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Boenning Morning Comment

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Stocks fell sharply again on Friday although a modest late afternoon rally enabled them to finish off the lows of the session. For months a 100 point shift in the Dow daily was a relative rarity but suddenly over the past three weeks it has become the norm. But for all the volatility, stocks remain squarely in the middle of their 2010 trading range torn between the positives of an improving economy and the negative impact of the European sovereign debt crisis.

On Saturday the headline in The Wall Street Journal was "Europe Clouds Recovery". The headline was modestly negative but the article itself was downright dour. Not only did the story highlight the obvious such as "new jitters about Europe's debt troubles", but it went on to suggest the improving economy since last summer may be running out of steam, that the European debt crisis would undermine confidence in the global financial system, that the debt crisis might spread to other nations including the U.K. and the U.S., that U.S. exports are like to fall, and even that the U.S. consumer would be suffering except for the fact that he is diverting mortgage payments to other forms of consumer spending. If there is a dark cloud anywhere in the sky, this article found it and described its potential to create ultimate damage in detail.

It reminds me of the Dow/Wall Street Journal news story in March 2009 questioning whether the Dow Jones Industrial Average might be headed for 4000 or not (it never even touched 6000).

My point in picking on this article is to describe the sudden shift in investor mood and sentiment. Less than a month ago as earnings season began, everyone seemed optimistic that we were on solid footing and engaged in an economic recovery that could last for years. Greece had crept into the headlines and we were all aware that at some point fiscal stimulus would disappear and higher interest rates would ensue. But earnings were so powerful and consumers were beginning to participate in the recovery that the skies were virtually cloud free.

Contrast that to today when fear is rampant, Washington is taking dead aim at Wall Street using threats of criminal indictments to dismantle our financial structure as we know it, epileptic seizures send stocks down 1000 points in a matter of minutes, oil is washing up on Gulf coast beaches, and taxes threaten to go through the roof.

But let's all take a real deep breath, stand back and let the emotions die down for a moment. Let's look at the actual realities and how they might change based on the news of the past fortnight or so.

Let us start in Europe which appears to be the epicenter of the current storm. Greece is a mess. It was a mess, it is a mess and it is likely to remain a mess for some time to come. This isn't all that new. Greek civilization peaked about 2500 years ago and hasn't been very important for the past two millennia. Today, when we think of Greece, we think of cruising the Mediterranean. I can't think of one significant product I own that is Greek. If Greece disappeared, I doubt it would make a difference to my economic life. Indeed, I doubt it would make much difference to the economic lives of almost anyone outside of Greece. Yes, there are banks in Europe that own some Greek debt but the recent Eurozone bailout package probably means those bonds won't default for another year or two at a minimum.

But Greece isn't the only country with sovereign debt issues; it is just the worst example. Portugal, Ireland, Spain and Italy all are of concern. The headlines talk of contagion and the domino theory. As long as I have been on this planet I have heard about contagion and domino theories. We fought a horrible war in Vietnam because of another domino theory. There theories rarely become reality. Sure, Portugal, Spain and Ireland are having to pay a bit more to borrow as well they should. But we aren't talking about anything dire yet and all these countries are reacting as they should. None is likely to be a AAA credit by Christmas but all know they have to get more responsible fiscally. One of the comments in Saturday's Journal article said, "If investors decide that countries with big budget deficits are a bad place to put there money, that's a problem, because half of the world economy has big budget deficits". Think about that quote for a moment. Borrowing is a zero sum game. For every borrower, there is a lender. Obviously, there comes a point were lenders don't have any more money to lend forcing the price of credit up. But that isn't happening today. Yes, the cost of credit for some is rising but the cost of credit for others (e.g. the United States) is falling. To some extent, the financial imbalances creating the need for lending and borrowing coincide with trade imbalances. The U.S. is a big borrower but because we have a huge balance of payments deficit, there are gobs of dollars sloshing around the world looking for a home. I am not promoting imbalances; they aren't the way to go. But I am suggesting that the two have to be looked at in tandem. Central banks around the world have created lots of monetary liquidity during the recent recession but because monetary velocity has slowed so much there isn't inflation today. In the place of inflation is lots of savings.

Said differently, as sovereign nations have financed their economic recoveries by reflating, the excess cash has found a home in sovereign debt. Moreover, many of the nations with the best balance sheets, places where you might think investors would seek out as safe haves, are countries with major governance issues. Numerically, the balance sheets of China, Saudi Arabia, Brazil and India look better than the United States, Germany or Japan. But how many investors would consider the former group a safe place to invest cash? Not many.

Where does that leave us? Clearly, markets are suggesting that world investors still want to put money into safe places in the United States, Germany and Japan despite rising deficits and debt ratios. But it is clear that demand isn't infinite and major worldwide borrowers need to be conscious of that fact. Many bears make the point that the U.S. is on a path to a $20 trillion national debt before long presuming nothing changes. That is probably a big and inaccurate assumption, and it is one that isn't going to play out for a number of years. What is more likely is the following. Sovereign debt crises happen often and they tend to peak post-recession. That is exactly how the picture is playing out today. There is an overlay of the EU, whether it will survive as one or whether Germany will ultimately quit and go off on its own again. It's way too early to conclude anything and it probably doesn't matter nearly as much as the bears think. If Germany departs the EU down the road, the countries along Europe's southern tier will have to restructure credit and probably some will face recession. Central banks of other nations may have to backstop commercial banks that carry too much debt of the weaker nations. We have seen that game play out before. Meanwhile, our economy will keep right on going. Yes, a few tenths of a percent will be nicked off of GDP growth. Multi-national companies will suffer earnings hits from currency translation losses. But, on the other hand, capital will flow into U.S. markets and U.S. borrowing costs will remain low as will the cost of commodities.

In summary, the pendulum in just a few short weeks has swung way too far from excessive optimism to almost extreme pessimism. Our economy remains on course for a solid recovery. Employment is starting to grow again. Even housing shows signs of bottoming. In the end, earnings and interest rates matter most. Earnings are solid and interest rates are down. That is a nice combination. It won't be long before investors rediscover that fact.

Futures point to a flattish open today. Don't expect recent volatility to go away overnight. But unless a new problem erupts, it shouldn't accelerate from here.

Today Dennis Hopper is 74.   Born to be wild.

James M. Meyer, CFA 610-260-2220

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