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John Dessauer's market review and update as of Wednesday June 22, 2016

Investors have three big questions on their minds. 1) Will the British vote to stay or leave the European Union? 2) Is the U.S. economy growing or slowing? 3) How low can interest rates go? The first will be answered next week. The second will be answered next month, when we get data on the second quarter. The third won't be answered until the flood of government bonds with negative interest comes to its ultimate conclusion. Bill Gross, now of Janus Funds, thinks negative interest rates are like a "supernova."

A supernova is an astronomical event that occurs during the last stellar evolutionary stages of a massive star's life, whose dramatic and catastrophic destruction is marked by one final titanic explosion. For a short time, this causes the sudden appearance of a 'new' bright star, before slowly fading from sight over several weeks or months.

Bill is a highly successful bond trader. He is warning those who are trading bonds with negative interest rates that there will be an end, a time when interest rates stop going down. Bond traders have no intention of keeping negative interest rate bonds to maturity. They intend on selling at a profit as interest rates keep falling. Traders keep buying because that has been a very profitable strategy for the past two years. As long as interest rates keep falling, trading bonds, even with negative interest rates, will be profitable, because the value of a bond, a fixed rate investment, rises when interest rates go down.

There are now roughly $10 trillion worth of bonds with negative interest rates. The end of the flood of negative interest rate bonds will come when traders believe interest rates are going to stop falling. They will not wait for interest rates to start rising. Fortunately, there is a lot of demand for government bonds, from pension funds, insurance companies, central banks and as collateral for inter-bank transactions. Bill Gross is right. From a historical perspective bonds are ridiculously overvalued. However, that has been a widely held opinion for five years. In 2011 pessimists began calling for a steep decline in bonds because interest rates could not keep falling. They did not take into account that central banks would push interest rates into negative territory. Someday the pessimists will be right and interest rates will stop falling. But, the end more likely will be a whimper than a catastrophic explosion. Strong economic growth and inflation are what it takes to drive interest rates sharply higher. Neither is likely to develop any time soon. The global economy looks set to keep growing slower than central bankers would like for the rest of this year and next. Slow growth, low inflation and strong fundamental demand will counter any wave of selling by traders.

The U.S. Federal Reserve did not raise interest rates at their recent meeting, but signaled it still plans two rate hikes this year.

In a statement explaining why interest rates were not changed the Federal Reserve board members said: “The pace of improvement in the labor market has slowed.” In an effort to justify two more 2016 interest rate hikes the board predicted: “economic activity will expand at a moderate pace and labor market indicators will strengthen.” However, the Federal Reserve board members have been too optimistic for the last couple of years. In addition, their projections for future economic growth undercut their interest rate optimism. The Fed has reduced its future growth expectations to a 2% annual rate, “for the foreseeable future.” At that rate of growth, inflation is likely to remain low and not rise to a level that would justify more interest rate increases. Those Federal Reserve board members who want to “normalize” U.S. interest rates still have an uphill battle. Unless there is some really good news on the economy in July they may have to delay raising interest rates a while longer.

The U.S. and China have something in common, good news on retail sales in May.

China reported May retail sales up 10% from a year earlier. The U.S. also had good news, retail sales increased more than expected in May and were revised upward for April. That combination boosted May year-over-year U.S. retail sales up 2.5%. Consumers in both countries are keeping economic growth alive.

My expectation is that the British will vote for the status quo next week. The fears over Brexit, like Y2K years ago, will quietly subside and be forgotten.

While the Brexit campaigns have been heated and aggressive, they also have made it very clear that leaving the European Union would mean several years of uncertainty. No one can say what would happen if Britain left the Union. But for sure others, like the French, would be angry and determined to show that Britain made a huge mistake. After leaving the British would likely find it very difficult to negotiate favorable trading terms with the rest of Europe.

Polls have been showing a gradual shift in favor of staying in the Union. A vote to stay would not be a “forever” vote. The subject could be brought up again in a future referendum. A vote to leave would be a “forever” vote. Britain would never again be invited to join the European Union. The 2014 referendum about separating Scotland from Britain was also fought with great passion. But, at the end, the Scots voted to stay with Britain. The status quo was more appealing than the unknown consequences of separation. The Brexit vote is likely to have the same fate.

Global fund managers have been selling. In recent weeks their cash holdings have increased to the highest level since November 2001, after the terror attacks on September 11. Average cash is now 5.7% of fund assets, higher than during the 2008 Wall Street meltdown. However, this is a tough time to be holding a mountain of cash. Extremely low interest rates mean money in the bank or money market fund earns virtually nothing. Take today's modest inflation into account and cash is a losing investment.

Fund managers must be nervous, edgy and ready to buy at the slightest sign economic conditions are improving.

The best advice is…do not follow the fund managers. Stocks have been holding up well in spite of the fund manager selling and collection of investor fears. Odds are stocks will continue to be our best choice.

I will have the next market review and update for you one week from today on Wednesday June 29, 2016.

All the best,

John Dessauer