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John Dessauer's market review and update as of Wednesday May 4, 2016.

The U.S. Federal Reserve is in a very tough spot, perhaps the toughest in the central bank's history.

There have been extremely difficult economic conditions in the past, the great depression of the 1920s, World War II, and the oil-inflation surge of the 1970s. But during past economic challenges the U.S. and other developed economies were on a gold standard. Not until the 1970s did a free, global currency market begin to develop and challenge the Federal Reserve's policies. Even then, the multiple currencies of Europe muted the currency market's power. Today the currency market has three dominant currencies: the euro, the yen and the U.S. dollar. In addition, the Chinese yuan is fast becoming a fourth major player. Never before has the U.S. Federal Reserve faced such an array of complex international challenges. As if this were not enough, there are domestic political challenges as well. Donald Trump says he would replace Janet Yellen as Federal Reserve Chair. Others want to curb Federal Reserve freedom by introducing periodic audits and even requiring congressional approval before adopting major new policies. Forgotten by politicians and voters alike is that our politically independent Federal Reserve literally saved the U.S. economy from a depression by dramatically expanding its balance sheet after the 2008 financial crisis. We will never know for sure, but most likely without the Federal Reserve's unprecedented help the U.S. economy would still be stuck in recession, or worse. It has been eight years since the end of the great recession of 2008-2009 and the U.S. economy is still limping along. In the first quarter of 2016 the

U.S. economy grew at an annual rate of just 0.5%. That is well down from the lackluster 1.4% annual rate registered in the final quarter of 2015, and the worst performance in two years. It is clear that our federal government's policies from the overly restrictive Dodd-Frank to the utterly incompetent execution of health care reform have severely hampered the economic recovery.

However, the situation is not hopeless. There are continuing signs of economic improvement. The U.S. is creating new jobs - albeit too few full-time, high wage jobs - and housing remains strong. But the U.S. economy also remains vulnerable. For example, if the dollar surged, U.S. manufacturers would suffer as foreign sales slumped and cheap imports flooded our market.

No central bank can control the currency market. Last week the Bank of Japan surprised markets by not adopting additional measures to stimulate the economy. In response the Japanese yen surged, threating Japanese exports. There was a near panic in Tokyo. It remains to be seen what the Bank of Japan will do to stop the yen's destructive rise. Intervention used to help, but recently has been ineffective. The Bank of Japan is in a tough spot. Consumer prices are still falling, economic growth is illusive and it is too soon to tell if negative interest rates are helping or hurting.

For the moment Japan's currency market problem reduces the pressure on the U.S. dollar. But the pressure can quickly rise again if the Bank of Japan finds a way to bring the yen back down.

In sharp contrast to the U.S. first quarter, the economies of the Eurozone enjoyed a surprisingly strong opening quarter of 2016. As a bloc, the Eurozone is the world's second-largest economy. The 0.6% quarterly expansion (roughly 2.4% at an annual rate)

was double the fourth quarter's rate and well ahead of the 0.4% expected. It is still early, but the first quarter's performance is evidence that negative interest rates and central bank stimulus are working. If the Eurozone continues to prosper, that will put pressure on the U.S. Federal Reserve.

The U.S. Federal Reserve went in a direction opposite to the Eurozone last December by raising interest rates and signaling that more interest rate hikes are coming. The assumption by some Federal Reserve board members is that with the unemployment rate low - at near full employment - and job creation strong, it is time to raise interest rates because the economy will soon begin to grow much faster. A second interest rate hike was expected in March. That didn't happen, but in the statement announcing the decision not to raise interest rates the Federal Reserve made it clear that the next move will be an interest rate increase. That is a risky position for several reasons. First, the U.S. economy was so weak in the opening quarter that it might not be able to keep growing if interest rates are raised again. Second, if the rate of growth does not improve this quarter, the U.S. economy might need lower rather than higher interest rates. Third, the U.S. Federal Reserve's position is the opposite of Japan and the Eurozone, where stimulating growth remains the top priority. And finally, the policy divergence raises the risk that higher U.S. interest rates will attract an inflow of capital that pushes the dollar up, further depressing the U.S. economy.

Currency markets are all about interest rate differentials. The U.S. has the world's largest financial market. U.S. Treasury securities are still considered as safe as any asset can be. The anemic rate of economic growth is assurance that inflation is not a concern. Under these circumstances modest returns of 1%-2% on U.S. securities look quite

appealing. Former Federal Reserve chair Ben Bernanke identified a global savings glut well before the 2008-2009 recession. The glut still exists, and if anything has grown. There are trillions of dollars looking for a positive return. If they flood into U.S. securities, the dollar will rise again and threaten the U.S. economy.

As I wrote at the beginning, the U.S. Federal Reserve is in a tough spot. They have raised interest rates once, and indicated that more rate hikes are coming. But the data on the opening quarter indicate the U.S. economy is much weaker than expected. Will the Federal Reserve ignore the first quarter data, stay its course and keep raising interest rates? Odds are the Federal Reserve board members are in shock at the very weak first quarter. They are also most likely stunned at the recent surge in the Japanese yen. They certainly don't want that to happen to the U.S. dollar. Under present circumstances it is, therefore, unlikely the Federal Reserve will raise interest rates any time soon.

The good economic news from Europe is a boost for U.S. multinational company profits. That will help stocks maintain their modest upward bias. What is needed next is improvement in U.S. economic performance. Nothing of any significance will happen at the federal government level until next year. Therefore, it is up to the Federal Reserve to keep the U.S. economy growing. Even though the Federal Reserve board has been split between those who want to raise interest rates because the unemployment rate is so low and those who oppose rate hikes while the economy is struggling and risks weakening further if the dollar surges, they are unanimous that their primary goal is keeping the economy growing. The weak first quarter is likely to chasten the rate hike hawks enough for them to agree to put off further interest rate hikes for the next couple of quarters. One more weak quarter or a dollar surge and the Federal Reserve will be forced to reverse

course and bring interest rates back down. In any case interest rates are not a current threat to stock prices.

P.S. I am currently on the Seabourn Quest sailing from Portugal to Copenhagen. We have been notified of a change in EU (European Union) policy. While sailing in their waters, any onboard purchases - even when the ship is offshore and underway - are subject to the EU VAT tax, which is a whopping 23%. Normally, once the ship is more than a few miles offshore, purchases on board are free of local taxes. Interestingly, the casino is not affected by the new tax rules. The casino can operate as soon as the ship is sailing offshore. The deeply indebted EU governments are obviously very tax hungry.

I will have the next market review and update for you one week from today on May 11, 2016.

All the best,

John Dessauer

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