

## Boenning Morning Comment

*This report is prepared for us by Tower Bridge Advisors*

September 3, 2010

Stocks staged another modest rally yesterday. Although it nowhere matched the robust move made on Wednesday, it was a healthy follow through. Decent retail sales numbers and no real negatives helped investors to regain confidence. Today's market will be all about the employment report due out at 8:30. The ADP report on Wednesday and other facts we know already suggest that employment fell and that private sector jobs were roughly flat with July levels. Any number that varies significantly from that description will move the market today.

Several weeks ago I noted that August was what I call a vacuum month for information, a period where little new data was reported. I suggested that market watchers and the media would fester on the negative, overplay what little they had to work with, and paint a picture that could be far more negative than reality. That appears to be exactly what happened. The Fed warned of quantitative easing but didn't pull the string and, unless today's employment number is alarmingly bad, it isn't likely to do anything in September. Retail sales trends remained about what they have been since spring. Auto sales were a bit weak after being a bit better than expected in July. Add the two together and results matched expectations for the summer. Manufacturing was surprisingly healthy. Unemployment claims bounced around but were about the same at the end of the month as they were at the beginning of the month. Overseas, economies were on course or maybe even a little bit better than expected. Whatever one's projection for the economy was a month ago, there is no rational reason for it to be any different today. The rally of the past two days almost reversed the declines in August. Therefore my conclusion is the same. We are likely to muddle along unless an unknown shock derails the economy. I say that with one caveat. If the Bush tax cuts expire and no new tax legislation is forthcoming in the first half of 2010 to provide some relief to low and middle income workers, the risks of recession would definitely increase. Hopefully, Congress will find a way to do something and that won't be the case.

I want to switch gears for the moment and talk about the appeal of bonds. Bonds have had both an inspiring and surprising year so far. Eight months ago, I think few would have thought that 10-year Treasuries would be flirting with the 2.5% level while the economy was growing and inflation was present. I think five factors have increased demand for bonds:

1. Individuals have poured massive amounts of money into bond funds, perhaps close to \$200 billion. Most of that came out of money market funds, bank accounts and CDs which collectively have paid little or no interest. In a phrase, they were chasing yield. As bond prices rose, returns on bond funds exceeded expectations. Individuals responded by investing even more money into bonds.
2. Banks have seen loan balances shrink and investments rise. Bank investments are largely Treasury securities. Said in a different way, as loans rolled off banks had to put the money somewhere. Somewhere turned out to be bonds.
3. The reduction in interest rates and low inflation created a big problem for pension funds. A new lower discount rate inflated the unfunded pension liability costs of many. As stocks stopped outperforming in the spring, the gap widened. Pension consultants scurried to suggest that pension fund administrators match the duration of their

portfolios to their pension liabilities. To do that, they had to move out of stocks into bonds. Such a move may reduce the variability of future unfunded liabilities but it may also limit future returns.

4. Recently, the Federal Reserve said that it would use the rolloff of mortgage related securities on its balance sheet to buy Treasuries.
5. Our trade surplus continues and nations with large dollar surpluses reinvest in Treasury securities.

That's five big buckets of money going to the same place. No wonder bonds are doing so well.

But there is little or no guarantee life for bond investors continues in this manner. At some point, the Fed has to abandon its zero interest rate crisis management. When it does so, it will be a net seller of bonds. When money markets and CDs start to provide more normal returns, individuals will rebuild balances seeking greater safety of principal. To do that they will sell bond funds. When loan demand returns, banks will sell investments (Treasuries) to make loans.

Note that none of these decisions are likely to be based mostly on the relative merits of where Treasuries are priced at the moment. The Fed's long term mission isn't to monetize our debt. Banks are in the primary business of lending, not buying Treasuries. Individuals naturally want to keep a large part of their assets liquid as long as they paid some kind of return.

Obviously, I have no idea when there megatrends reverse. Between the Fed, the banks and individuals, I know that trillions of dollars will leave the Treasury market at some future time. All that is needed for that to happen is a return to normal. I would think I would want to be underweighted in bonds before that happens. I am not suggesting it will happen tomorrow or any time real soon. But it will happen. Beware.

Today snowboarder Shaun White is 23. Charlie Sheen is 44.

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Additional information is available upon request.

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