Weekly Commentary October 21, 2016

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Rising Dollar Pressures Stocks; Former FOMC Member's Take on Economy

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Risk markets are worried about a December rate increase. The immediate manifestation is the strength of the US dollar, which has risen about 4% against developed economies currencies in the last 30 days to the highest level since last January. The Chinese RMB is has depreciated 1.5% since September and is now nearing a 6-year low, just a hair's breadth below the 6.83 that the Chinese government pegged the yuan at for nearly 2 years during the financial crises before letting it appreciate another 12% in the next 3 years. The US dollar also appreciated in October and November of last year in the lead up to the last rate hike. Traders remember the crater that commodities fell into following the Fed action and there is some anxiety that the same scenario will repeat itself.

But that is unlikely. Oil and other commodities were already in massive bear markets before the January swoon and last year fears of a Chinese economic crash were rife. Commodity prices have put in a firm bottom last February, fears of Chinese collapse have faded and the US and European economies are on stronger ground. Nonetheless, until both the election and the rate hike the following month are in the rear view mirror, it may be hard for the equity market to make convincing headway.

Earlier this afternoon I had the opportunity to interview Narayana Kocherlakota, now a professor of economics at University of Rochester. For six years ending last December he was the president of the Federal Reserve Bank of Minneapolis and an active FOMC member. Before he left the Fed he had advocated a much more aggressive response to the Great Recession and was the leading proponents of setting negative funds and deposit rates. Our discussion ranged over many topics: He agreed that the "neutral" funds rate is now much lower than it had been, probably between 2.50% and 3%. Although this is lower than the consensus on the Fed, it is far above President James Bullard's rate of below 1%. If he were on the Fed, he would not raise in December. He said that he found that Chairman Janet Yellen's speech in Boston earlier this week suggesting that the economy may have to "run hot" for a while to jolt productivity back to former levels intriguing. He is not a productivity pessimist and does belief that we will return to historical levels in not too many years. I mentioned excess regulation and poor educational achievement as other reasons for the productivity slowdown. He conceded the latter but did not think Dodd-Frank, in general, went too far to shutting down our banks. I did find today's page 1 story in the *WSJ* in which Minouche Shafik, deputy governor of the Bank of England, estimated that the $275 billion in legal costs for global banks since 2008 translates into more than $5 trillion of reduced lending capacity. I am sure excessive government regulation is part of the story explaining very slow worldwide productivity growth.

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