery caused by managers gambling with company funds in the financial futures market. Chinese are, for the most part, short-term oriented stock market investors. They follow current trends, buying more when stock prices rise and selling fast when they decline. The "stampede" label fits the recent plunge in the Chinese stock market. Western analysts can try and make more out of the plunge than a mindless "stampede," but that only shows their lack of experience in China. The stock plunges in Europe and the United States have been equally mindless. The difference is that Chinese stocks may stay down for a long time. Once burned, Chinese stock market players take a long time to recover. Investors in Europe and the United States tend to look at the fundamentals to see if the decline was justified. As can be seen from the recent economic data, fundamental conditions in Europe and the United States continue to improve rather than deteriorate.

It often takes a few weeks for stocks to fully recover after a stampede, so patience is required. As far as interest rates are concerned, we can be sure the Federal Reserve board members will be closely monitoring data here at home and abroad to see if the stock stampede has caused any fundamental damage.

I will have the next market review and update for you one week from today on Wednesday January 20, 2016.

All the best,

John Dessauer

©January 2016