Boenning Morning Comment

This report is prepared for us by Tower Bridge Advisors June 18, 2010

Stocks reversed course in the last half hour yesterday turning a sour session into a small gain. While technicians may like the way the market behaved, the economic data out this week were not very encouraging. Housing is a mess, retail sales are punk and no one is hiring. That doesn't mean we face a double dip or anything like that, but it does mean that this economy is moving forward more slowly that previously expected. Without top line grow (inflation is now negative), it is harder to make money and grow.

When our economy was in the depths of the recession and financial markets were on the brink of collapse, the government moved boldly to stop the hemorrhaging as it should have done. In early 2009 Congress passed a stimulus package that served to prop up spending until the economy could catch up. But unlike other stimulus packages born in the depths of recession, this one did very little to stimulate spending or employment growth. The biggest chunk of money went in the form of grants to states to close budget deficits and to support enhanced unemployment claims. This provided the unemployed with spending money and states an out to keep more workers on the payroll. But as that stimulus starts to run out, states are being forced to cut and the unemployed have to look to other sources for cash flow. In a year when the President got on the bully pulpit many times blasting auto companies, banks, brokers, insurance companies and now oil companies for all sorts of evils, very few incentives have been put forth to entice businesses to expand. To save money, drug companies have merged and cut spending including research and development. Oil companies are preparing to move resources offshore with a 6 month drilling moratorium likely to extend much longer. Companies are loathe to hire new full time workers because of sharply escalating health insurance costs. New regulations being promulgated are intended to sharply limit the number of current health plans that will be grandfathered. Companies are almost certain to react by using many more part-time workers and paying $2,000 per employee fines in lieu of paying for uncontrollable increased health care benefits. The net impact is that many Americans are going to be forced to use after tax dollars to buy health care on Federally created exchanges instead of using pre-tax dollars to buy subsidized health care through work. Add in the tax increases coming in 2011 and it isn't a recipe for robust growth.

One of my great mystery questions of life is who gains from a Congressional circus like we saw yesterday when a villainous CEO (or CEOs) comes up to the Hill to get pummeled and berated for hours on end. Do any members of Congress feel they are going to get more voter support for asking some tortured CEO nine ways to Sunday whether he beats his wife? Obviously BP looks bad after yesterday but does it look any worse yesterday than it did the day before? Did we learn anything from a CEO told by lawyers to spend all day acting ignorant? Do we think Congress is out in front of the problem? Is the well going to get capped any day sooner? Am I the only one who thinks they all look like idiots? But this perp walk won't be the last. In this Congress it has become a way of life.

What is ironic about this administration is that it so often threatens the death penalty and then backs away. Remember the threat to AIG that it would tax bonuses at 90%? That died almost immediately. The Justice Department started a criminal investigation of Goldman Sachs even as many insiders wonder whether the Abacus civil case has any legal merit. Attorney General Holder wants to investigate BP criminally yet we don't yet know exactly what caused the explosion. For all the mistakes BP apparently made, it remains unknown why the blowout preventer didn't work.

But these threats usually die. I see the SEC has stopped its investigation of AIG personnel regarding the creation and selling of credit default swaps. I doubt anyone is going to criminally indict Goldman Sachs unless a pervasive trail of criminal intent can be discovered. No one is going to put Tony Hayward in jail because of the Horizon rig explosion. Onerous features inserted into legislation later quietly get removed. It is a bit like a parent who threatens all kinds of punishment to the recalcitrant child only to back off once push comes to shove. The end result, of course, is that the child ends up confused not knowing what to expect in the future and that is probably what will happen in our real world as well. While know one yet knows the final rules, forthcoming changes are likely to be more burdensome than obstructionist when all is said and done. That is not to say that there won't be changes and that there won't be damage. I believe the new health insurance reform is going to be hugely expensive and will have to be modified along the way. Financial reform will take small steps in the right direction but loopholes will allow banks to do most of what they do now. Technology is likely to stay ahead of regulation. The SEC on Wednesday had to implement its new circuit breaker rules for the first time when Washington Post's stock doubled in minutes, probably a result of a rogue trade. Did the circuit breaker work? I would argue no. It didn't stop the sharp spike in the stock even if it might have prevented it by being even worse.

There are times when a child must be punished or else bad behavior is reinforced. At some point things broken must be fixed. Aspirin relieves symptoms but is not therapeutic. But this administration and most that preceded it have been unwilling to get to the core of the problems we face and Congress has proven meeker than the White House. That means we need another crisis to force action. That crisis is going to have economic roots. At some point our debt will swell to unsustainable levels or the budget deficit will get out of control. That is the bad news.

The good news is that the fixes are remarkably simple if they are done at a time when the economy is not in crisis. ***So in good public spirit, I offer five steps to fix our problems:***

1. **Return interest rates to normal levels.** Price fixing never works and artificially low interest rates are simply another form of price fixing. It doesn't work because it creates distortion and unintended consequences. The intended consequences of low rates are to encourage low-cost borrowing. But the reality today is that low rates create an unusually steep yield curve at a time when Americans want to get rid of debt. So savers lose hundreds of billions of dollars of spendable income, banks are encouraged to invest rather than lend, and Washington saves billions in interest costs.
2. **Means test Social Security benefits and delay the start of Social Security benefits to age 70.** It was never intended for Americans to live 20 years in retirement and receive financial support for all those years. Without changes, by the end of this decade there will be one person working for every person receiving Social Security. It can't work that way. The sooner it is fixed, the better.
3. **Ditto Medicare.** Start it at age 70 as well and make it outcomes based, not fee for service.
4. **Bring our troops home.** At least there is a game plan to do that!
5. **Use the carrot as well as the stick.** There is nothing wrong with targeted tax credits for appropriate investment and hiring.

Conclusion: None of the above is all that painful and America could see an unhindered path to growth if Washington had the courage to do the right thing. In fact, it is precisely America's frustration with Washington's unwillingness to face our problems that causes its popularity to fall to such low levels.

Futures point to a lower opening. Today is quadruple expiration day for options, futures, etc and the day of rebalancing for the S&P 500 and other related indices. Expect huge volume and perhaps more volatility than normal.

Today Paul McCartney is 68.

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