Boenning Morning Comment

This report is prepared for us by Tower Bridge Advisors May 14, 2010

Stocks fell sharply yesterday with all the action taking place in the final hour. There was no real fundamental cause for the decline. Stocks failed in several attempts to move higher and program traders swooped in around 3 PM with sell orders that swamped the market into the close. The euro lost ground once again. Traders fretted verbally about the sovereign debt crisis but bond market action was fairly docile. Volume was moderate.

Various reports now suggest that some combination of the Justice Department and the New York Attorney General's office is investigating virtually all the major investment bankers seeking to determine whether they withheld material information as they sold mortgage derivative products. Although none of the actions of the bankers passes anyone's smell test, finding that they committed any pervasive fraud is likely to prove very difficult. Anyone who reads prospectuses and offering documents know that they contain many pages of legalese that warn of an overwhelming number of adverse possibilities including the likelihood that the selling broker is on the other side of the trade. If government agencies now find that the rule book needs to be rewritten, it should do so. In fact, for the sake of everyone including the investment bankers, it is imperative that new rules promoting fairness and transparency be written. But a revisionist reading of history suggesting that past actions violate tomorrow's laws is a waste of time. New York's Attorney General is going to run for Governor. Looking for wrongdoing among the investment bankers may be popular as a populist strategy, but an indictment that would cost tens of thousands of jobs in New York itself carries such a high burden that such action is probably highly unlikely. Just another example of 15 minutes of righteous indignation based on the facts reported so far.

Yesterday was the fifth session of the last six that the Dow has moved by more than 100 points. Volatility is back in a big way. But with all the volume, the market doesn't seem to have found a direction. The volatility seems to indicate the following:

1. Lack of conviction that the actions by the EU over the weekend were much more than a band aid. The problems were buried and the can was kicked down the road. That may be true, but a real solution isn't going to happen overnight. Portugal and Spain are beginning to take fiscally responsible steps; only time will tell if they are the beginning of what is needed. Great Britain has changed Prime Ministers and that promises to usher in an era of fiscal caution. Both are good signs although neither can solve the problems overnight. Nothing can.
2. Stocks don't appear to be cheap any longer. After a largely unbroken 14-month rally, stocks probably need a rest. I have often pointed out that the middle month of a quarter provides the least amount of economic information. Combine worry and the lack of data, and you have the perfect formula for volatility.
3. Market breadth and liquidity are much thinner than most presume. Since the bull market began, the public has been noticeably absent. That is apparent from both mutual fund flows and daily volume. As institutional traders become more fearful and active, they only have themselves to trade with. Only a few dozen entities account for half of all trading. When they lean even slightly in one direction, you get some fairly big moves in prices. The stock market isn't alone. Volatility is probably centered today in currency markets demonstrating itself mostly through a weak euro. But currency movements spark movement in other markets. Gold goes up. Other commodity prices come down, at least in dollars. Money flows away from the euro into the U.S.

Treasury market pushing yields down decisively. Worries in China set off a different chain reaction. Eventually it spreads out to stocks.

4. Synthetic derivatives and credit default swaps effectively allow unlimited betting on both the long and short side of the market. In a normal short sale, the seller is required to physically borrow a security to make delivery. You cannot short what you cannot deliver. But synthetic derivatives and credit default swaps are essentially side bets. As long as you can find someone to take the other side, you can bet as much as you want. That is why the nominal size of the credit default marketplace is so huge. A good part is used for hedging, particularly in the currency markets. But a lot is simply hedge funds and others making straight up bets. Unlike a football game where the side bets don't affect play of the game itself, the price of credit default swaps directly impact the value of the related assets. For example, the price of Greek debt credit default swaps forced the interest rates of Greek debt dramatically higher.
5. Washington uncertainty, at the moment centered on financial reform, contributes to the level of uncertainty although I don't really want to overplay this. With that said, politicians are very good at reading public sentiment. In the end, that is how they must survive. Public rage over the apparent unfairness in financial markets is high and, if anything, increasing. That is going to provide cover for Congress to write a fairly tough financial reform package. At the same time, in a rush to judgment, Congress needs to try and be as careful as it can not to write legislation filled with unintended consequences. That rightfully slows down the process. In the end, the bill isn't likely to be perfect and the layers of bureaucracy are likely to be uncomfortably large. But clearly the alternative of doing nothing is unacceptable.

So what gets us out of this volatile mess we suddenly find ourselves in? Time and data. The core underlying truth is that the U.S. economy is doing just fine. Last Friday's employment report was completely ignored as everyone focused on Europe. But we are now creating a healthy number of jobs once again. Growth is also occurring overseas. Ultimately this growth will drive asset values higher. However, although there are only a modest number of earnings reports coming now, they are beginning to show that expectations and reality are getting closer together. Cisco (CSCO-$26#*) beat estimates the other night by two cents a share. Last quarter it beat by a nickel. Others only matched optimistic forecasts. Thus, the pattern of whereby companies reported earnings that crushed estimates forcing analysts to raise future forecasts significantly may be coming to an end. That suggests that stocks may begin to advance in a slower bumpier fashion. The current sideways or slightly negative pattern with enhanced volatility probably is part of that adjustment.

A couple of final points. The front page of The Wall Street Journal this morning highlights efforts by House leadership to rein in travel perks as if it has suddenly decided on the eve of elections to take the high road. Heck, it is just doing what businesses started to do years ago. No kudos for Congress. P.S. the Senate plans no such action. After all, only a third of the Senate is up for reelection.

Finally, as expected, the Republican leadership is quick to attack the Supreme Court nomination of Elena Kagen. As partisanship continues to grow, this is hardly a surprise. President Obama could have nominated a Robert Bork clone and started with 30 no votes. But in the interest of fairness, it would seem to make some sense for Ms. Kagen to speak at hearings first before expressing outrage. This is a battle Republicans aren't likely to win anyway unless something really untoward is discovered and seating Ms. Kagen isn't likely to shift the Court's balance. It would seem that in a Congress with more than a full plate of agenda items, there are better fights to pick. Like taxes.

Today Cate Blanchett is 41. George Lucas is 66.

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