Boenning Morning Comment

This report is prepared for use by Tower Bridge Advisors July 5, 2017

Stocks generally rose on Monday in a holiday shortened session with light volume. Interest rates, especially at the long end of the curve, continued to creep higher. Despite the pre-holiday mood with lots of traders away, there was a flurry of economic data which confirmed little deviation in the economy's path. Manufacturing continued solid although auto sales continued to lag. That continues the pattern of recent months. The most important economic indicator this week, the monthly employment report, comes out before markets open on Friday. There is little reason to expect any major change from recent monthly gains averaging a bit over 150,000. The only factor keeping the increases down from well over 200,000 is the shortage of qualified job applicants in a labor market growing tighter.

While some suggest we are at or near full employment, the rise in wage rates suggests that there is still room to go. Some now forecast that the unemployment rate can fall as far at 3.5%. There isn't an actual number that suddenly triggers a spike in wage rates. Rather, they build more gradually. But if we were really at full employment, the pace of gains would accelerate in a noticeable fashion. We haven't quite arrived at that point yet. Nonetheless, the Federal Reserve, which has already moved short term rates higher several times since December, will continue on its path of rate normalization. However, today's release of minutes of the most recent FOMC meeting will likely show some split within the membership whether to continue on the path of raising rates every other meeting or so, or slow the pace of rate increase and start reducing the size of the Fed's balance sheet.

We believe the latter will be the case. For one, rate increases take time to show their impact. It often takes 6-9 months for the full impact of rate increases to show in the economic data. While some increase in inflation pressures from higher wages is evident, other deflationary pressures, notably from commodities and the impact of the Internet, have helped to keep overall inflation well below the Fed's 2% target. Although Fed members think those pressures are transient and will fade over coming months, they have been persistent and longer lasting than some key members believed.

Reducing the size of the balance sheet, overloaded with longer dated bonds and mortgage backed securities, also would put more upward pressure on long rates rather than short rates. The string of short term rate increases since December, coupled with little change in long rates, has served to flatten the yield curve. While a slowly sloping yield curve doesn't send bad messages to markets, an inverted curve, where short rates exceed long rates, is almost always a red flag signaling pending economic slowdowns. The Fed clearly doesn't want to see that. Could it happen? If the Fed is persistent raising short term rates at the same time our economy decelerates faster than expected (for whatever reason), the curve could invert. Thus, a much safer approach would be to string out the increases in short rates, at least until there is a more visible response in inflation, while, at the same time, beginning to bring down the size of its balance sheet, bloated by bond purchases post the Great Recession.

All this presumes inflation stays tame and economic growth remains around 2% year-over-year. Q1 GDP barely grew over 1%. There are indications that Q2 grew a bit faster but the year-over-year pace stays around 2%. Donald Trump, in his steady stream of tweets, takes credit for record stock prices, full employment, and a strong economy. In some respects he may be right. The absence of a steady stream of costly new regulations and at least some peeling back of Obama administration new rules has lowered some costs and increased optimism. However, at the same time, the lack of success to date moving the administration's fiscal agenda forward and uncertainty particularly about the course of future tax rates, has held back spending and increased the savings rate. Indeed, based on data so far this year, U.S. growth continues to lag behind growth in Europe and China. As a result, the dollar has been much weaker than expected at the start of the year and overseas earnings, which obviously benefit U.S. multinational corporations, are better than expected. The combination led to better than expected Q1 revenues and earnings. In about 10 days, second quarter earnings season will begin. Market watchers are looking for more of the same with companies beating forecasts on both the top and bottom lines. Earnings are estimated to be about 10% higher than last year. That message hasn't been lost on equity investors who pushed major averages up close to 10% through the first six months of the year.

In fact, equity prices have been rising faster than earnings. Part of that may relate to the fact that interest rates have been lower than previously expected, especially at the long end of the curve. Soon after Trump was elected, yields on 10-year Treasuries spiked to 2.60%. However, as growth rates slowed and the fiscal agenda remained incomplete, rates fell back to about 2.15%. That was partly responsible for the rapid rise in stock prices. Equity values hinge on earnings and interest rates, not tweets or Washington tumult. Better than expected earnings and interest rates that now look that they will stay low for longer, sparked a strong positive response.

All this suggests that these leadership names could well be very volatile over the next several weeks. I have no idea whether we are in the second inning or the seventh inning of a correction. What I can suggest is that corrections end when weak hands capitulate. If I can take you all the way back to 1998 and 1999, we saw exactly the type of 10-20% swoon I am talking about take place among leadership names in October of each year. The total time span for each correction was about four weeks. By year end, however, all the losses were recouped.

What does this all mean? If you own one or more of these names, like their fundamental outlook and feel they are fairly valued, hang in there. If you like them but feel they are still somewhat overvalued, see if you can pick up a few bargains as the correction runs its course. But it is important that you watch and listen to second quarter results to make sure the fundamentals are still intact.

Otherwise, the next few days will be relatively lot on news pending the release of Friday's employment report. President Trump heads to Europe for a scripted speech in Poland where he will praise that country for spending 2% or more on its own defense. He then moves to Hamburg for the G-20 meeting, his first face-to-face meeting with world leaders since he backed out of the Paris Climate Accord. No doubt, he will complain about trade agreements again and reiterate his desire for pledges for allies to spend 2% on defense. At the same time, he will likely support NATO in some fashion. That said, the big events on his agenda will be any coordinated response, if any, to North Korea's launch of an ICBM yesterday and his first face-to-face meeting with Vladimir Putin on Friday. As always with Trump, it's the unscripted statements or steps he takes that will evoke a reaction in markets. Stay tuned.

Edie Falco turns 54 today. Huey Lewis is 67.

James M. Meyer, CFA 610-260-2220

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