Boenning Morning Comment

This report is prepared for us by Tower Bridge Advisors June 28, 2010

Stocks finished mixed on Friday ending a lousy week for stocks. Investors finally got to see the final version of financial reform. In general, the draft that now needs to be approved by both houses of Congress didn't produce many last minute surprises. It created a reasonable framework but it also was lacking in specifics. That is left to the regulators. Investors pushed financial stocks higher relieved that some of the toughest provisions of the proposed legislation were softened a bit. Energy stocks moved higher as a developing tropical storm raised fears of meteorological turmoil in the Gulf of Mexico. Most other stock groups traded modestly lower. Volume was high due to Russell index rebalancing.

Over the weekend, the leaders of the G-20 nations met in Toronto and basically came up with nothing as expected. Most nations have already chosen a path of trying to spend less and get balance sheets back in order after a multi-decade period of excess spending. The U.S. was the one holdout opting instead for more stimulus spending to support a weak economy. While the group issued a joint statement targeting deficit reduction over the next several years, the wording essentially allows any nation to pursue any economic path it chooses over the next 2-3 years. In reality, nations choose their own paths anyway.

The economic path the U.S. has chosen for the past decade has been to use Federal government deficit spending as a means to boost growth. One the spending side of the equation, there hasn't been much difference between the Bush and the Obama administrations. Although the rhetoric of the two administrations have been much different, the realities have been strikingly similar and they contrast sharply with the policies that began with Ronald Reagan and continued through Bill Clinton that centered on lower taxes and balanced budgets. While President Bush did push tax rates modestly lower on the surface, the alternative minimum tax already in place eroded much of the stimulus that came from lower rates. Lower taxes on capital gains and dividends generated some stimulus in good times but became ineffective once the 2007-2009 recession hit. On the spending side, both the Bush and Obama administration spent without any regard to income sources. Two big wars, an unfunded Medicare drug plan, extensions of Medicaid and unemployment benefits, tax rebates, stimulus plans and huge amounts of pork barrel spending managed to balloon the federal deficit without creating jobs.

Today, everyone is questioning the Keynesian economic approach of stimulating through spending. Clearly the numbers support that skepticism. But there is spending and then there is spending. Transfer payments, whereby the government simply takes in revenue via taxes and writes a check either as a welfare payment or for some make work program that produces no long term benefit, are not stimulative at all. In fact, they may have a negative effect if the recipient doesn't spend all you give. I think it is fairly obvious that if you tax Person A to pay person B to dig a hole and fill it up again, that no net benefit is created. But if you tax Person A to have Person B build a new road network that will attract new capital investment, then real value has been created. If the road entices businesses to come in and spend money, there is a true multiplier effect. Simply said, over the past decade, the government has emphasized transfer payments via pork barrel projects that provided limited benefit and enlarging transfer payment programs including extended unemployment benefits, block grants to states, and Medicaid while doing very little true investing. There are times transfer payments are necessary. In the depths of a recession, it is the government's function to support those in need. But at some point, the crutches need to be removed. Europe says now. We say later. Since the rally in the dollar seems to be ending, investors are not taking the U.S. side in this argument.

As the Obama administration tries to move America toward an environment where more business activities are controlled in some fashion by the Federal government, other developed nations, overwhelmed with the costs of such functions as health care, are trying to pull back. Retirement is being deferred and benefits are being eliminated overseas. The pressure is just beginning to be heard here. It will only get louder.

I don't always agree with The Wall Street Journal's editorial policy but the lead editorial in Saturday's edition is a must read and covers much of what I just said and more. One of the reasons our economic recovery is so slow is that the private and public sectors are pulling against each other. Corporations and individuals are trying to save and repair broken balance sheets while the government is trying to get everyone to spend more. Even zero interest rates aren't getting people and businesses to spend. Furthermore, a sweeping new political agenda has the private sector confused. It is reacting naturally by delaying spending and investment until it can get clarity. This government's belief is that government control of key economic activities will be better than private control. Thus, government wants to centralize the control of health care delivery and the reimbursement of health care costs. It has become the only game in town for mortgages and student loans. Finreg now promises to add layers of supervision over the banks and investment brokers. It wants to direct our future direction in energy and internet services. To do all this, it will spend more and the private sector will either spend less or make less profit.

