Boenning Morning Comment

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

Stocks registered strong gains yesterday breaking a five day losing streak although they faded a bit in the late afternoon. One got no sense that there was much conviction by either buyers or sellers. A hostile takeover bid generated a bit of excitement and earnings reports from Wal-Mart and Home Depot, both Dow components, weren't especially newsworthy. It was a sunny day amid the dog days of August.

Indeed, there has been little in the way of news to support the doomsayers who predict either double dip recession or deflation. Let me start with the latter. There isn't even a whiff of deflation at the moment. If anything, prices appear to be nudging just a bit higher. Yesterday's producer price index report serves as testimony. Wages are also rising. There are some who predict another downturn in residential housing prices, but so far the evidence points more to stabilization than any further substantive decline. The housing market is still in the process of clearing but rents are up for the 10th straight month and lower mortgage rates keep down the monthly payment allowing potential buyers to be a bit more aggressive on price. In some markets (e.g. Manhattan) where balance has been restored, prices are actually rising slowly. So much for inflation.

As for growth, the signs are mixed. Retail sales, after picking up a bit in early July are softening once again. Investment spending is still up but the rate of increase is slowing. Trade deficits are larger than expected and there are even some signs of inventory buildup. But so far, the news is about a slowing in the rate of growth. Except for state and local government spending, there isn't any broad area of decline. That is no change from last week, last month or three months ago. Some try to make an analogy between economic growth rates and airplane flight speed. An airplane flying too slowly might stall and crash. The analogy is quite graphic but it is questionable whether it holds any validity.

What is clear, however, is that very slow growth isn't going to promote job creation. Congress remains in recess and really only has about three weeks in September to do any substantive business. I have written already that I believe it might be political suicide for incumbents, particularly Democrats, to go into the election without resolving outstanding tax issues. Yet the clock keeps ticking and the stark reality may be that time will run out before anything gets done potentially ending with a scenario whereby taxes are increased via the expiration of the Bush tax cuts in a manner that makes absolutely no one inside or outside of Washington happy. Some argue that tax issues will ultimately get resolved in a lame duck session but I don't see how anything beyond emergencies will get done then especially if there is significant turnover as a result of the elections. As for next year, if Democrats cannot pass at least a temporary fix with majorities in both houses of Congress and the White House, how should anyone expect a fix next year with a more conservative legislature?

Meanwhile, money continues to flow into government bonds. If anything, the flows are accelerating. Investors are creatures of habit. They chase what has been working all the time. Note that the impact on bond prices as rates go from 4% to 2.5% is much more dramatic than when rates go from 6% to 4.5%. The Fed is feeding this frenzy as it announces that it will step up the purchase of Treasuries using the proceeds from the pay down of mortgages on its books. Indeed, as rates decline faster, more mortgages are refinanced and the Fed is left with more money to make more purchases. That has the potential to push rates down even further reinforcing the cycle. Lest I point out, these crowded trades have an ugly habit of unhappy endings.

This infinite loop that the Fed is at least somewhat complicit in creating is like pushing on a string. Lower rates will allow IBM to refinance debt at 1% saving itself millions. But those savings won't translate into new jobs. Hiring will be dictated by demand for its services not by its cost of debt. Americans will use the lower rates as opportunities to refinance homes. But many won't participate because they don't have high enough credit scores or because they no longer have equity in their homes. The most affluent refinancing and increase savings with very little trickling down to the economy. Meanwhile, lower rates penalize savers forcing many to save more sacrificing consumption in the process.

I am not saying that low rates are bad but I am saying that artificially low rates are bad at a time when Americans prefer to save rather than borrow. As I have said often, the Fed should focus on money supply growth and let rates take their own course. One of the reasons for yesterday's stock rally was a statement from St. Louis Fed President James Bullard that further quantitative easing might become necessary, i.e. the Fed might step in and buy more bonds at a faster rate. At least one influential brokerage yesterday predicted a $1 trillion quantitative easing package might be forthcoming by the fourth quarter. Sure if the Fed wants to simply print more money, some of it will get spent. If your kid is crying, feeding him candy will stop the crying for the moment. But just as the candy bar provides only temporary relief and perhaps even more anguish beyond, printing money to buy our own debt is a horrible long term solution. In the end, it can only cheapen the dollar and create inflation. Proponents will argue that quantitative easing is simply a short term answer. So is the candy bar. But whatever the Fed buys today, it will ultimately have to sell tomorrow.

