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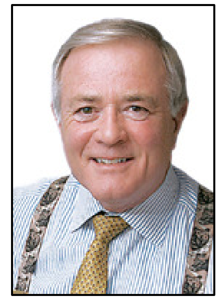

William Rutherford

Fed to markets: interest rates may stay lower longer

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After a slow start for January, U.S. equity markets finished February on a strong note. U.S. indices showed the NASDAQ leading the way with a 7.1 percent gain for the month, the best since January 2012. The Dow was up 5.6 percent, and the S&P up 5.5 percent. Year to date, the Dow was up 1.74 percent, the S&P up 2.21 percent and the NASDAQ up 4.8 percent.

The drop in gas prices drove the U.S. into deflationary territory, as consumer prices declined 0.1 percent year over year. Prices fell 0.7 percent from December.

However, the U.S. is not expected to join Europe in a deflationary economy. Consumer prices in January, aside from energy, showed a healthy gain of 1.8 percent, in line with the Federal Reserve's desired goal. Food costs were up 3.2 percent, shelter up 2.9 percent, and health care 2.3 percent.

John Williams, president of the Federal Reserve Bank of San Francisco, said he believes that inflation will rise to the Fed's desired level by the end of 2016. Janet Yellen, chairwoman of the Federal Reserve, indicated in testimony to Congress that weak inflation was due to the transitory effect of lower energy prices. Policy makers think the steep fall in energy prices will abate. We are already seeing price increases at the pump, with the cost of a gallon of gas increasing about 30 cents since the beginning of February.

Meanwhile, the easing of inflation has added to inflation adjusted wages, which have posted their largest gains since November 2008. Real average hourly earnings moved up 1.2 percent from December. A tightening labor market has also added to wage increases, with Wal-Mart, Aetna, Starbucks and others announcing increases for their employees.

Strong winter storms were expected to shave some growth from the first quarter economy, as happened in 2013. Gross domestic product for the U.S. expanded at a 2.2 percent annual rate in the fourth quarter of 2014, down from an expected 2.6 percent. The growth experienced in the second and third quarters of 2014 proved unsustainable.

For all of 2014, GDP expanded at 2.4 percent – slightly better than the 2.2 percent annual growth rate of 2010-2013. By comparison, the economy grew an average of 3.4 percent per year during the 1990s.

Consumer spending matched its fastest rate of growth since 2006 during the fourth quarter. Personal consumption expenditures rose 4.2 percent. Lower gasoline prices may have had an effect, and with unemployment at its lowest levels in five years, housing prices are recovering. The consumer, 70 percent of the economy, seems poised for additional spending.

Janet Yellen's testimony before Congress suggested that the Fed is willing to keep interest rates lower and longer than previously expected. Just to be sure that the markets did not get too complacent, Fed speakers took to the rubber chicken circuit to call for an increase in interest rates. However, in spite of the appearance of renewed economic growth, the economy still has pockets of weakness that should prevent it from becoming overconfident about the state of the economy. Fed futures seem to indicate a rate increase might not come until fall or even later.

European economies remained sluggish at best. The eurozone is still in deflation. Interest rates on sovereign date have turned negative, and the ECB has mounted its own version of quantitative easing.

Greece remains a significant problem for the European Union and the euro currency. Greece has hinted that it may default on bonds owed to the International Monetary Fund, which would be a first in the 70-year history of the IMF. Russia and China are circling in the waters around Greece, which must cause the European powers concern.

The Ukraine continues to be a headache for Europe, and therefore the U.S., with Vladimir Putin seemingly having no end to duplicitous behavior. Now with his principal political opponent assassinated in Red Square, Putin has appointed himself in charge of the investigation. Protesters have taken to the streets of Moscow by the tens of thousands. Could a crackdown be in the offing?

The Chinese central bank has cut interest rates for the second time in four months, signaling its concern over economic growth. Meanwhile, by the end of February, Japan had seen its equity markets increase 1,347 points this year, to the highest level in about 15 years and about 50 percent of their all-time high.

The outlook for the U.S. is positive, with caution ruling the day. Europe and Asia will eventually work out of their malaise, but it will take time. Stay fully invested with diversified holdings.

William Rutherford is the founder and portfolio manager of Portland-based Rutherford Investment Management. Contact him at 888-755-6546 or wrutherford@rutherfordinvestment.com. *Information herein is from sources believed to be reliable, but accuracy and completeness cannot be guaranteed. Investment involves risk and may result in losses.*