Boenning Morning Comment

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For a week with so much news, it has been a relatively quiet week in the stock market. Stocks gave ground yesterday despite strong earnings from Dow components 3M and Caterpillar. Concern continues about Greece, at least until there is a settlement regarding the size of the haircut Greek debt holders will accept. The drama could play out for next two months until a March 20 deadline. But in the end all sides would lose in the absence of compromise so it would seem logical that an agreement is inevitable before the midnight deadline.

This week world economic leaders are in Davos Switzerland. They all mouth the right words showing fiscal conservatism and a sense of urgency. Similarly, President Obama, in his State of the Union Address, touched all the hot buttons including tax reform, deficit reduction, employment growth and mortgage remediation. But recognizing problems and solving them are two different things. Two facts can be said about most of the solutions. First, they can't be achieved overnight. In some cases, even under the best of circumstances, the solution will take years. Second, almost every solution involves a degree of pain to some sector of the economy. In many cases, a solution that will benefit many offers unintended consequences. For instance, low interest rates helps to support housing, keeps down the cost of doing business, and incentivizes consumers to borrow and spend. But it also robs savers of income pushing them to spend when they don't want to or to take greater risks to support their income needs. Federal Reserve efforts to not only reduce short term interest rates to zero but to push long term rates as low as possible makes banks earn less money and more reticent to lend to borrowers who might otherwise qualify for credit.

It is simple to say that over the past year, despite all the focus on excessive debt, especially at the sovereign level, very little has actually been accomplished. Yes, nations like Spain, Italy and Greece have gotten more disciplined but debt levels are still rising. Austerity measures designed to control the expansion of debt have led to recession. In the short run, recessions actually serve to increase debt levels, not cut them. In the U.S. we have a painful debate over the debt ceiling and created deficit reduction commissions. Only in government does deficit reduction mean slowing the rate of debt increases, not actual declines in the level of borrowing. All sides agree that in order to actually reduce debt and more in the direction of a balanced budget, Congress has to tackle entitlement reform and cut spending as a percentage of GDP. But hardly anyone actually is willing to discuss details. This year, the reticence is blamed on the election; next year there will be a different excuse. Big painful problems are hard to solve. A crisis is usually the motivator. Right now in the U.S. there isn't a crisis and, therefore, there isn't a meaningful effort to find a solution.

But being an election year, both sides need to posture. They need to identify the problems first. All sides can agree on what they are. I listed them above and the President stated them Tuesday evening. Where they differ, obviously, is in the theoretical solution. I use the word theoretical because both sides mouth the words their constituents want to hear but until the aforementioned crisis appears, don't expect to see a solution other than modest window dressing.

Everyone talks of tax reform. Specifically, all seem to agree that the stated corporate tax rate of 35% is too high and makes the U.S. anticompetitive. All sides would like to broaden the individual tax base, lower rates and eliminate loopholes. But the devil is in the details and often the details lead us in a completely opposite direction. Everyone talks of tax simplification but hark back to the President's speech Tuesday night. He wants to increase tax incentives to move manufacturing back to the U.S. He wants to tax overseas earnings directly, not wait to tax income at the

time of repatriation, if that ever occurs. On the individual level, he wants to tax "millionaires" (I put that word in quotes because sometimes in Obama-speak a millionaire starts as low as $200,000) more, and tax the middle class less while, at the same time, reducing the number of Americans who pay any tax at all. He wants to expand credits for clean energy production and use. In other words, one side of the mouth utters the phrase tax simplification while the other side produces a broad list of additional incentives and disincentives using the tax code. I picked on Obama only because he brought up the issue this week. Republicans are just as bad in the ways their abuse the tax code.

Yet for all these unsolved problems, our economy moves ahead. Why? It really isn't that complicated. After the recession hit us all, we adjusted. While it takes the government years to move even the slightest bit, individually we move rather quickly. When it was clear that we had no more home equity to borrow against and our credit cards were maxed out, it hit us all collectively that we could no longer spend beyond our needs. So we adjusted. We took less expensive vacations. We traded down from Bloomingdale's to Macy's; from Macy's to Wal-Mart; and from Wal-Mart to Dollar Tree. We clipped coupons and went to Costco. We stopped eating out as much and when we did we traded down. We took less expensive vacations and kept our car for an additional year or two. It hurt at first but life went on. Some of us lost our homes but not many. Some of us lost our jobs, but if we persevered most found alternatives. Some of those alternatives paid less but at least we kept on our feet.

