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John Dessauer's market review and update as of Wednesday October 14, 2015

Mixed signals on the U.S. economy leave the Federal Reserve divided and the outlook for interest rates uncertain.

Last month a majority of the board members of the Federal Reserve voted not to raise U.S. interest rates. Some in the minority, who wanted interest rates raised, apparently are really upset. One board member has come out and said that the Federal Reserve is taking a big risk by leaving interest rates low when the economy is so close to full employment. The risk he is talking about is, of course, inflation. It might seem unrealistic for a Federal Reserve board member to be concerned about inflation when overall economic growth is slow and wages are hardly growing at all. But history is on his side. And, there is more than one Federal Reserve board member worrying about future inflation. In the past, low unemployment was soon followed by rising wages and rising inflation. With unemployment at 5.1%, it is understandable that some would worry that history might be about to repeat itself.

In addition to the low unemployment rate, the low numbers of Americans filing for unemployment compensation for the first time is seen as a sign of a tightening labor market. However, the problem with this measure is that you must first be employed for a period of time before you can file for unemployment. The low number of first time filers could simply mean that existing businesses are no longer laying off large numbers of employees.

When it comes to the labor market, the underlying problem for the interest rate hawks is the very low labor participation rate. At 62.4%, the rate is the lowest since 1977. If the labor participation rate were significantly higher, I have no doubt the Federal Reserve would have voted for higher interest rates in September. So, the split between those who worry most about inflation and those who worry most about the sluggish rate of economic growth comes down to interpreting the data. For ordinary folks there is no doubt that this recovery has been very weak and that large numbers of Americans are out of the workforce or underemployed. However, for some Federal Reserve board members and many economists, an unemployment rate of 5.1% and low numbers filing for first time unemployment claims are warning signs that call for higher interest rates.

The signals from the rest of the economy are also mixed. For example, consumer spending is growing at a reasonable rate, but manufacturing, due to the strong dollar and declining exports, is soft. Sales of new single-family U.S. homes were better than expected in August, while sales of existing homes were disappointing. An interesting data point on housing is the increase in the number of home buyers paying cash. From the beginning of 2014 through May 2015 the number of cash buyers increased to 33%, up from 20% in 2005. Among the cash buyers, the biggest increase came from people who speak Chinese. When buying a house in the United States, 46% of the Chinese pay cash. Daren Bloomquist, Vice President, RealtyTrac said this about Chinese buyers: “The recent turmoil in the Chinese economy has not deterred the inflow of cash buyers of U.S. real estate.”

After the meeting in September Federal Reserve chair Yellen talked about the softening global economy. She made it seem that the turmoil outside the United States

was the primary reason there was no change in U.S. interest rates. There certainly is turmoil in emerging markets, slowing growth in China and weaker than expected data from Germany. However, I suspect she chose to put the blame on the global economy because that way she did not have to come down clearly on one side or the other in the debate over the conflicting domestic signals.

The slowing economy of China gets the media headlines, but there is far more economic drama among emerging economies that are dependent on oil or commodities. For example, before the oil price collapsed, Brazil was growing at a 7% annual rate. Today Brazil is in recession and a political impasse is blocking the way to badly needed reforms.

China's slowdown was inevitable. Growth at a 10% annual rate was sustainable for only so long. Once a substantial middle class developed, China had to change – to transition from fast export oriented growth to slower, but more sustainable, domestic consumption. China may make the headlines, but China is not the major component of concerns over global economic turmoil. The greater cause of global turmoil is the decline in commodity prices - especially oil. Oil prices really have collapsed. Brent crude LCOc1 has fallen to less than $50 a barrel from a high of $115 in June 2014. That price collapse is devastating to economies like Brazil and Saudi Arabia. Call it the dark side of today's oil story.

In the 1970s, the economic darkness came from sharply higher oil prices. In that decade, we suffered soaring inflation, a bond and stock market collapse, and in the early 1980s, a nasty recession. In the 1970s, an oil price decline would have been seen as economic sunshine. The idea that an oil price collapse would cause widespread economic

turmoil would have been laughable. However, after decades of high oil prices and convincing data that the world was running out of oil, too many economies became dependent on high priced oil. In addition, investment in energy exploration and production has been a driving force for this otherwise lackluster recovery from the recession of 2008.

Low cost energy is an economic blessing for all who are energy consumers, and they are, by far, the majority in the global economy. The positives from the oil price collapse are taking time to fully develop. However, we can see the first signs of the positives in the U.S. consumer spending data. Revised data show U.S. consumer spending in the second quarter growing at a 3.6% annual rate. When the revised figures were released, the Commerce Department noted that consumers were being helped by cheap gasoline prices.

China is in a transition from export dependence to domestic consumption. The rest of the global economy is in a bigger transition from high cost to low cost energy. As the damage from the oil price collapse diminishes and the benefits from low cost energy emerge, the rate of growth in the U.S. and global economies will increase, and then the Federal Reserve will have good reason to raise interest rates. The economic signals will no longer be mixed.

And, as the rate of economic growth improves, former Federal Reserve chair Bernanke will be right… an interest rate hike will be good news for the stock market.

I will have the next market review and update for you one week from today on Wednesday October 21, 2015.

All the best,

John Dessauer

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