Boenning Morning Comment

This report is prepared for us by Tower Bridge Advisors August 2, 2010

Stocks closed mixed on Friday in a quiet summer trading session. The big news Friday was the release of second quarter GDP. On the surface, the growth rate of 2.4% was pretty close to estimates. Hence, the lack of change in the market on Friday. But given the chance to stew and reflect, market watchers had all sorts of observations Friday and over the weekend.

Probably the consensus conclusion was that the threat of deflation was rising. Conceptually, deflation is feared by economists because it leads to hoarding, inventory liquidation and a reticent spending behavior in the belief that prices tomorrow will always be lower than prices today. It means that businesses lack pricing power and must move more volume somehow to offset the effects of lower prices. At best, it leads to a sideways economy. Japan has been caught in a deflationary spiral for decades and serves as the poster child for behavior we do not want to emulate.

While our inflation rate hovers around 1% and nominal GDP is only a little over 4%, getting from where we are today to persistent deflation isn't just a minor move. Yes, I do realize that preliminary second quarter GDP of 2.4% is lower than Q1 GDP of 2.7% and well below GDP in Q4 of 2009 of about 5.0%, an obvious sign of deceleration. But if you dig deeper, what I believe you will see is an economy that is moving forward both slowly and consistently. Real final sales (adjusted for changes in inventories) actually ticked up in the second quarter and have been just shy of 2% for each of the past three quarters. Disposable personal income rose 4.4% in the second quarter on both an actual and real basis. That compares to increases of 3.8% nominal and 1.7% real in Q1. What kept GDP growth down was a 6.2% increase in savings and Americans did exactly what you would expect them to do in the wake of the worst recession in 70 years. They paid down debt and worked to rebuild their balance sheets. The 6.2% savings rate was up from 5.5% in Q1.

There are actually two reasons to save. One I just mentioned. The second is that falling asset values and leverage don't mix. Although we don't have deflation in regards to overall GDP activity, at least not yet, we have had persistent deflation in assets for the last several years. And the net impact is exactly what I just mentioned when I described deflation. Most Americans are shying away from both real estate and stocks fearing lower values. If you go shopping, sales are meant to entice you to buy. But you won't buy even during a sale if you believe another sale at a better price will follow soon and the merchandise you want will probably still be available. That is exactly what is going on in the housing and stock markets. Potential buyers simply don't trust the valuations. Worse yet, in the stock market many no longer even trust the system. I don't want to digress much but just as FinReg gives regulators more authority, the SEC is still clueless as to what happened on May 6 during the "flash crash" nor can it explain subsequent episodes such as the sudden 10% jump and decline in Cisco within just a few seconds last week yet it allows the rules to stand as they are with virtually no inhibitions on black box trading. Thus, trust in value continues to wane. It will take a persistent rise in values to change psychology. That will happen (hopefully!) gradually and over a period of years.

The bottom line in my view is that nothing has changed. In fact, if it is changing at all around the edges, I think it is changing slightly for the better. Most important, anecdotal employment surveys and weekly jobless claims suggest modest improvement in the employment picture. I never try to hazard a guess for the monthly employment number

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(the July number is due out Friday) because the data is notoriously volatile and subject to wide revisions, but if I were a betting man, this time I might opt to choose a number better than consensus.

Thus, while the deflation fearing forecasters might look for nominal GDP to fall from 4%+ to 1%-, I think we are likely to stay about like we are for a while meaning 4%+ nominal GDP growth. If the government can pass a tax bill that makes sense before elections and if the November elections prompt some change in direction, I think there is a possibility that 2011 may be better than expected. On the other hand, if Republicans simply can't put a better agenda than the word NO on the table and if Congress decides to wimp out on taxes and do nothing, 2011 will have some real hurdles to cross.

I continue to favor three types of stocks, (1) companies will large persistent free cash flows capable of supporting good dividends, (2) true growth companies, and (3) companies that do a large percentage of business in fast growing emerging markets. Companies that do all three will be leaders.

Futures this morning are up sharply on the heels of good economic news from China.

Today Peter O'Toole is 78.

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