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John Dessauer's market review and update as of Wednesday February 24, 2016.

U.S. banks are in far better financial condition than in 2008 and in better shape that their competitors in other countries. Still, U.S. bank stocks have been dragged down along with the others. And that has frightened investors, pulling down a long list of quality U.S. stocks. Adding to the confusion is concern that our Federal Reserve will keep raising interest rates. Being ignored are the data showing the U.S. economy slowly gaining strength. Odds are the Federal Reserve will be cautious. Consumers will increase spending. Corporate profits will improve and stocks will recover.

A lengthy study by three economists at the London Business School looked at the relationship between Central Banks' interest rate cycles and financial markets. They paid special attention to the United States and Britain. They went back to 1900 for Britain and 1913, the year the Federal Reserve was founded, for the United States. Their conclusion is that stocks and bonds do better when interest rates are falling than when they are rising. In the United States, stocks averaged a 9.3% annual gain during an easing cycle and just 2.3% a year when interest rates were rising. Government bonds averaged gains of 2.3% a year when interest rates were falling and 0.3% a year when they were rising. This history explains why stocks started running into trouble as it became clear the Federal Reserve was going to start raising interest rates. However, it does not explain the full blown panic that has since developed and pulled stocks down so precipitously.

First, history shows that stocks can continue rising even when the Federal Reserve is raising interest rates. Second, this is not a typical tightening cycle. The board members of the Federal Reserve have gone to great lengths to make it clear that they are moving to "normalize" interest rate levels. They are not tightening to slow the economy or blunt rising inflation. After years of unprecedented monetary accommodation, it is time to end the massive QE (Quantitative Easing) and move away from near zero interest rates. Pessimists and terrified individual investors have ignored that message. Not only have they ignored that clear statement of Federal Reserve intentions - they have gone on to add fear of a recession to their list of reasons for selling stocks. It is beyond historical precedent and common sense to ignore Federal Reserve policy statements and go on to believe the Federal Reserve is willingly crushing stocks and tipping the economy back toward contraction. But that is the reality of current investor sentiment.

Investor fears have been exacerbated by developments in Europe and Japan where negative interest rates are being used to stabilize currencies and stimulate economic growth. The unintended consequence of negative interest rates has been a plunge in bank stocks.

Japan joined the negative interest rate club last week. Japanese bank stocks are down 36% since the start of the year. Italian bank stocks are down 31% and Greek bank stocks are down 60% since January first. A broad index of European bank stocks is down 24%. Negative interest rates have added fear of a squeeze on bank profits to worries about bad loans and slowing growth. It is difficult for banks to make a profit when interest rates they can charge on loans are so low. And it would be destructive for banks to charge customers for keeping cash on deposit. Switzerland, which has negative interest

rates of 1%, applies that to foreign depositors in an effort to discourage buying Swiss francs. Otherwise, negative interest rates in Switzerland and elsewhere apply mostly to institutions buying government or bank bonds.

The malaise of European bank stocks has deep roots that go beyond negative interest rates. There are too many banks in Europe. And most have flawed business models. While they have improved capital ratios, they are saddled with bad loans and poor profits.

American bank stocks have been dragged into the storm. They are down 19% this year. However, American banks were much quicker to write off bad loans and increase capital after the 2008 financial crisis. Capital ratios have been increased from 9% in 2009 to 12.5% or better today. Big American banks are not about to start crying for life saving bailouts. That does not mean they are trouble free. Big American banks need to slim down and change business models to adjust to the slow growth, low interest rate environment. Ironically, the new rules and regulations imposed by the Dodd-Frank legislation to reduce the risk of another 2008 financial crisis are making it difficult for big banks to change. Current rules and regulations need to be amended to facilitate change and allow big banks to slim down and restore profit growth. Given the political pressure on big banks to slim down, we are likely to see rule and regulation changes fairly soon. It is unusual for big bank political critics and big bank managements to be on the same course at the same time.

Not only are American banks stronger than appreciated; the U.S. economy is on track to keep growing. Joel Naroff, chief economist at Naroff Economic Advisors in Holland, Pennsylvania said it clearly: “If we step back and view the economy from afar,

we see that consumers are spending, manufacturing is beginning to rebound and housing, though not great, is hardly weak. The domestic economy is fine."

The bottom line is that the panicky selling of stocks is an overreaction. Underlying fundamentals are much stronger than generally understood. The selling wave will run its course. Massive withdrawals from equity mutual funds have reached or soon will reach capitulation levels. That means a stock market recovery is not far away. It could be, given the past few days, the worst is over for stocks.

Analysts at Argus Research remain optimistic. They expect a rebound that will mean gains of 8%-10% on stocks by year end. They understand the headline risks. "If the Fed hikes rates too frequently, we may see a sharp economic slowdown and potential bear market in 2017 and 2018. All in all we remain bullish on stocks, given the recent market pull back."

In my opinion it is unrealistic to worry about a Federal Reserve induced economic slowdown. If anything, the Federal Reserve will go very slowly to "normalize" interest rates. Headline news about the U.S. economy is likely to improve in coming weeks. Never the less, I would avoid stocks in European banks. American bankers were first to adjust after 2008. They will be the first to further adjust and get profits growing again.

I will have the next market review and update for you one week from today on Wednesday March 2, 2016.

All the best,

John Dessauer

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