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John Dessauer's market review and update as of Wednesday December 16, 2015

Markets are convinced the Federal Reserve will raise interest rates this week. But, critics abound, arguing that the Federal Reserve will have limited options if raising interest rates slows the economy. On the other hand, the critics say, the Federal Reserve's options would be unlimited if they patiently wait for inflation to rise.

Eric Maskin, who won the Nobel Prize for economics in 2007, is a critic. He said last week in Moscow: "The unfortunate thing is that if you raise interest rates there is a risk - again, it may be small, but it's a significant risk- that you will slow down the recovery. Maybe she (Federal Reserve chair, Janet Yellen) knows something that I don't know, and she sees signs of inflation I don't see, but I really don't understand why it's so important to raise interest rates when there is so little to be afraid of."

Maskin touched on another issue, one that is very sensitive: income inequality among Americans. Federal Reserve Chair Yellen was asked about income inequality during her December 3 testimony before Congress. She said it was showing a "very disturbing trend." Maskin said: "I worry that raising interest rates is a move to increase inequality, not to decrease it. Most people don't have much savings, most people rely on their wage incomes. And the problem with raising interest rates is that you make investment in business less profitable and so you make it more difficult for wage earners. You help savers, the investors, but you hurt people who rely on wage incomes."

Income inequality is often a popular topic for the media, but so far, in the context of the coming interest rate increase, the media have been silent on the income inequality aspect of the interest rate increase. However, with a Nobel Laurate raising the issue, you can be sure it will be a topic taken seriously during the Federal Reserve's interest rate deliberations. Income inequality is not likely to stop the coming interest rate increase, but it will likely slow, if not stop, interest rate increases in 2016.

There is another issue that will also slow, if not stop, future interest rate increases and that is the risk that the economy will slow. Because of Quantitative Easing and the now swollen balance sheet, the Federal Reserve will have to use new tools to raise interest rates. In the past that was done by selling treasury securities. But the Federal Reserve's balance sheet is now more than $4.5 trillion, as opposed to $800 million before the 2008 financial crisis. Investors are afraid the Federal Reserve might start liquidating the $4.5 trillion. If the Federal Reserve started selling, securities markets could be severely rattled, damaging the economy. So the Federal Reserve has assured investors that it will not sell securities, at least not until the economy is a lot stronger. But what happens if the Federal Reserve makes a mistake and raises interest rates too high too soon? The answer is there would be very little the Federal Reserve could do to restore economic growth. The Federal Reserve, with a $4.5 trillion dollar balance sheet, could not launch another Quantitative Easing program to stimulate the economy. The Federal Reserve's only option would be to bring interest rates back down to near zero. And that might not be enough to stop the economy from slowing. On the other hand, suppose the Federal Reserve is patient and waits for inflation to rise. Further, suppose the pessimists are right for a change, and inflation rises faster than expected. Thanks to the swollen

balance sheet, the Federal Reserve would have unlimited options to sell securities, raise interest rates, tighten the money supply and stop inflation. This is why Federal Reserve critics like Maskin say there is little to fear from inflation under the present circumstances. Why then is there so much pressure to raise interest rates? The answer is that several Federal Reserve board members are uncomfortable with interest rates staying so low for so long. They worry about unintended negative consequences from a prolonged period of near zero interest rates. The last Federal Reserve interest rate increase was in June 2006, almost ten years ago.

How will the Federal Reserve go about raising interest rates?

In October 2008 the Federal Reserve started paying interest on bank deposits held at the Federal Reserve. The current rate is 0.25%. Bank deposits at the Federal Reserve are called "fed funds" and are actively traded among the banks. Not surprisingly, the current fed funds rate is 0.25%. Instead of selling securities and rattling markets, the Federal Reserve will raise the interest rates on bank deposits to 0.50%, an increase of 0.25%. The idea is that banks will not be willing to lend money at less than what they can earn on deposits with the Federal Reserve. Deposits at the Federal Reserve are the lowest possible risk. Lending anywhere else carries a higher risk.

After a first interest rate increase, market attention will be drawn to the question of what comes next. Will, as some expect, interest rates be increased several times in 2016? Or will the coming interest rate increase be a "one and done" move?

The continuing oversupply in oil and other commodities will keep inflation depressed. In addition, as we saw last week, the fallout from overleveraged energy producers is causing turbulence in bond markets. One high yield, or junk, bond fund

closed its doors and stopped withdrawals because it could not sell assets. The fund held too many bad loans connected to the oil patch. On December 4, OPEC scrapped member oil production limits, that sent oil prices down below $36 a barrel and also sent oil company stocks down sharply. The supply situation is no better for other commodities. The world's two biggest mining companies, BHP Billiton and Rio Tinto are sticking to plans to keep digging more iron ore and other metals in spite of current oversupply conditions. It may be several years before the commodity oversupply situation stabilizes. Meanwhile, it is hard to see an outbreak of high inflation with commodity prices so low.

Odds are the Federal Reserve will not automatically raise interest rates in 2016. Instead they will be cautious, and watch the economic signals - especially wages - very carefully.

Over the weekend there was good news for the stock market. Last week's market plunge will likely be reversed soon.

First, the data on China's economy in November were encouraging. Factory output rose to a five-month high, growing at a 6.2% rate. That was significantly better than October's 5.6% rate. Fixed-asset investment grew 10.2% in the first eleven months. Retails sales grew at an 11.2% annual rate in November. China's economy is responding to government stimulus efforts.

Closer to home, U.S. consumer spending was relatively strong in November after being below expectations in September and October. The U.S. economy still faces headwinds, such as rising health insurance costs, but is still growing at a steady 2+% rate.

Friday's 300+ point plunge in the Dow Jones Industrial Average was an overreaction. Stocks remain attractive.

I will have the next market review and update for you one week from today on Wednesday December 23, 2015.

All the best,

John Dessauer

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