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John Dessauer's market review and update as of Wednesday March 30, 2016.

The December vote to raise U.S. interest rates was unanimous, but that masked the fact that the Federal Reserve's Board is deeply divided. One side, led by Vice Chairman Stanley Fisher, holds a traditional view that low unemployment inevitably leads to higher inflation. His group feels it is necessary for the Federal Reserve to get ahead of inflation and keep raising interest rates. However because of financial market volatility, his group did not push for a second rate hike this month. The opposition is led by Lael Brainard, a Federal Reserve Board member. She worries that the global nature of financial markets - and the U.S. dollar's key role - requires the U.S. Federal Reserve to move very slowly and carefully. Specifically, she warns that in today's world there can't be a "Great Divergence" between U.S. monetary policy and the rest of the world without serious unwanted consequences. In other words, it is risky for U.S. interest rates to go up when interest rates in the rest of the world are going down.

While complicated, this internal debate at the Federal Reserve is at the core of the uncertainty among economists and investors about the future for economic growth and financial markets.

The classic threat to any economy is inflation. Rising inflation has destroyed currencies and crushed economies throughout history. In the 1970s the U.S. economy suffered from destructive inflation. It took a series of interest rate hikes and s deep recession in the early 1980s to defeat that bout of inflation and set the U.S. on a new

growth path. The 1970s inflation was triggered by skyrocketing oil prices. That clearly is not the case today, but our low growth in productivity has the potential to unleash equally destructive inflation. There is growing upward pressure on wages. We can see that in the politically popular push to raise minimum wages. It can also been seen in the U.S. pockets of prosperity where businesses are having difficulty filling positions. Rising wages with no to slow growth in productivity means businesses will have to pass through to customers the higher labor costs or suffer decreasing profit margins. This is what worries Stanley Fischer and his group.

Ms Brainard and her group do not disagree with Fischer. Instead they worry about destructive economic forces from another direction: the global savings glut. Former Federal Reserve Chairman Ben Bernanke identified the savings glut before he became Federal Reserve chairman. The glut has been growing ever since, and becoming ever more skittish because of the long run of low interest rates. Savings have piled up in nervous emerging market central banks' foreign exchange reserves, among corporations, and among wealthier individuals, especially in developed economies. The amounts are staggering. We saw the danger of it in late 2015 as world financial markets anticipated the long awaited December U.S. interest rate hike. There was a tsunami of money that swept into U.S. short term assets. That sent the dollar soaring, stocks plunging, and tightened credit in the rest of the world, making the situation very challenging for central bankers. The anticipation of a very small interest rate increase in the United States changed the outlook for economic growth at home and abroad. The soaring dollar hurt U.S. exports and made imports cheaper. Economists quickly cut forecasts for U.S. economic growth. Tightening credit threatened to extinguish economic growth elsewhere.

By mid-February, policy makers around the world finally were able to stop the panic and calm markets with assurances that they were continuing to support economic growth. The March 16 decision not to raise interest rates, confirmed expectations that the U.S. Federal Reserve was not going to stubbornly push ahead with the planned interest rate hikes.

Economists and market pundits are still busy making bets on when the Federal Reserve will raise interest rates again. No one is taking the bet that they won't raise interest rates again this year. Everyone thinks we will see at least two more 0.25% interest rate hikes this year. They could be wrong.

First, the risks the Brainard group has identified are gaining strength. Central banks in Europe, Japan and China are loosening monetary policy to stimulate anemic economic growth. Negative interest rates are being applied in Europe and Japan. Meanwhile, slow as it is, the U.S. economy continues to grow. In this environment it won't take much to trigger another tsunami of short term capital that would send the dollar soaring again and tighten credit in economies around the world. It isn't hard to see why so many worry about another recession.

Currency markets have always been all about interest rate differentials. Federal Reserve chair Volcker learned that the hard way in the mid-1980s. He followed the Fischer approach and launched a preemptive strike against inflation by raising interest rates. The problem was that his inflation fears were unfounded. Inflation stayed low and the dollar soared. The soaring dollar quickly cut into U.S. economic activity, forcing Volcker to reverse course and bring interest rates back down. Fortunately interest rates were well above zero, and financial markets were more balanced back then. Volcker's

reversal brought the dollar back down and prevented a U.S. economic disaster. The situation is far more fragile today. The savings glut is in large part due the long stretch of very slow growth. Savings - that in better times would be invested - have been accumulating on the sidelines. The glut by itself has depressed interest rates. That is now combined with sustained long term efforts by central banks to keep interest rates low in hopes of encouraging investment and stimulating economic growth. What is needed to end this self-intensifying low interest rate spiral is a major shift in investor confidence. That, in my opinion, would be best accomplished by resolving the internal debate at the Federal Reserve in favor of Ms Brainard and her group. It would be far better to accept a modestly higher rate of inflation, than to crush the U.S. and global economies in the name of keeping inflation in the United States at 2%. A 3% or 4% inflation rate might be an annoyance for some Americans, but it would mean a better rate of wage increases, a stronger U.S. consumer, and faster economic growth. I believe investors would cheer. Capital spending would increase, corporate profits would grow and stock prices would rise. A victory for the Brainard group would not be a defeat for the Fischer group. It would mean a simple but profound shift in policy, namely that the 2% inflation target is not a ceiling but a center of a symmetrical target.

The Brainard group prevailed this time, but the debate goes on. Hopefully, the two sides will make peace and not push on with more interest rate hikes that would trigger another market jarring flood of short term capital into the U.S. dollar. However, if we have to go through one more round before the issue is settled in favor of Brainard, do not listen to the pessimists. The Volcker lesson is that the Federal Reserve learns from its

mistakes. In the long run, meaning the coming six months, the issue will be resolved and we will be looking forward to growth in profits and the economy.

I will have the next market review and update for you one week from today on Wednesday April 6, 2016.

All the best,

John Dessauer

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