Weekly Commentary **November 13, 2015**

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Markets Test Fed; Earnings in Tailspin

Friday, 10:25 a.m. EST

The market is clearly testing the Fed's resolve to raise rates at its next meeting. Oil prices have collapsed and are at or near their August lows. The CRB Index is within a fraction of a point of its August low. In addition, the PPI index came in well below expectations, owing to a large drop in business service prices. Ex food and energy, the drop of 3 tenths percent was four tenths below expectation, putting the year-over year rate of core producer price inflation at a mere 0.1%. The overall index is down 1.6% from a year ago. Although the new formulation of the PPI does not go back before 2011, on the older series, referred to as "Finished Goods," we are at the highest *deflation* level since the total collapse of commodity prices at the depth of the financial crisis.

To be sure, on the inflation front, there is absolutely no reason for the Fed to move. And if commodity prices continue to spiral downward, they will probably defer. But if prices stabilize at current levels, the odds are very high that the Fed will hike. The unemployment rate is 5.0%, only one tenth above the lower limit of the Fed's "natural rate of unemployment." Some in the FOMC might think that level should be lowered, but nonetheless, it would be virtually impossible for the Fed, given its past statements, not to begin the tightening process since this level has been reached. Remember 2 years ago, Bernanke said that Fed would likely begin tightening when the unemployment rate reached 6.5%!

All said, it is hard to see how a 25 bp increase in the world's shortest interest rate should tank the economy or the financial markets. It is almost certain that the funds hike will be gift wrapped in the most dovish language possible. The next increase might wait until June, and perhaps later. I think there is very little risk that the rate will be raised too quickly.

In the meantime, forward earnings are dropping precipitously. The S&P now puts 2015 earnings at $106.44 and that is before factoring in some of the horrible misses emanating from the retail sector. At an S&P of 2038 currently, that puts stocks at 19.15 times this year's earnings and 21.44 times GAAP reported earnings. Earnings are 6% to 7% below 2014. It is sobering to note that last year at this time, 2015 earnings were forecast at $131.00! Oil and the dollar are the major reason for the decline, but I don't believe Macy's and Nordstrom can blame these factors. Next year looks much brighter, but 2015 looked just as bright this time last year. Earnings fears are certainly going to weigh on the markets in coming weeks.

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