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John Dessauer's market review and update as of Wednesday November 11, 2015

Happy Veterans Day!!

When the Federal Reserve raises interest rates, the markets - especially the currency market - will be the judge. The strong dollar is already damaging the U.S. manufacturing sector. A much stronger dollar would make members of the Federal Reserve board regret their decision to raise interest rates.

The report on job creation in October was better than expected. Nonfarm payrolls increased 271,000, the best month since last December. The unemployment rate fell to 5%. In Response, Bill Gross, now of Janus Funds, said he is 100% certain the Federal Reserve will raise interest rates next month.

It is important to understand what is going on during this time of intense anticipation of an interest rate hike. This is not the typical situation where higher interest rates are needed to slow growth and blunt inflation. The discussion among Federal Reserve board members is about "normalizing" interest rates. The question being debated is whether the economy is strong enough to tolerate a small increase in interest rates. The data remain mixed. Manufacturing is being hurt by the strong dollar. Retail sales growth is modest. There are pockets of strength - car sales and housing, for example. However, the economy is far from a boom that would call for higher interest rates.

Inflation remains well below the Federal Reserve's 2% target rate. Not only is there no compelling reason to tighten monetary policy by raising interest rates - there is a risk that even a small interest rate increase will take a bite out of economic growth.

The Federal Reserve board members who want to keep interest rates near zero and who oppose raising interest rates are hoping very low interest rates will eventually kick-start a virtuous cycle of investment, higher productivity, and better pay that will heal the deep wounds from the worst recession since the great depression.

Laurence Meyer, who served on the Federal Reserve board in the 1990s says this hope is a "new view of the reach of monetary policy." "It goes against everything I taught at the University for 27 years." He is talking about the traditional view that monetary policy influences prices - not the size of the labor force, which is determined by long-term forces including population growth. Meyer goes on to say: "Should the Fed stimulate enough demand for labor to put a dent in the underemployed, it would be a fantastic achievement. That might be a gamble worth taking."

There are six million Americans working part time jobs rather than full time because the economy isn't strong enough. In addition, there are 600,000 who have become so discouraged that they have stopped looking for work. There is no debate about the sorry state of employment or the slow economy. The debate is about the role of monetary policy. The Federal Reserve has applied unprecedented policies, including Quantitative Easing and extremely low interest rates for several years - long enough, some argue, to have exhausted the monetary possibilities.

The biggest risk in keeping interest rates at record lows is at some point inflation will rise - not just to the Federal Reserve's 2% target, but much higher - high enough to require really tight monetary policy with much higher interest rates.

Federal Reserve Chair Yellen worries that the current low inflation is due to short-term "transitory" forces. The very low oil price would fall in the category of

“transitory” inflation forces because oil prices likely will stop going down and then become a neutral inflation force.

However, analysts at Morgan Stanley Wealth Management think Yellen is likely to be in for a surprise. “Going forward, the Fed may find that it is surprised at how persistent and nontransitory the inflation shortfall proves to be.” In other words, the long term inflation risk may be far less than many believe. The inflation hawks are already in denial. They were convinced the massive expansion of the monetary base would lead to skyrocketing inflation. In their view, we should be suffering double digit inflation by now because the Federal Reserve has printed trillions of dollars of new money. Not only have we *not* had a burst of monetary inflation; the evidence indicates inflation will stay low for a considerable period of time.

“The open secret in US inflation is that for the past two decades core goods inflation has generally been negative. Indeed, core goods inflation has averaged about -0.2% a year for the past decade. In the past year alone, core goods inflation has declined by -0.9% as US import prices have fallen.” *Morgan Stanley Wealth Management, November 2015*

Remember Milton Friedman’s definition? “Inflation is too much money chasing too few goods.” If the inflation hawks were right, the expansive monetary policy applied by the Federal Reserve to counter the deep recession of 2008 by now would have pushed core goods inflation well into positive territory. That has not been the case. Clearly there is more to the story of inflation than how much new money the Federal Reserve prints.

The Morgan Stanley analysts highlighted the decline in import prices. That is a direct result of a strong dollar. To be sure, there is more to the story of the long term

decline in core goods inflation than the strong dollar. At times during the last two decades the dollar was weak and core goods inflation still was negative. Technology is a major factor in reducing the cost of goods. For example, the cost of a computer today is far less than a decade ago. But when the dollar is strong, as recently, core goods inflation falls fast. A strong dollar makes American goods and services more expensive for foreign buyers, while making foreign goods and services cheaper for Americans.

The biggest risk when the Federal Reserve raises interest rates is that the dollar continues to gain strength and further damages U.S. economic activity.

In the world of currencies everything is relative. It isn't just how strong or weak the U.S. economy might be. The issue is how the U.S. compares to the rest of the world. At the moment, the rest of the world does not look as good as the U.S. That is why the dollar has been gaining strength. Growth is slowing in China. Brazil is in recession. Japan is struggling to keep growth positive. Europe is still applying aggressive monetary easing in an effort to keep demand growing. The U.S., with its slow growth and employment issues, is the most attractive economy. Raising interest rates even just 0.25% will make the U.S. even more attractive. How high will the dollar go? Only time will tell. For the Federal Reserve, what looks like a great idea in December could look quite the opposite by April. Above all, remember the Federal Reserve does not want the U.S. economy to weaken. They have reversed course in the past and can do it again.

The stock market has recovered. October was a very good month. A 0.25% increase in interest rates will not make cash much more attractive, and would worry bond investors. Stocks remain our best investment choice.

I will have the next market review and update for you one week from today on Wednesday November 18, 2015.

All the best,

John Dessauer

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