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John Dessauer's market review and update as of Wednesday November 18, 2015

October's jobs report has economists all excited. They expect a tightening labor market to be followed by rising wages. The problem is the link between unemployment and wage growth—the so-called "wage Phillips curve"—has flattened in recent years. Relatively strong job creation and a low unemployment rate no longer guarantee higher wages.

It is well known that the current unemployment rate is misleading. There are roughly six million Americans with part-time jobs who want full-time jobs. And another 600,000 are so discouraged about finding work that they have given up and dropped out of the workforce. Another reason the "wage Phillips curve" has flattened is the low labor market participation rate. The participation rate among 25-54 year olds is just under 81%. That is lower than at any time since 1984. For American men the participation rate is lower than in France or Sweden. The fraction of 25-54 year olds with jobs has recovered only about halfway to its pre-recession peak. Employers do not have to raise wages; they simply need to offer attractive jobs at current wages to tempt the now idle back to work.

There may be another stopper coming that will keep wages where they are. Former House Speaker John Boehner was in Naples last week. He gave a talk to a group of local Republican leaders. He said the rising health insurance costs under the Affordable Care Act—Obamacare—continue to be a "Big Problem." Health insurance premiums are going up next year. And, if my experience is any example, the sticker shock will be paralyzing for many employers and workers alike. My company has one

full time employee. She has a young daughter. Both are in excellent health and have had no major medical costs. Blue Cross and Blue Shield of Virginia recently sent a notice that her health insurance premiums would go up by 41% next year. That is an additional cost of $5,760 a year. That will be a very real cost to the company with absolutely no additional benefit to the employee. With that sort of labor cost increase there is very little financial room left for an increase in wages. Obamacare may be a reason wages will remain flat in 2016. By the way, the total new premium for 2016 under the Blue Cross and Blue Shield proposal would be $19,884. That is clearly not "Affordable." If this is typical, and I am sure this case is not unique, then Obamacare will soon be a financial burden, retarding wage and economic growth. Reforming Obamacare needs to be a top priority for the President and the Congress.

Commodity prices are down and likely to stay down for a decade or more. The reason is not so much a lack of demand; it is overinvestment in mining and exploration that have increased supplies.

Oil fell below $42 a barrel last week. Copper prices fell to the lowest level since 2009. The Bloomberg Commodity Index fell to the lowest since 1999. The popular conclusion is that slowing growth is to blame for the steep decline in commodity prices. Yes, global growth is slowing, but that is not the explanation for sinking commodity prices. Developed economies are growing. Even China is growing and the rate is likely to be 6%-7% for the next few years. The growth problem is concentrated in emerging economies - more specifically commodity-driven emerging economies. Oil is not the only commodity where the price has fallen due to an enormous and totally unexpected increase in supply. Not many years ago the consensus was that the world was running out

of recoverable oil and scores of other commodities. Thanks to investment, innovation and technology, the world’s oil supply has grown beyond the most optimistic expectation. The same is true for many other commodities. Increasing supplies brought commodity prices down and that has slowed growth in commodity producing economies. Our neighbor to the north, Canada, is a prime example. Falling oil and other commodity prices have pushed Canada into a recession. There is no reason to expect a quick turnaround in oil or other commodity prices. The supply side has changed so dramatically that it will be at least a decade before demand catches up with the new levels of supply.

China once was a driving force in demand for oil and other commodities. You could blame China for the inflated commodity prices that encouraged all the investment in exploration and production that has now led to the price decline. But, affixing blame will not change present reality. China is changing from a manufacturing/export economy to a service/consumption economy. The new China needs fewer commodities.

The bottom line is that in addition to suffering the lingering consequences from the 2008 financial crisis, the global economy must also adjust to a new world of lower commodity prices. There are real benefits for consumers in the new world economy. They are helping to keep consumer-driven growth alive. But the past, excessive dependence on high commodity prices is now hurting economies from Saudi Arabia to Brazil. That will not change quickly. Developed economies including the United States, Europe, China and Japan will be the first to show the economic benefits of lower oil and commodity prices. Others will lag far behind.

The combination of a Federal Reserve about to raise interest rates and the changing world of oil and commodity prices is confusing investors, causing stock market volatility.

With 90% of companies in the S&P 500 stock index having reported third quarter results, profits are down 0.9% from last year's third quarter. This will be the first down earnings quarter since the recession of 2008. Worse, earnings are expected to fall more than 2% in the fourth quarter. Two back-to-back down quarters qualifies for an "earnings recession." Never before has the Federal Reserve even contemplated raising interest rates during an earnings recession. The Federal Reserve's current focus on raising interest rates provides fuel for the pessimists to scare investors with dire predictions of lower stock prices to come.

However, this time the Federal Reserve is looking at the cause of the earnings recession, which is the plunge in oil and commodity prices. The bulk of the S&P 500's earnings declines come from the energy and materials sectors, companies that are cutting back because commodity prices have plunged. The Federal Reserve sees the downward pull from lower oil and commodities as temporary. Stock analysts feel the same way. They expect S&P 500 earnings to rise next year. And excluding energy and materials related companies, the S&P 500 earnings are positive this quarter and are expected to be positive again next quarter.

The future for interest rates and inflation depends on wages and whether or not they will start rising in 2016. If they remain flat, inflation will stay low and the Federal Reserve will have an interest rate problem. If Obamacare turns out not to be a major factor and a tighter labor market behaves as it has in past cycles, then we will see stocks,

interest rates, and inflation move higher. Remember - rising wages will mean growth in consumer spending, and rising demand - both of which will mean solid increases in corporate profits.

Howard Silverblatt of S&P Indices says dividends this quarter are on track to make the sixth consecutive quarterly record. Dividend increases set records in 2013 and 2014. This year will be another record. Keep in mind BNY Mellon's Leo Grohowski told us that the dividend payout ratio is still relatively low. We might see another record dividend year in 2016.

Dividends clinch the deal. Stocks are better than cash or bonds. Hold on to stocks, this positive stock market cycle is not over.

I will have the next market review and update for you one week from today on Wednesday November 25, 2015.

All the best,

John Dessauer

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