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John Dessauer's market review and update as of Wednesday May 31, 2017

Pessimists who think the long, slow economic recovery from the 2008-2009 financial crisis and recession is "long in the tooth" and soon to expire in a classic fashion are going to be disappointed. Stock market runs and economic cycles have typically ended after a "boom" that drives growth rates too high to be sustained. Interest rates rise as the Federal Reserve tightens to beat back inflation. That may happen again, but getting there will take more time than most expect. There are just too many economic headwinds that will keep growth rates in check.

The good news is that stocks will remain attractive until this cycle finally reaches its full maturity.

"Behind every significant postwar recovery has been the same driving force: a sustained rise in private investment and new home building, which increased borrowing and drove up interest rates." Phil Gramm and Thomas Saving in *The Wall Street Journal* May 18, 2017. The recovery from the 2008-2009 crisis has been very different. Private investment has been lacking and housing starts have lagged past recoveries. Banks have held excess reserves with the Federal Reserve rather than lend. The result has been an agonizing slow recovery.

Another aspect of this recovery has been the surge in our national debt. Since 2008 the national debt has almost doubled reaching nearly $20 trillion or 105% of the economy. The debt surge has not received the criticism you might expect because of very low interest rates and the Federal Reserve's Quantitative Easing. By expanding its

balance sheet the Federal Reserve effectively financed 55% of the increased debt. The Federal Reserve's balance sheet is now $4.5 trillion up from $1 trillion a decade ago.

Circumstances are changing and professional bond traders are concerned.

The Federal Reserve has stopped buying new treasury securities. This means the Treasury now has to rely on private sector investors to buy all new debt and to replace maturing securities. Bankers, faced with daunting new regulations under the Dodd-Frank legislation, are finding treasury securities very attractive, more so than risking the regulation gauntlet by lending to consumers and businesses.

What bond traders are worried about are Federal Reserve plans to start shrinking its balance sheet. Shrinking the balance sheet means stopping the reinvestment of maturing securities and/or selling securities. So far the talk among Federal Reserve board members has been about stopping the reinvestment of maturing securities. There has been no talk of plans to outright sell securities. The reason for so much angst about Federal Reserve policy is that a decision not to reinvest maturing bonds would act as a monetary tightening. The Federal Reserve would no longer be a buyer of securities it would become a competitor in the private sector credit market.

Years ago when federal government deficits rose there was concern that the government would "crowd out" private borrowers, depressing economic activity. Today with the enormous government debt, large deficits and a Federal Reserve with a too large balance sheet, I would have expected "crowding out" to be a siren song for the pessimists. Instead, the pessimists have been quiet on that front. However, among bond traders and Federal Reserve board members there are serious concerns about "crowding out" and its consequences.

The Federal Reserve has been busy assuring bond traders that it will not be a "crowding out" participant. For example, Philadelphia Federal Reserve bank president Patrick Harker, a voting member of the FOMC policy committee, said he wants to make balance sheet reductions like "watching paint dry." Others have signaled that there is no need to cut the balance sheet back to the $1 trillion of a decade ago. In fact they say there are good reasons for the Federal Reserve to keep a large balance sheet for many years to come. Former Federal Reserve chair Ben Bernanke wrote in a recent blog post for the Brookings Institution, "There's no rush," when it comes to shrinking the balance sheet. That leaves the federal government as the chief concern when it comes to crowding out private sector borrowers.

The economy needs help. "President Trump's tax-cut proposal is a medicine that should be taken at full strength to trigger strong, sustained private investment." (Phil Gramm and Thomas Saving) The problem is that tax cuts are likely to mean larger federal deficits, at least until the economy gains more strength. So, the federal government will remain a dominant force in the private sector credit market.

The classic end to a business cycle is a "credit bubble" that drives prices and interest rates higher. But government borrowing plays no role in a "credit bubble." Consumers and businesses are the players who borrow and spend to excess. Under present circumstances I don't think consumers and businesses could create a credit bubble if they wanted to. Banks are reluctant lenders. There used to be a saying that banks only lend to those who don't need to borrow. That went out the window when mortgage backed securities became the rave. But now, in the aftermath of the great financial crisis, we are back to the days when banks' credit standards are very high.

When Ben Bernanke began taking the unprecedented step of dramatically expanding the Federal Reserve's balance sheet to fend off the downward depression pressures, pessimists sounded the inflation alarm. They were sure that the increase in the money supply would have the usual end in a burst of high inflation. After all that had been the case in the 1970s and in earlier inflation cycles in the U.S. and other countries. They turned up wrong about inflation. But, they were almost right about the huge housing credit bubble that led to the 2008-2009 financial crisis. The global economy did come too close to a new depression. Fortunately, the Federal Reserve took unprecedented steps to prevent a depression and keep the economy growing.

The risk today is not a classic credit bubble and soaring interest rates. The risk today is economic stagnation. Both the Federal Reserve and the Trump administration are determined to prevent stagnation and stimulate faster economic growth. Odds are they will at least partially succeed. That will mean continued growth in sales and profits for businesses. Under these circumstance stocks remain very attractive.

I will have the next market review and update for you one week from today on Wednesday, June 7, 2017.

All the best,

John Dessauer

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