Boenning Morning Comment

This report is prepared for us by Tower Bridge Advisors May 12, 2010

Stocks finished modestly lower yesterday in a choppy session. Volume was moderately active. The action resembled a coiled spring unwinding after days of violent motion, a catharsis that is probably necessary in the aftermath of all we have been through over the last week and a half. It will be a pretty active week for earnings and maybe the reports to come will divert attention from all the noise we have been listening to of late. Lest we forget, earnings have been pretty darn good of late. With that said, Disney (DIS-$36), a Dow component, sold off last night after reporting.

As stocks seem to have begun the process of settling down from last week's sharp selloff, I thought I would try this morning to dispel what I believe are a bunch of myths, or maybe more politely said, consensus beliefs that the market holds to be true.

Myth: Insurance company greed is the primary cause of spiraling health care costs.
Reality: If you look at historic profit margins of the health insurance industry, they are less today than they were in the middle of the past decade. If all insurers were non-profits, i.e. I could wipe away insurance profits and convert them to health care cost savings, I could probably cut U.S. health care spending by roughly 10%, less if you presume that insurance company fraud is smaller than Medicare fraud. There are lots of contributing factors to the spiraling health care costs including insurance profits, legal costs and bureaucracy. But probably the two biggest factors are that we still have a cost-plus system rather than an outcomes system for payments, and the consumer rarely has the opportunity to make an economic decision relative to his or her choice of health care.

Myth: Wall Street greed was the ultimate cause of the recession.
Reality: Wall Street greed may have stoked the embers and taken advantage of the economic pain to its collective advantage but the root cause of the recession was excessive leverage employed by everyone from government down to each of us individually, and an excessive period of easy monetary policy that stimulated bad lending. The secondary cause was an almost complete lack of regulatory enforcement. Since most of the real sins fall in some fashion at the feet of government and government can never accept blame for anything, an unremorseful Wall Street became the easy scapegoat.

Myth: Hedge funds, quant funds, high frequency traders and investment banking firms have added liquidity to and reduced the cost of investing.
Reality: There is no question that all the above entities have added volume. Lots of volume. But there is no statistic to demonstrate that liquidity today is any better than it was 10 years ago or, for that matter, 50 years ago. Look at a 10-year trend line for the VIX. It is almost perfectly horizontal. A definition of liquidity is the ability to convert an asset to cash quickly without price impairment. While transaction costs have fallen from nickels to pennies, thus reinforcing the myth on the surface, the real fallacy of this myth is the implication that liquidity relates either to trading speed or volume. In fact, liquidity is dependent on market breadth and balance. When the number of participants goes from thousands to dozens, you run the risk the market went through last week when a relatively few participants either decide not to trade or too many are on the same side of the trade.

It may be helpful to discover days or weeks later the course of events that might have led to a market that moved the price for certain stocks to near zero while others went into the thousands of dollars per share. But the events themselves aren't what are important. What is important is that for some period of time, a small number of very big fast sellers, maybe as few as one, represented in the market by computers, took the market hostage. There were literally no buyers big enough to serve as counterparty to the seller and no sellers to serve as counterparty to the aggressive buyer. You can attach whatever label you want to what transpired but it isn't liquidity.

Myth: If the aftermath of last week's trading is the imposition of restrictions on fast trading, proprietary trading or swap desks, the cost to trade will go up.
Reality: While the profit opportunity for some may be reduced depending on the restrictions, there is no way trading costs are going to increase. Competition won't allow it.

Myth: If the Fed raises interest rates, it would be detrimental to economic growth
Reality: Restoring rates to normal levels is different than raising rates to the point where the cost of capital would restrict new investment. Right now for many businesses the cost of capital is less than the rate of inflation. In real terms, money is free. Raising rates to or even slightly above the inflation rate won't crimp capital spending. Americans have almost $10 billion invested in CDs, money market funds, etc. tied to short term rates and less than $3 trillion in non-mortgage consumer debt tied to changes in short term rates. Rising short term rates therefore may actually increase consumer income. The losers would be banks who have enjoyed a super steep yield curve since quantitative easing began and government which will experience rising costs of Treasury financing. Indeed, you can come to the conclusion that American consumers have been financing the need to restore the health of banks by accepting (unwillingly) lower rates on money market funds, CDs and bank deposits. Returning to normal is always positive, in my view, but that doesn't mean Wall Street won't have a tremor as the Fed begins the process of raising rates. Raising rates to stifle inflation is quite different and is usually adverse to equity investors.

Myth: A strong dollar is bad because it reduces exports and causes multi-national companies to take currency adjustment losses.
Reality: Both of the above are true but financial asset prices are a reflection of the supply and demand of capital. Money always flows in the direction of stronger currencies. Thus, a strong dollar attracts capital. Capital inflows raise the value of monetary assets which, in turn, mean higher prices for stocks and bonds. Don't buy that? Go back to the 1990s and look how stocks did when the dollar was strong. Then move forward to the present decade and look how they did when the dollar was weak. I would also note that P/E ratios rose in the 1990s and fell persistently this decade.

Myth: Housing is an early cycle play that never came alive this cycle.
Reality: Because of a large overhang of empty homes and foreclosures, housing did not act normally this cycle. But we believe that overhang will be worked off within the next year and housing activity can return to normal levels over the next 12 months. That suggests a substantial increase in new construction activity just as Federal stimulus is abating, a nice a fortuitous event if it plays out that way.

Conclusion: Promoters use half-truths and fractured fairly tales to make a sale. That applies to politicians and to Wall Street as well. Here's the reality as I see it:

1. Financial reform is needed. Clearly, no one wants to revisit 2008 and no one wants to repeat last Thursday. If the reform doesn't offer all investors a reasonable and safe playing field, it will be to the detriment of all. We know one truth. The system in place for the last three years doesn't work right.

2. The U.S. economy is on solid ground. The near term threat of a European sovereign solvency has been averted even though we recognize that the problems haven't been solved. Nonetheless, we see no major obstacles to growth through 2011.
3. As we leave the early part of an economic cycle and enter mid-course, old problems will continue to recede but new ones will start to emerge. The European debt crisis may be first but others will follow. Higher interest rates are inevitable. Inflation fears almost always rise as an economy strengthens. Taxes are going to rise next year by a record amount. The path of least resistance for equities is still up but the rate of increase is likely to slow and the road will get bumpier over time.

Today Steve Winwood is 62. Yogi Berra is 85, one of my true heroes growing up.

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