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John Dessauer's market review and update as of Wednesday December 9, 2015

For the first time in seven years, the Federal Reserve is set to raise interest rates next week. The question is: will next week's rate hike be "one and done"? Or will it be the start of a series of rate increases? Presidents of Federal Reserve banks are sharply divided on that question. My view: The Federal Reserve will raise rates by 0.25% next week and then patiently watch markets and the economy for the next several months.

The division among Federal Reserve Bank presidents was on display last week at a Philadelphia Federal Reserve conference. Narayana Kocherlakota, president of the Federal Reserve Bank in Minneapolis, was sharply critical of the Federal Reserve. He said it was too anxious to begin raising interest rates and thus would fail to create perhaps millions of jobs in a timely manner.

James Bullard, president of the Federal Reserve Bank of St. Louis, argued that it is time to raise interest rates and to begin shrinking the central bank's $4.5 trillion balance sheet.

The Federal Funds futures market indicates a 79% chance the Federal Reserve will raise interest rates at its meeting next Tuesday and Wednesday. And the futures indicate a 50% chance interest rates will be raised again by March.

After a strong November jobs report, investors became more convinced the Federal Reserve will raise interest rates next week. Nonfarm payrolls increased 211,000 in November and the number of new jobs created in October was increased by 35,000.

While good news, the report still showed a mixed picture, with continuing pockets of weakness in the U.S. job market. Manufacturing lost 1,000 jobs. November was the third straight month with lost jobs in manufacturing. Mining lost 11,000 jobs in November and the oil patch continued to shed jobs. For example, Schlumberger announced another round of job cuts in addition to the 20,000 layoffs already reported this year.

A broad measure of unemployment that includes people who want to work but have given up searching, and those working part-time because they cannot find full-time employment, rose one-tenth of a percentage point to 9.9 percent.

Strong job creation in November did not push the unemployment rate down. The unemployment rate stayed at 5% because so many came back into the work force.

The bottom line on the November jobs creation report is that it is good enough to give the Federal Reserve justification for an initial interest rate increase. But it is not strong enough to support a series of interest rate increases. Unless the economy starts showing new strength and wages begin to rise strongly, the coming interest rate hike will likely be a "one and done" move.

Will the U.S. economy gain strength in 2016? Will U.S. economic growth finally rise above 3% next year? A year ago, leading economists predicted growth of 3+% this year. Having been wrong has not deterred some from making the same prediction for 2016.

A year or so ago Richard Hoey, Chief Economic Advisor to BNY Mellon, thought we were at an end of the slow growth economic cycle and that this year would mark the beginning of a stronger growth period with annual growth rates at 3% or better. That has not been the case. The economy stumbled in the first quarter. Optimistic

economists blamed bad weather. Weather was, no doubt, part of the problem, but as the year progressed the anticipated new strength turned out to be quite modest. Slow growth with very low inflation has once again been the case in 2015.

Analysts at Morgan Stanley Wealth Management think 2016 will be the beginning of a new cycle with stronger economic growth. They are in the camp that expects a series of interest rate increases starting next week and continuing through all of next year. They are not alone.

According to a Reuters' poll last week, Wall Street's top bankers expect the central bank to maintain a slow pace of interest rate hikes, with the median fed funds rate at 0.75% by mid-year and 1.125% a year from now. Among the Federal Reserve's policymakers the median outlook is for four quarter-point interest rate increases next year.

What are these interest rate hawks expecting from the economy that would justify a series of interest rate increases? The answer is: rising wages. However, there are reasons to think that wage growth will continue to be restrained by the strong dollar, layoffs in the oil patch, discouraged workers coming back to look for a job and rising health insurance costs. The stock market may be the best of the leading indicators.

The stock market has been going nowhere, trading in a fairly narrow range. The reason is clear. Without improvement in final demand, profit growth will remain slow - in single digits. Sluggish final demand growth is not only a restraint on profits; it is also a restraint on wage growth. Wages are not an accounting phenomenon - they are a current cash obligation. Businesses will not raise wages unless there is a corresponding increase

in available cash. In an economy like ours where the consumer accounts for two-thirds of final demand, what is needed is a virtuous, self-fulfilling cycle of rising consumer spending that fuels rising wage growth. That is easy to say and very difficult to accomplish. It has been seven years since the last great recession. History says that by now final demand should be growing at a much faster pace. Political partisans can argue about the reasons for the persistent slow growth, but until there is a significant change, slow growth will continue. In fact, it is remarkable that the American economy is doing so much better than others in spite of all the headwinds, domestic and foreign.

Conclusion: The stock market has it right. There are too many hurdles - especially uncertainty about the cost of health insurance - for wage growth to improve. Average hourly earnings were 2.3% better than a year before in November. That was down from 2.5% in October. The Federal Reserve will not risk slowing the rate of economic growth. Next week's 0.25% interest rate increase will be a "one and done" move until there are signs that final demand growth has significantly improved. Stocks remain attractive.

I will have the next market review and update for you one week from today on Wednesday December 16, 2015.

All the best,

John Dessauer

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