But the private sector is reacting as it should. Do nothing until the rules of the game are known. While health insurance reform has passed Congress and is now law, what passed is a framework. Regulators have to create the details. The same is true with financial reform. The new law is about to pass but details aren't know. Banks know they will have to keep more capital in the future. But they don't know how much. Until they do, they will be tentative lenders. The government wants to apply telephone rules to the Internet. That implies centralized influence on pricing and rates of return. Until the details are known those who build the enabling networks, like the telephone and cable companies, will sit on their hands and move slowly. Less spending means fewer jobs, exactly the opposite of the government's intent.

This is a big week for data. This morning it was reported that May spending rose 0.2% while personal income rose by 0.4%. Americans continue to save. That means the healing process continues. Inflation data was very tame. All good news. Americans have the capacity to spend once confidence in the future returns. Later this week, we will get some more housing numbers. Housing is a mess today after the number home buyer tax credits have expired. We will also get data on June manufacturing and auto sales. Finally on Friday is the big June employment report which takes on added importance after the May report that was so disappointing.

The lynchpin to everything right now is jobs and we are entering a period where job creation is going to be a problem. The withdrawal of housing tax credits has sent new home construction to 40 year lows. Gradually the inventory overhang still left over from the imploded housing bubble will be absorbed without further government intervention. But it will make for a messy next few months. Census workers, hired in large numbers this spring, will be laid off again. State and local governments have to resize now that Federal stimulus money is running down. In other words, there are going to be bumps in the road as the economy is forced to wean itself from Federal support and Congress will no longer keep adding to spending and deficits at the alarming rate of the past two years. Will the bumps create a second recession? As I noted last week, that is unlikely although the next several months won't feel all that great.

Time is a great healer and it will work again. The Obama agenda has largely run its course. There may be an energy bill that puts more oomph behind the regulatory framework governing offshore drilling but climate control isn't getting anywhere. Neither is immigration reform. There are some tax issues that remain unresolved and it would be nice if Congress dealt with them before the November elections. By the end of this year, clarity will improve as rules and regulations attached to health insurance and financial reform become clearer. The November elections will likely cause some real soul searching among Democrats who will get a lot of pushback against an agenda of exploding Federal spending and against Republicans who are quick to say no but don't offer viable alternatives. There should be a big enough shift that the most liberal government expansionary plans will be dead in the water as of the first week in November. The elections will also shift the economic agenda to one of spending with restraint rather than spending with abandon. If the economy takes a turn for the worst, look for more discussion of targeted tax cuts versus more big stimulus plans.

What does this all mean for stocks? This week's action will be guided by the data releases, with Friday's employment report being the most important. Hopefully, the private sector added at least 50,000-100,000 jobs last month. That seems a reasonable estimate. *In mid-July second quarter earnings season will begin. Judging by the few off-quarter numbers we have seen lately, investors appear to be in a mood to ignore good numbers and punish those who either report disappointing results or who offer disappointing forecasts. That suggests that support levels for the stock market that have been in place since last November may not hold. That isn't a prediction but it is a yellow flag warning.* There is such a strong consensus today not to buy figuring support will fail that anything contrary could well trigger a surprising and sudden rally. It is very hard to find anyone bullish over the short term. Remember that earnings themselves matter less than the reaction to the numbers.

But with that said, I still see little reason to suggest that this economy is ready to roll over and die. It may not grow very fast but that is consistent with what we have been saying for over a year. If the economy does start to weaken later this summer or fall, watch for the Obama administration to move quickly to either defer the Bush tax cuts or to modify them in a way that would be stimulative. This is an election year and employment is always the number one issue for voters. Thus, while investors are reacting today to slower growth, by the fall they will be reacting to stabilization and a clearer outlook for 2011. Thus, any pullback this summer should be temporary in nature. We could be in for several more weeks of choppy trading but it isn't the beginning of the end.

Futures suggest a rather flat opening.

Today John Cusack is 44. Mel Brooks is 84.

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