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John Dessauer's market review and update as of Wednesday March 29, 2017

Is the Federal Reserve still too optimistic about the rate of U.S. economic growth? Instead of gaining strength in the first quarter, the U.S. economy most likely slowed, possibly to a 1% annual rate. If so, the Federal Reserve will once again have to revise its interest rate hiking schedule.

Remember a year or so ago when the Federal Reserve raised short term interest rates by 0.25% and expressed confidence that more rate hikes were coming? Then, to their collective surprise (shock?), the economy slowed and talk of interest rate hikes stopped. Could they be making the same mistake again? We have now had two interest rate increases and the talk is about several more coming this year. The optimists at the Federal Reserve focus on the unemployment rate, saying that is the most important data point. The problem with that theory is that we have had a low unemployment rate for quite a while. After a couple of years with low unemployment, the inflation rate is supposed to be high enough to justify higher interest rates. That has not happened this time. The economy has stayed in low gear and inflation remains lower than the Federal Reserve would like.

I wonder how the optimists at the Federal Reserve will react if Bob Johnson, director of economic analysis at Morningstar, is right. He thinks the first quarter is a disaster and that the rate of growth could be as low as 1% and certainly below the 1.9% rate for the final quarter of last year. He also says that economists have been reducing forecasts for all of 2017 and that the current thinking is growth of only 2% for all of this year.

Bob Johnson is not alone. At least one voting member of the Federal Reserve Board feels there is no rush to raise interest rates. Minneapolis Federal Reserve Bank president, Neel Kashkari, said last week, “We do not have a high-inflation threat right around the corner. I’d be very surprised if core inflation reaches 2 percent this year.” He argues there is no rush to raise interest rates. In sharp contrast, Chicago Federal Reserve Bank president Charles Evans says there could be two, three or four more interest rate hikes this year. His view is based on the 4.7% unemployment rate, which is regarded as full employment and by implication, a forerunner of high inflation. However, the Federal Reserve’s preferred measure of inflation, excluding food and energy, rose only 1.7% in the twelve months ending in January.

Kashkari focuses on the rate of economic activity, saying: “The data are basically moving sideways, so I’m asking, what’s the rush to raise rates. When the data really call for it, then we should remove accommodation.”

There are 17 voting members of the Federal Reserve’s board; they comprise the FOMC or Federal Open Market Committee. There is an anonymous chart called the “dot plot” which displays policy makers’ estimates for rate increases over three years. The “dot plot” was updated after the Federal Reserve’s March 15 meeting. Of the 17, two favored just one rate hike this year. One wrote in two rate hikes. Nine said there will be three rate hikes and five said four or more rate hikes this year.

The next FOMC meeting will be in early May. If the first quarter does come in at a 1% growth rate, the five who predicted four or more rate hikes will be happy the “dot plot” is anonymous. It would be very hard for the Federal Reserve to justify raising interest rates when the rate of economic growth has declined from 1.9% to 1%.

On a more positive note, the slowing economy should encourage Congress to support President Trump's tax reform agenda. Investor anxiety, as conservative members of Congress refused to support health insurance reform, stopped the long advance of the S&P 500 stock market index. That index went 109 consecutive trading days without a 1% decline. Then the Republican split on health insurance reform sent the S&P 500 index down for the week - the first weekly decline since the November election.

Having failed on the first try at health insurance reform, the President needs a victory. The Republicans in Congress know that. They also know they are also being held accountable for the performance of the economy. A slowing economy will both frighten and encourage Congress to move quickly on tax reform. They will be frightened that they might be accountable if the economy dips into recession and encouraged to use tax reform to provide an economic stimulus. Odds on some tax reform by August have improved.

Earnings are just as important for the stock market as tax reform and infrastructure spending. Fortunately, corporate profits are doing much better than the economy. According to Thompson Reuters data, earnings are expected to have grown by 10% in the just ending first quarter. One reason is that economic data from outside the U.S. has been improving. Growth rates have ticked up in Europe, Japan, China and emerging markets. This favors the large multinational companies. Stocks remain our best investment choice.

Speaking of China, that country's contribution to the U.S. economy is growing. Last year investment capital from China flowing into the United States tripled to $45.6 billion. That is part of our capital account surplus, the other side of the trade deficit.

In addition, China is learning that it can be cheaper to make things in the United States than in China. This is from a recent *Wall Street Journal* article:

"Although U.S. wages are still higher than those in China, the gap is rapidly narrowing. Moreover, industrial land in the U.S. is often cheaper than in Chinese coastal cities. The shale-gas revolution has dramatically lowered U.S. energy costs. But the real key is technology: Advanced manufacturing is leveling the playing field.

……for an expanding number of companies the math behind relocating production to the U.S. is starting to add up. They won't be returning large numbers of assembly jobs to shattered rust-belt communities: That idea, which played so well for Mr. Trump on the campaign trail, is pure fantasy."

Chinese capital flowing into the United States to create jobs here… that must be a shattering notion to all the China bashers. Otherwise it is very good news. The U.S. needs capital investment as well as tax reform and infrastructure spending.

I will have the next market review and update for you one week from today on Wednesday April 5, 2017.

All the best,

John Dessauer
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