Over the past three years, after we got our lives back in balance, we found that we could relax a bit. We finally traded in the old clunker for a new car. New car sales now are about 30% higher than they were at the bottom but still 20% below the old peak. We have begun to travel again. Hotel occupancy is up and airplanes are full. We bought a flat screen TV and an iPhone. We freshened up our wardrobe.

State and local governments are doing the same thing but they are a couple years behind. They woke up and found out finally that they had to adjust. The big cuts came over the past two years. But now, revenues are starting to rise again. They aren't exactly ready to rehire but most of the cuts are now behind us.

At some point the Federal government will get the message as well.

But back to the overall economy. The consumer is 60-70% and he is spending more, not a lot more; just some. Growth is only about 3%, in line with population growth plus some productivity gains. Profits are near record levels and companies are starting to invest that money here at home to accommodate the modest but steady advances in demand. We are now adding 150,000-200,000 jobs per month. That is 2-3 million new jobs on a base of about 135 million. 2% isn't great but all those new workers have money coming in and money going out. That's good. Technology creates growth opportunities. iPhones, tablets, and cloud computing all need software to be productive. Throw in Facebook, Twitter and interactive television and there is a sea of burgeoning opportunity. The Chinese may be able to make the hardware but they don't understand our culture and can't do the software.

While the media wallows in a sea of depression (they sell more papers if we are all depressed), and government officials do double-talk as they avoid the difficult issues, we go on with our lives. The stock market seems always to reflect reality. Spin doesn't work in the marketplace. Stocks reflect earnings and earnings prospects. Right now they point higher. Yes, Europe is an issue but even if profits in Europe flatten or fall modestly, the U.S. is improving and emerging markets are starting to emerge once again. If you haven't been watching, there have been solid sustained rallies in China and Brazil. Even in Europe, the picture is brighter. Italian short term debt sales today went very well and, at least for the moment, 10-year Italian bond yields are below 6% rather than above 7%. 6% isn't a very good sustainable rate but for now demand seems to be adequate to permit refinancings to continue.

I noted on Wednesday that February is coming soon and in the absence of a lot of news traders often dwell on the negatives in the mid-month of every quarter. But if rates in Europe show any stability and economic activity doesn't fall off a cliff, maybe this time around, markets can behave reasonably well. A modestly volatile sideways month would be a victory. It's worth hoping for.

Today, reports that Q4 GDP were a bit below 3% was a bit disappointing. But that's history. We are seeing earnings reports daily to suggest life in Q4 was just fine. So far the big drags have been currency translation which most investors rightfully ignore and higher commodity costs which appear to be moderating. Next week we will get a lot of data and most of it should be fairly good. By all indications the auto market is holding up well, manufacturing is improving and there is no reason to expect Friday's employment report to be out of line with recent numbers. Housing remains the primary weak spot. The good news is that it doesn't appear to be getting any worse; multi-family construction is actually rising at a healthy pace.

We have gotten conditioned in recent years to wait for the other shoe to drop. Maybe this time will be different. I don't know. But if we do cross a speed bump, I don't see why it should be a severe one. The Greek problem is going to be solved along the lines of expectations. Italian and Spanish bond yields may rise at times of peak refunding but the ECB knows when those periods are and is ready to step in and help. Meanwhile, the U.S. economy keeps plodding along. These aren't boom times, but they certainly aren't bad times either. With bonds still yielding only 2% or so, stocks look like the place to be and U.S. companies seem better situated than their European or Japanese counterparts. That would appear to be a nice backdrop for U.S. equity investors. While investor sentiment has improved, large institutions are still overweighted in bonds and underweighted in stocks.

Futures this morning point to a modestly lower open.

Today Bridget Fonda is 48. Mikhail Baryshnikov is 64.

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