John Dessauer Investments, Inc.

John Dessauer's market review and update as of Wednesday July 5, 2017

The Federal Reserve raised interest rates and the yield curve flattened because interest rates on long-term treasury bonds went *down.* On June 14th the target range of the Fed funds rate increased to 1%-1.25%, the third increase in six months. On the same day yields on ten year Treasuries dropped to the year's lowest at 2.5%. Why would interest rates on long term bonds go down when interest rates on short term securities are going up? The answer is that bond buyers have low inflation expectations.

A related question is what has happened to the Phillips Curve? Economic theory, expressed by the Phillips Curve, says unemployment can't keep going down without sparking high inflation. But, unemployment has been going down, all the way down to 4.3% and the Federal Reserve's favorite inflation measure shows inflation running at a 1.5% annual rate, well below their 2% target. The opposite has also been the case. After the financial crisis unemployment peaked at 10%. According to the Phillips Curve inflation should have collapsed, but it didn't. Underlying inflation was 1.3% in 2009, only a little lower than today. Over the last decade reality has challenged economic gospel. Inflation has been a flat-line as unemployment first soared and then plunged, a range of 10% to 4.3%. However, ten years of challenge have not stopped economists from holding firmly to the gospel of the Phillips Curve. Some think inflation will take off sharply if unemployment goes any lower. Others think temporary factors, especially the decline in oil prices, explain the persistent low inflation rates. One thing is clear, economic ideas such as the Phillips Curve, once held as gospel by a majority of

economists, have been thrown into question by reality in the last nine years. Inflation has defied mainstream economists as well as stubborn pessimists. Pessimists were 100% certain that inflation would soar as the Federal Reserve flooded the economy with new money. Economists were sure inflation would rise when the unemployment rate went below 5%. The missing link may be the economy itself. Perhaps inflation has been subdued because of painfully slow growth and tepid wage gains. Older ideas such "too much money chasing too few goods" and the Phillips Curve may still be valid. Inflation may well come back and challenge central banks. But first the U.S. and other developed economies will have to find the means to stimulate growth well above 1.5%-2%.

The BEA (Bureau of Economic Analysis) has revised its data for the first quarter. Now the data says the U.S. economy expanded at a 1.4% annual rate in the opening quarter of this year. That is modestly better than the 1.2% rate first published by the BEA, but still weaker than it should be this far into a recovery. There was hope for a rebound this quarter. Consumer spending rose 0.4% in March and April. And after-tax income rose 0.6% in May, the biggest monthly increase since December 2012. But now there are doubts about a rebound in growth. Consumer spending rose just 0.1% in May. Consumers chose to save rather than spend, driving the national savings rate to 5.5%. Is it coincidence that consumers changed saving and spending after the latest Federal Reserve interest rate hike?

At long last interest on savings in the bank or money market account will amount to something. At the same time monthly payments on loans to buy expensive durable goods from autos to washing machines will go up. American consumers are reacting sensibly to the changing interest rate environment. Savings look more attractive as short

term interest rates rise. And rising interest rates make borrowing to buy expensive durable goods more expensive. This presents the Federal Reserve with a new challenge because consumer spending accounts for 70% of the economy. If consumers increase savings rather than spending, the rate of economic growth will go down if the Federal Reserve keeps raising interest rates.

It may take more time than economists expect for consumers to adjust to a more normal interest rate environment. Slow growth and low inflation will likely be the norm until the Federal Reserve stops tightening monetary policy and consumers make the adjustment.

What does all this mean for the economy and financial markets?

“Would I say there will never, ever be another financial crisis? You know probably that would be going too far but I do think we’re much safer and I hope that it will not be in our lifetimes and I don’t believe it will be.” Janet Yellen, Chair of the Federal Reserve, speaking in late June in London.

Credit and banking are at the core of risks to financial markets. A credit bubble is what tips the balance to high inflation, high interest rates and recessions. If she is right then the risks for investors in stocks and bonds are far less than pessimists believe.

Jimmy Rogers, a legendary pessimist, predicted in January that the worst crash in our lifetime is right around the corner. He made a similar prediction in January of 2016. Ordinarily, after a long upward move in stocks, pessimists are safe predicting market crashes because a steep temporary correction can come along at any time. However, a long slow recovery with low inflation does not provide much fodder to scare investors. With consumers behaving sensibly in response to the Federal Reserve changing monetary

policy, pessimists like Jimmy Rogers may fade from favor as their followers lose patience.

I will have the next market review and update for you one week from today on Wednesday, July 12, 2017.

All the best,

John Dessauer

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