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John Dessauer's market review and update as of Wednesday December 30, 2015

Happy New Year…..May 2016 bring you peace and prosperity.

This is the time of year when economists and market pundits look back and then try to determine which trends are fleeting and which will last through the New Year. Currently the most popular forecasting target is the Federal Reserve. Predictions range from an interest rate increase every quarter to a Federal Reserve mistake, forcing interest rates back down.

Steven Ricchiuto, chief economist for Mizuho Securities, distinguished himself by predicting back in the spring of 2014 that the first Federal Reserve rate hike would not come until mid-2016. That was the farthest rate hike prediction at the time. All of his peers expected a rate hike much sooner. While he missed the mark by six months, he never-the-less came closer than the rest of the early 2014 forecasters. And he is not backing down. In an interview last week, he said the December 16 interest rate hike "was very, very stupid." That is rough language for an economist. But his assessment has a lot of distinguished company - including former U.S. Treasury Secretary Larry Summers, Nobel Prize laureates in economics Paul Krugman and Joseph Stiglitz, and noted bond investor Jeffrey Gundlach. As for the future, Ricchiuto said: "They will go another 25 basis points and will be stuck there for a long period of time." In other words he expects the Federal Reserve to raise interest rates 0.25% one more time. Other economists expect the Federal Reserve to raise interest rates at least twice in 2016. Based on their latest forecasts, the Federal Reserve board members expect four interest rate increases in 2016.

The widely different interest rate forecasts reflect differing opinions about the underlying state of the U.S. economy. Those who expect four interest rate increases in 2016 think the U.S. economy is so strong that it needs higher interest rates. Others, like Steven Ricchiuto, think the U.S. economy is weak and still needs all the help it can get.

Stocks have been volatile because investors are confused. Is an economy so strong that it needs four more interest rate increases good news, or a sign that inflation has become a major issue? Is an economy still so weak that it needs zero interest rates good news, or a warning that the next recession is just around the corner? The economic data, right up the present, are so mixed as to be of little help in resolving the divergent interest rate forecasts or settling investors' confusion.

For example, the Bureau of Economic Analysis (BEA) issued a revised report on the economy in the third quarter. Now the BEA says the economy grew at a 2% rate in the third quarter. That is down from the earlier report of 2.1% and well down from the 3.9% pace in the second quarter. Is the slowdown from the second to the third quarters the new trend? And why in the world did the Federal Reserve raise interest rates when the current growth rate is only 2%?

There are data indicating that the economy's underlying condition might be stronger than the 2% top line growth rate. Consumer spending, which accounts for about two-thirds of the economy, is growing at a 3% rate. Business spending on equipment is booming, growing at a 9.9% rate in the third quarter. A measure of private domestic demand, which excludes trade, inventories and government spending, grew at a 3.2% rate in the third quarter. The Federal Reserve last month decided to focus on the points of strength. Even so, they raised interest rates ever so slightly, by 0.25%.

However, there are data pointing in the opposite direction. For example, sales of existing homes fell 10.5% in November, the biggest drop in five years. And the drop was widespread, down 13.9% in the West, 6.2% in the South, 15.4% in the Midwest and 9.2% in the Northeast. And manufacturing is struggling because of the strong dollar. Seven years after the recession and the economy is still struggling, offering no convincing evidence of strength or weakness.

My expectations for the U.S. economy

There are headwinds that need fixing by our political leaders. The most obvious is the cost of health insurance. The certainty is that premiums are going up more than we were told. The uncertainty is, by how much more. Higher health insurance premiums will act as a restraint on wage increases for the coming twelve months. Anemic wage increases will disappoint the inflation/interest rate hawks.

However, there are some real benefits coming along, especially low energy costs. So far we have seen the downside from falling oil prices. Energy companies have cut jobs, reduced spending and suffered falling profits. In the New Year, the balance will shift and the benefits from lower energy and commodity prices will start making the headlines. Gasoline prices have dipped below $2.00 a gallon. It is not a coincidence that consumer sentiment and spending have turned out better than feared this holiday season. Cheaper oil and gasoline are not a cure all for what ails the economy, but they are far better than the opposite - an oil shortage with rising gasoline prices. Through the winter, Americans will benefit from lower costs for heating. The cost of electricity is coming down. American businesses are already enjoying lower energy costs.

I expect the economy to grow at a rate of 2.5%-3% in 2016. That will be strong enough to lift demand and boost corporate profits. To those who worry about growth slowing and a new recession, I say: remember - the Federal Reserve's number one priority is maintaining economic growth. If it turns out the Federal Reserve board members are too optimistic and the economy shows signs of slowing, they will reverse course and take steps to keep economic growth alive and well.

I expect 2016 will be a year to focus on specific companies, their dividends, and corporate profits. The broad market indices like the Dow Jones Industrial Average will likely make new highs, but struggle to add more than 10% by year end.

If the Morningstar long term analysis of individual investor behavior holds true, the stock market should be up in the first half of the New Year. Individual investors have taken money out of mutual funds every month since July. In the week ending December 16, redemptions soared, reaching $28.6 billion - the biggest weekly outflow since June 2013. The withdrawals hit both stock and bond funds. Morningstar's analysis shows individual investors going in the wrong direction every time. They sell when they shouldn't and buy when they shouldn't. Six months of selling, culminating in a massive outflow near year end, is a signal that both stocks and bonds will do better in the coming six months than they have in the last six months.

Even with a modest capital gain, the total return (including dividends) on stocks will likely reach or exceed 10% in 2016. Our best strategy continues to be to stay invested in carefully selected stocks.

I will have the next market review and update for you one week from today on Wednesday January 6, 2016.

All the best,

John Dessauer

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