# Boenning Morning Comment

*This report is prepared for us by Tower Bridge Advisors* February 8, 2010

Stocks finished with a small gain on Friday but that fails to tell the tale of the tape. For much of the session stocks moved sharply lower continuing the decline of the past few weeks. But suddenly within the last two hours of trading there was a sharp reversal. There was no news and no trigger. Market watchers might suggest valuation. Some might suggest short covering.

I have a different explanation/thought. **I think for the first time in almost a year, the market over the past week or so has been hijacked by the large black box quant traders and hedge funds**. Two separate factors were at work. Over the past several months, one of the most popular trades has been what the Street refers to as the reflation trade. That is or was a bet that massive monetary easing was going to lead to a demonstrable increase in inflation or, at the very least, inflationary expectations. If one believes that theory, and the vast majority of traders did, there were a lot of directional bets to be made. One bet was to buy commodities or stocks of companies tied to commodities. That included most energy and basis material stocks. It also favored owning gold. Finally, with our deficit rising, it also meant a bet against the dollar. For a while, especially late in 2009, that trade worked beautifully. Moreover, with the low interest rates in the U.S., one could leverage that trade borrowing in dollars and investing in commodity assets overseas.

But in January, that trade stopped working. Commodity prices stopped going up. Oil couldn't stay above $80 per barrel. Gold started to fall. Worse, economic problems in Europe and Japan suddenly made the dollar look like the financial Rock of Gibraltar. That set off a mad scramble. Suddenly everyone had to reverse their bets. Many sold other liquid assets to cover losses. As this occurred, it sparked an increase in volatility and that, in turn, sent black box computer models into overdrive. They feed off of volatility. The volatility we have seen over the past few weeks, while a bit disconcerting especially in light of what we went through in 2008, was nowhere near 2008 levels but it was enough to set off a spate of sell programs further exacerbating the move lower.

All this is a bit of a hypothesis that I can't prove definitively but there is a lot of evidence in my favor. Floor traders can see from volume surges when computer programs kick in and they kicked in actively last week. Parenthetically, Friday afternoon's buying came after technical support levels held. Also being Friday afternoon, traders covered shorts not wanting to be long going into a weekend where the unforeseen (e.g. a sudden rescue of Greece) would create even more havoc for traders.

The other factor that supports my thesis is that everything last week was moving in unison. While it is common for commodity prices (including gold) to move in unison, it is not common for all asset classes to drop at the same time. All the selling at once suggests that whatever trade the momentum players were making wasn't working and they were all shifting directions at once. Any investor with a fundamental bent simply had to stand back, watch and wait for the storm to end. Perhaps it ended on Friday. We'll see. But the good news is that these sorts of events create values.

It is likely that annualized S&P 500 earnings during the fourth quarter ended pretty close to $70 and that included very anemic earnings from the financial sector. On Friday, the market was trading at only 14 times trailing earnings.

S&P 500 estimates for 2010 are around $77 and could trend slightly higher. Indeed, the fundamental data we got last week was generally quite positive. That includes Friday's employment report. The unemployment rate fell to 9.7% surprising everyone. While that may get adjusted back upward a bit, we do seem to be at an inflection point. While the employer survey still showed a drop of 20,000 jobs, note that includes a 70,000 drop in construction jobs. This year was a cold snowy January. Last year was rather mild. My guess is that without weather factored in, there might have been some improvement in January.

**Whether Friday midday constituted an end to this correction or it has a little ways to go, valuation suggests that this is a much better time to be buying stocks than selling them**. It is fine for analysts and commentators to fuss about the budget and deficits but those really aren't 2010 concerns. The concern right now is the economy and jobs. Obviously, everyone wants to see solid job growth and, equally obvious, the path from losing over 8 million jobs to creating millions of new jobs has to pass through zero, the point we are at right now. It's a bit like that period of silence that a space craft returning to Earth goes through as it reenters the atmosphere. You have every reason to expect that things are OK, but apprehension rises until communication is restored. In Friday's employment survey, the average work week rose, the average pay per hour rose, and the number of temporary jobs spiked, all signs of good news to come. Anecdotally, companies talk of expansion and growth. Almost none suggest more layoffs. The few exceptions center on large mergers (e.g. the drug industry). As for the worries du jour, the debt problems of Greece and others, these are the aftermath of financial mismanagement last cycle, not the seeds of the next economic downturn. A few countries have pushed to expansion button a bit too hard and will pay the price. That may be Greece and Dubai today, but it has happened many times in the past. It happened in Latin America countless times. It happened in Eastern Europe not long after the fall of Communism. It happened in Southeast Asia in the late 1990s. And it will happen again. Fiscal discipline will become a continuing focus in the years ahead but it isn't likely to create a financial meltdown in 2010 or even 2011.

No, as I noted, the biggest factor overwhelming all financial markets today is a realignment of momentum driven portfolios. That process may well be closer to an end than a beginning. Whenever it is done, markets should calm down and values will become more evident.

Futures point to a flat opening.

Today actor Seth Green (a Philly native) is 36. Gary Coleman is 42. Ted Koppel turns 70. Conductor John Williams is 78. And Drew Brees is headed for Disney World.

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