Boenning Morning Comment

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The day after the Federal Reserve raised interest rates 25 basis points and outlined plans to begin reducing the size of its balance sheet beginning later this year, stocks open lower. But prices bottomed early in the session. While the subsequent recovery didn't erase all of the morning losses, it mitigated, as least for now, the technical damage done to this year's high flyers. For the moment, these market leaders sit in no man's land still above short term technical support levels but below recent highs. Over the next week or so, they will either break down and move lower or recover to or above recent record levels. While it is too early to call, whichever way they go may well dictate the path for the whole market, at least over the near term until we get to second quarter earnings season.

The Fed rate increase comes against a backdrop of very tepid economic data. Inflation readings remain very weak as key commodities, notably oil, remain under pressure. Retail sales are also subdued, in part due to deflationary pressures from weak oil prices and in part related to the deflationary pressures from the Internet which makes efficient price discovery so easy for the consumer.

One sign of weakness is the narrowing spread between the yields on 2-year and 10-year Treasuries. Today, that spread has narrowed to 80 basis points. It was closer to 140 basis points near the end of 2016 but now threatens to match the lows of last summer just a couple of basis points below current levels. When and if this spread were to actually go negative, it would be a significant warning of a pending economic slowdown. So far, that threat isn't significant but the closer the spread gets to zero, the more ominous the warning signs. For some months now, economists have been forecasting a rebound in economic growth after a weak first quarter. But there are few signs yet of any measurable improvement. While stocks have been setting record highs, the catalysts have been lower inflation, better earnings, especially overseas, and a weaker dollar, not stronger U.S. economic growth. In many cases upward moves in such financial measures as long term interest rates and the value of the dollar have made a complete roundtrip from the euphoric moves following the election of Donald Trump. Long rates today are at their lowest levels of the year and the dollar has completed reversed its post election gains. Oil is also trading at its lowest level of 2017. Capital spending, which had promised to be the sector that could give the economy the most strength, has stalled amid ongoing economic weakness and uncertainty over the fate of tax reform legislation.

While Washington conversation changes almost daily, Republicans are still working both quietly and feverishly to find some compromise in healthcare reform that can satisfy 50 or more Republican Senators out of 52. The Republican leadership fully understands the importance of getting some milestone legislation passed this year. As far a health care is concerned, the basic package involves tax relief for high income individuals with an offsetting cut in Medicaid funding. While this may appeal to some conservatives, both Republicans and the President know that any bill that reduces government support for health insurance programs for tens of millions of Americans is unlikely to sit well with the white blue collar base that got Trump elected. This week, in a closed door session with Republican leaders, Trump called the House version "mean", the same bill that he and other House leaders celebrated just a few months ago in the White House Rose Garden. "Mean" is simple code for the fact that the Medicaid cuts are simply too pervasive and too hard to swallow. The trick for Republicans is simple to understand and complex to achieve. They campaigned on repealing what they viewed as a flawed bill. The failure of the public exchanges attests to at least some flaws of Obamacare. But if Republicans make changes seeking to improve the law, they will own it, no matter what the consequences might be. Taking away Federal premium support for tens of millions of Americans is probably too high a price to pay.

Reaching compromise is important because the spending and tax cuts that will be imbedded in any health care reform legislation will simplify the process of achieving broader tax reform. That's important because as complex as healthcare reform might be, the number of moving parts in tax reform legislation are infinitely greater. As a result, right now I would put odds of some kind of healthcare reform, watered down significantly from the House version, at no greater than 50-50. Should the Senate find a solution before the August recess, work on tax reform, the real keystone to Trump's fiscal growth agenda can then begin. Here the issue is finding the revenue offsets for a cut in the corporate tax rate. Border adjustment isn't very popular, even with a long phase in period. Other alternatives so far won't raise much revenue. We could see a tax cut by the middle of 2018 but as of now, it is likely to be a shell of what Trump and the Republican leadership had hoped for.

Without these stimuli, it is hard to see how the country's growth trajectory is likely to change. Some deregulation will help around the edges but it is hard to see how any steps Washington can expect to take will add any more than 25 basis points to growth.

But there is hope away from Washington and that hope comes via new technology. You have all heard about the Internet of Things (IoT). It is a combination of advanced semiconductor technology that attaches analog sensors to devices and then uses a combination of sophisticated software and high speed communications to intelligently improve productivity. A simple version that we can all understand is a smart thermostat, one that can both learn your patterns (i.e. when you are home or away) and be controlled remotely. There is no sense of heating or cooling a home when no one is there. For years one could program a thermostat to increase heating temperature at 5 pm and lower it in zones at night when everyone is asleep. But the newer thermostats take that several steps further, sensing patterns and adapting as more data is received. A simple smartphone app can be used for manual adjustments and overrides. Thus, comfort levels increase while heating and cooling costs decrease.

This is one simple application. Sensors and intelligent coding can help reduce inventories by maximizing turnover. Sensors can tell an aircraft owner when maintenance is actually needed versus simply doing it at certain time intervals. Production lines can be speeded up with better information. Warehouses can accelerate the flow of inventory. As data analytics improve, so do outcomes. Oncologists can optimize care using data adjusted for all combinations of age, the severity of the cancer, sex, etc. Dosages can be modified as more data is inputed. All this improves productivity. Growth is a product of population growth and productivity improvement. Technology driven productivity gains can dwarf improvement from fiscal policy initiatives.

Technology moves ever faster. It took decades for the phone to replace the telegraph. Cars were adopted more quickly. Computers became pervasive even faster. Today's technological discoveries can be mainstreamed in just a few years. Leadership companies are either new born disruptors or mature companies able to adapt quickly. Microsoft's ongoing success is clearly related to how fast it was able to move its epicenter to the cloud from the desktop, for instance.

What is most amazing to me is how disruptive technology has become. The race to be the low cost producer is accelerating. Think about it for a minute. If new technology can help an airline drive prices down $20 per ticket and only one airline invested to gain that cost advantage, it could price a seat in a way whereby it would make money while its competition lost. The competition would then have to scramble to catch up or go out of business.

These technological changes are why Federal Reserve models aren't working. Historically, as the Fed raised interest rates and the cost to borrow, such moves would lead to higher inflation. But so far, the Fed's slow movements haven't offset the pervasive deflationary pressure of the Internet. The end result is likely to be that technology will keep downward pressure on inflation for years to come and, therefore, the normalized interest rate will be much lower than in the past and, perhaps, well below what the Fed's models are telling it today.

Said in a different way, new technology is proving to be more successful in driving down cost than in boosting output per man hour in part because our economy is so much more service oriented today than manufacturing based. The net result is that we as consumers are more financially productive. A dollar goes a longer way. Looking at our economy through that lens, 2% real GDP growth becomes much more acceptable.

Today, Phil Mickelson turns 47.

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