John Dessauer Investments, Inc.

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John Dessauer's market review and update as of Wednesday February 17, 2016.

For stock and bond investors, first it was fear of the drag from falling oil prices. Then came fear of a Federal Reserve interest rate increase. That was soon followed by fear of china's slowing economy. Next, fear of a new global recession was added to the growing pessimistic complex. And now there are doubts the world's central banks can prevent another global financial crisis and deep recession. Stocks are down and that has been scary, but given intensity of the popular fear, stocks have held up reasonably well. That is because the fundamentals are better than the crowd assumes.

Jeff Mortimer is the Director of Investment Strategy for BNY Mellon, a massive wealth management organization. In light of the extreme volatility on stock and bond markets he was asked what are the markets signaling for the U.S. economy. He responded by reviewing the work of University of Chicago Booth School of Business, Professor Campbell Harvey. Professor Harvey discovered that when the yield curve inverts, such that short-term interest rates are greater than long term interest rates, an economic recession can be predicted to occur 12 months later on average. The yield curve has inverted three times since Professor Harvey published his findings. And, yes, each time that was followed by a recession. In recent weeks short-term interest rates have gone up and long-term interest rates down, raising the possibility that the yield curve might invert again. But, on closer examination that seems unlikely. The Federal Reserve board members are well aware of the yield curve and Professor Harvey's discovery. They

are not going to deliberately cause a recession by raising short-term interest rates too much too soon. The Federal Reserve does not have control over long-term interest rates. Market forces have pushed the yield on ten year Treasury notes down to 1.8%. The question is why have long-term interest rates gone down, when in past they went up after a Federal Reserve short-term interest rate increase. Is the market signaling a significant slowing in the economy? Or is all the recession chatter overdone?

Here is Jeff Mortimer's analysis: "It is easy to get caught up in the latest headlines proclaiming a possible U.S. recession, but we disagree with those calling for this scenario. We believe it is reasonable for long-term rates to have moved temporarily lower in light of the recent monetary action by the Bank of Japan and slower growth expectations."

Jeff might have added that negative interest rates are becoming common in Europe as well as Japan. Yields on Swiss, Dutch and German government bonds are negative. Nestle, the Swiss foods company, recently sold bonds with a negative yield. Investors are willing to accept negative yields on bonds with two and five year maturities. Better to suffer a small loss than suffer a big loss on riskier assets.

Jeff and BNY Mellon do not expect negative yields to be the case over the longer term. "We expect, however, that long-term rates will begin to rise gradually as the U.S. economy moves beyond what we believe to be a soft patch caused by a severe energy sector slowdown and concerns surrounding many emerging market economies."

Jeff and his colleagues are not wild optimists. He believes interest rates are going to stay low for a long time, "many years" and that the U.S. economy will grow at a

modest pace. He concludes: “Professor Harvey’s work has stood the test of time and isn’t calling for a recession. Neither are we.”

The wild and scary stock market has not deterred American consumers. They have increased spending three months in a row.

Surprise, consumer spending not only did not decline in December, it rose 0.2%. Earlier the Commerce Department said consumer spending declined 0.1% in December. Now they say consumer spending rose 0.2% in December and also rose 0.2% in January, the third consecutive monthly gain. Keep in mind these figures include the downward pull from falling gasoline prices. Excluding cheaper gasoline, which depressed service station receipts, consumer spending rose a very healthy 0.4% in January. The data are even more impressive when you remember the severe winter storm that blanketed the Northeast, forced the cancellation of 13,000 flights and caused coastal flooding and power outages. Bricklin Dwyer, an economist with BNP Paribas in New York said: “Consumer fundamentals still look very strong.” Housing is also looking strong. Stephen Hilton, chairman and CEO, Meritage Homes Corp. recently said: “I’m not seeing any signs of recession from the housing perspective. December was a very good month for us. January, we’re off to a good start. I’m not seeing anything on the horizon outside of Houston that leads us to believe there is a recession.”

Consumers account for roughly two-thirds of U.S. GDP. With consumers spending it is hard to believe the economy is heading for a recession.

The strong dollar isn’t doing as much damage as in the past.

According to an analysis of 60 economies by the IMF (International Monetary Fud) from 1980 to 2014 on average a10% depreciation in a country’s currency was

followed by a significant 1.5% of GDP boost in exports. Devaluing the currency was a way of stimulating export sales by making them cheaper for foreign buyers. The results used to happen right away, with most of the export gains coming in the first year after devaluation. That is no longer the case. Japan is a good example. The Japanese yen is down sharply, but export volumes have not changed. The IMF calculates that Japanese exports are around 30% lower than it expected given the weak yen. Japan is not alone. Other countries, including South Africa and Turkey also are reporting disappointing export volumes. The IMF and World Bank have highlighted a possible explanation. Globalization has turned lots of countries into waystations in the manufacture of individual products. Components are imported, augmented and re-exported. This means that much of what a country gains through devaluation, it loses through pricier imports of essential components. The World Bank argues that this explains about 40% of the diminished impact of devaluations globally. The U.S. dollar is the prime target for devaluations. In other words the strong dollar is not helping U.S. foreign competition as it did in the past. The strong dollar may hurt foreign profits of U.S. companies, when reported at home, but that is an accounting phenomenon and does not say much about the volumes of products and services sold abroad. The relatively strong U.S. labor market is telling us that the U.S. is still selling products and services abroad. If the dollar were doing the amount of damage seen in past decades, our unemployment rate would be much higher.

There are growing signs OPEC is unraveling. Members are going broke because the oil price is so low. They would rather see OPEC production cut than see oil prices continue to fall.

Nigeria is an OPEC basket case. A default on Nigerian government bonds is now widely anticipated. That would rattle even Saudi Arabia, which has been confident of being able to borrow to cover oil sale shortfalls. At best it would mean much higher interest rates on OPEC member borrowing. Reports of OPEC production cuts lifted oil and stocks last Friday and again on Monday. The reports may be early, but OPEC really is in in financial stress and production cuts are their only real option.

More and more the data point toward a bottom in oil and a recovery in stocks.

I will have the next market review and update for you one week from today on Wednesday February 24, 2016.

All the best,

John Dessauer

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