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John Dessauer's market review and update as of Wednesday April 6, 2016.

It is a tribute to central bankers, especially in the United States, Europe and Japan. The pessimists are wrong again. They so confidently predicted that central bankers would bumble into a "race to the bottom" currency war. They said global central bankers had run out of ammunition to attack low growth and deflation and that a new financial crisis was inevitable and imminent. For a few weeks earlier this year their dire prognostications seemed plausible. Stock markets fell sharply as panicky investors sold. However, as March turned into April, financial markets calmed and new data showed signs of continued growth in the United States and Europe. Central bankers have done what once was thought impossible: added economic stimulus without disrupting currency markets.

At the heart of the pessimists' "currency war" hypothesis was a conviction that history would be repeated, namely that central bankers would drive down their currencies by slashing interest rates. History is ripe with examples of countries driving their currency down to discourage imports and boost exports. During the height of the euro debt crisis, economists lamented that poor Greece no longer had the option of devaluation to restore competitiveness. They said being part of the euro left Greece with only tough choices. The story of Greece and the euro is just one example, but it shows how currency devaluation is imbedded in economic thinking. Before the euro, Greece had gone through several recessions and had devalued its currency each time. Devaluing the currency was accepted as the easiest way to arrest the downward pull of recession and restore

competitiveness. And, Greece was not alone. Currency devaluation has been used by scores of countries over many decades. No wonder the pessimists' "currency war" hypothesis appeals to so many.

Currency markets are all about interest rate differentials. Money flows into the currency with the highest real interest rates. Therefore, in this world of low inflation, it was assumed money would flow out of euros and out of Japanese yen after both central banks adopted more aggressive monetary policies. It was further assumed that the money would flow into dollars, pushing the U.S. currency even higher. That would have made conditions in emerging markets extremely difficult. Likewise, it would have made China's efforts to stabilize the yuan far more challenging. In short, a soaring dollar could have precipitated a global recession. A second recession, with central bank balance sheets stretched to the limit, could turn out to be painful and long lasting. Fear of a "currency war" was the underlying cause of the turmoil we saw on stock and bond markets earlier this year. Even though central banks have demonstrated that they can provide stimulus without driving their respective currencies down, "currency war" fear still makes financial headlines and is common fodder among the usual pessimistic stock market pundits.

The great recession of 2008-2009 has been followed by unprecedented actions by the U.S. and euro central banks. First it was the U.S. Federal Reserve chair Bernanke who pioneered Quantitative Easing (QE), pumping trillions of dollars into the U.S. banking system. Then the euro central bank followed with its own version of QE easing. And faced with financial market turmoil so severe it threatened the still fragile recovery, central bankers became more aggressive without causing a "currency war." Against all

expectations, the dollar retreated after Europe and Japan attacked sluggish growth with more aggressive monetary policies. How did they do it? The answer is complicated, but it shows that today's central bankers are far better informed about financial market conditions than were their predecessors decades ago.

In Europe last month, ECB President Mario Draghi announced a new program consisting of four long-term refinancing operations, each of four years duration. He increased the central bank's monthly bond buying by 33% and expanded the buying to include investment grade corporate debt. This approach directly addresses bank balance sheet issues and provides incentives for banks to increase lending. In decades past, he would have simply cut interest rates and let the euro fall to stimulate exports and discourage imports. Draghi addressed the interest rate question by saying that reducing interest rates no longer seems to be an effective tool.

In Japan, central bank Governor Haruhiko Kuroda, after introducing negative interest rates last month, held policy steady, clearly tolerating a stronger yen. Negative interest rates have prompted large Japanese insurance companies and pension plans to repatriate foreign holdings. The inflow benefits the Japanese economy while strengthening the yen.

Did central bankers work together? I don't think so. Rather I believe that over the last eight years central bankers have learned hard lessons. Simple, beggar thy neighbor, policies like slashing interest rates and devaluing the currency, no longer work. In fact they do more harm than good. I believe central bankers are still acting in the best interests of their respective economies, rather than coordinating policies.

Has it worked? Here is what Morgan Stanley had to say in their April issue of *On The Markets*: “The result of these central bank actions and rhetoric has been a massive improvement in global financial conditions.” So, yes it has worked. Not only have central bankers not caused a “currency war”; they have stabilized financial markets and set the stage for continued growth in their respective economies.

For stocks, the good news is that the earnings drag from a strong dollar is gone. It takes a while for the accounting to catch up, but for the second half of this year the dollar will no longer be a headline issue when profits are reported.

In a week or so we will start seeing reports on profits for the first quarter of 2016. Expectations are very low. The current consensus for earnings for the S&P 500 companies is $120 a share, up less than 2% from 2015’s opening quarter. With expectations so modest, it won’t take much to generate some upside earnings surprises.

I will have the next market review and update for you one week from today on Wednesday April 13, 2016.

All the best,

John Dessauer

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