The simple truth is that when the Fed decides it is time to sell bonds in earnest, who is going to want to buy? When the Fed is a big seller, it is logical that bond prices will fall and rates will go up. Just as everyone today is buying bonds in front of the Fed pushing rates to historic lows, when the Fed starts selling, everyone else will try and step in front and do the same thing. The Fed might be able to control short term rates with monetary policy but it has less control of long rates. The dilemma is that the Fed would like to wait to sell until the economy is strong enough but when that time comes, persistent bond sales will increase the cost of capital and stop the economy in its tracks. Said simply, steps to boost the economy today will hamper growth in the future.

The bottom line is that the government has gotten itself into a bit of a pickle. Deficits are too large, the debt burden is too high, the Fed's balance sheet is in danger of becoming overextended and tax policy makes little sense. Meanwhile programs are added (e.g. health insurance reform) whose costs exceed future revenues only adding to the problem.

Yet, despite this, the natural forces of population growth and productivity improvements are allowing for very modest growth. Left unchecked, the economy probably can move forward in similar fashion for several years to come. That won't thrill those used to 4%+ growth but it is far better than what we just lived through. Unfortunately, it will be accompanied but persistent high unemployment because 2% growth won't produce enough jobs to bring down the employment rate any time soon. That is politically unacceptable in a country that still remembers the Great Depression. So, I am afraid, we are destined to be fed a lot more candy bars until we simply can't eat any more candy.

If you look back at the stock market over the past century, you will see 15-20 year cycles repeated. There was a down cycle early in the century that bottomed in 1907-08 with the crash that ended with J.P. Morgan's assistance.

Expenditures associated with WWI and the Roaring Twenties all came tumbling down in the Great Depression of 1929-37. Recovery really didn't begin until well into World War II. Recovery post-war led to a new boom that carried into the Mid-60s but then Vietnam, Watergate and hyperinflation took over. That 18 year negative cycle ended with the Volcker/Reagan years and continued to the Internet boom. Since 2000, however we have been in another down cycle as repeated bubbles burst starting with the Internet and spreading to housing and debt. If you believe in these cyclical patterns, that suggests that the rebalancing process necessary to become the base for the next boom might not be completed for another 5-10 years. Given how lopsided personal and government balance sheets are today, that might be true once again.

I will offer two facts for consideration. First, the peak year for baby boomer births was 1953. In 2018, those babies will turn 65. There are very interesting economic implications to that. At age 65, they will spend well above average in some categories (e.g. health care) and well below average in others (apparel, autos and home furnishings). Second, President Obama has gone from record approval ratings to negative approval ratings in less than two years. George Bush left office with near record low approval ratings, well below where Obama's are today. Americans are centrists who haven't had a centrist President in a very long time. They are unlikely to get one in 2012 no matter who runs or who wins. The conservative wing of the Republican Party is firmly in control and it seems almost certain to me that President Obama will seek a second term. But after big swings right and left, America might be ready for a more moderate candidate in 2016. By 2016-2018, hopefully we will have more centrist fiscal policies, the baby boomers will be ready to pass the mantel to the next generation, the deleveraging process will be over and fast growing China, India and Brazil will have an even greater economic impact than they do today. Thus, I look for the next real new upturn to begin in the second half of the decade we have just begun.

That doesn't mean stocks can't do well for extended periods in between. They did well in 2003-2007, 1974-1978, and even 1933-37. Perhaps 2009-2013 will be another such four year window. I do know that some areas of the stock market, notably the blue chips, are at valuation levels I haven't seen in many years. But I think investors must be patient, nimble and disciplined. They must respect valuations, not chase whatever is working simply because it is gong up, and be ready to change direction quickly. It is a more difficult market but one that can still generate positive returns.

Futures point to a fairly flat opening.

Today actor Edward Norton is 41. Robert Redford is 74. Former First Lady Rosalynn Carter is 83.

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