Boenning Morning Comment

This report is prepared for us by Tower Bridge Advisors August 30, 2010

Stocks rallied sharply on Friday and closed at their best levels of the day, something that hasn't happened all that often lately. The news highlight of the day was a speech given by Ben Bernanke outlining what he believes are the tools available to the Federal Reserve to stimulate the economy if needed. Although acknowledging that the pace of economic growth has been slowing a bit, Mr. Bernanke did not alter the Fed's current economic predictions nor did he say when it might engage in further stimulus activities. Although he didn't open any new ground, investors were encouraged that he didn't say anything more negative and that the Fed was prepared to act boldly if it was deemed necessary. Also on Friday, a first revision to second quarter GDP turned out to be a little bit less negative than forecasted.

Let me start this morning by looking at the GDP revision. A lot was being made over the last few weeks about the probability that second quarter GDP growth would be lowered from 2.4%, perhaps by as much as 50%. The tone of the discussion suggested that a downward revision would be tied to further economic deceleration. Connect the dots and before long you would be looking at a double dip recession.

That logic is simply faulty. That is not to say there can't be a renewed recession but it isn't going to be related to the second quarter GDP revision. The government makes a first estimate of GDP after the end of each quarter with limited actual data in hand. For the numbers not yet available, usually key data points for the quarter's last month, the Commerce Department makes estimates. Later, when the data becomes available, it is substituted for the estimates and a first revision is issued. That is what happened on Friday. Later revisions are made as data gets revised but the biggest adjustment is almost always the first one and the biggest unknowns that get filled in are changes in inventory and trade data.

As was well recorded, estimated Q2 GDP growth was announced on Friday at 1.6%, down from an original prognostication of 2.4%. But, as always, the devil is in the details and the details weren't nearly as bad as the top line might indicate. More than 100% of the adjustment was due to a decrease in inventories and an increase in imports, not to any change in final sales or demand. Personal consumption expenditure growth of 1.38% in the revised numbers was actually a bit better than the 1.15% gain announced previously.

That leads me to two conclusions. First, one shouldn't make any adjustments to economic forecasts based on the revised data. Second, and perhaps more important, second quarter GDP data is ancient history and not really useful as a predictive tool anyway.

So much for GDP numbers, at least for now. This week we will get a lot of data on the state of retail, manufacturing and employment in August, fresh data that will help us form a better picture of where we are today. It is my guess that virtually all the data will lead one to the same conclusion that growth in the U.S. continues but at a decelerated pace. Because the actual growth percentages are so low, either side of 1%, the debate whether we will slip into a renewed recession will continue. Anecdotal evidence suggests back-to-school activity has been sluggish. In some pockets of the economy, inventory liquidation has begun. We are beginning to see a few corporate profit warnings, something that we haven't seen in almost a year. Most economists predict that private sector employment growth

was anemic at best in August. Manufacturing probably also grew at a reduced pace in August. If there is a bright spot to look forward to this week, it might be auto sales that seem to be hanging in.

Just as the data show economic deceleration, there seems to be no real game plan in Washington to boost activity. The Fed on Friday suggested that it could engage in another round of quantitative easing if necessary but Mr. Benanke also said, and rightfully so, that the Fed alone cannot control our economic destiny. President Obama returns to Washington from vacation and Congress will be back next week. This week, the economy simply isn't on anyone's agenda. The President's activities center around remembering Hurricane Katrina on its 5th anniversary, celebrating the end of active troop involvement in Iraq and the beginning stages of Israeli/Palestinian peace talks. With part of his economic team leaving and the rest under attack, no one knows what the game plan might be from here forward except for rhetoric. Taxes will be on the Senate's agenda but whether the Senate can move forward on any plan or will simply punt until after elections is anyone's guess. My own guess is that Washington is crisis driven. If the employment report on Friday is bad enough, maybe it will create the beginnings of a response. But if total job losses are moderate and if unemployment remains moderately below 10%, I don't see much happened. That likely will not evoke a remarkably buoyant reaction from the financial markets.

Politically, the Republicans will be glad to let the Democrats stew in their mess for another two months until elections. As for the Democrats, there seems to be no real consensus what to do. Some want to follow the Paul Krugman mantra and engage in another round of massive stimulus. A Sunday New York Times Op/Ed piece by Laura Tyson does just that. But others, fearing escalating debt and deficits, are fearful of moving in that direction. The White House so far hasn't taken a stance.

Where that leaves most Americans is confused and a bit nervous. In that state of mind, few make big bets. Inventories are kept lean, domestic capital spending for expansion is almost nil, and certainly no one is ready to go out and buy a house. Over the weekend there was even chatter of yet another housing tax credit, a remarkably terrible idea in my mind.

This state of mind evidences itself in the economic state we find ourselves, still growing but at very slow rates. Today's nervousness isn't nearly the same as 2008's panic and fear. Virtually everyone, except those unemployed and/or under water on their mortgages, is in much better shape than they were in the fall of 2008. But excessively protective behavior, and a lack of willingness to deal with today's problems, would send us down the path of Japan in the 1990s, a path no one wants to travel.

The cure is leadership but that probably will have to wait until after the elections in November. As I noted last week crisis creates action. If the elections send a loud signal for change and action, a liberal White House and a more conservative Congress will have to find some common ground. They will. They will because they will have to. It is that simple.

I would like to think that Friday's big rally was the start of a real recovery in the stock market. If the gains are reinforced by a strong rally today, that might happen. But the more likely course is that Friday's rally, based on short covering and the reality that news was simply less bad than expected, won't endure. For now we remain stuck in the same trading range we have been in since May. It will be a data dependent week. If the numbers suggest continued sluggish growth, the range will hold. But if the numbers are worse than expected, there is some downside risk.

Futures point to a rather flat opening. Bonds are rallying after an extremely weak Friday. The economic data this morning on personal income, spending and inflation offered no real surprises.

Today Cameron Diaz is 38. Warren Buffett turns 80.

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