Boenning Morning Comment

This report is prepared for us by Tower Bridge Advisors July 7, 2017

Stocks fell about 1% yesterday against a backdrop of a somewhat weak prediction for today's employment report and foreign policy concerns related to North Korea's recent ICBM launch and the upcoming meeting today between President Trump and Vladimir Putin.

You probably are tired about my harping persistently about my "two-day" rule. But it works more often than not. To repeat once more, markets don't change direction without two contradicting good or bad days in a row. In other words, the end to an up cycle requires two bad days in a row. We haven't had that yet.

There is more to the current weakness than simply the reversal of the tech names. Let's look at some of the other factors:

1. While economic data hasn't been bad, it has hardly been encouraging. Retail sales are punk. Consumers are saving rather than spending. Auto sales are down. Bank lending has picked up a bit in recent weeks but is far from robust. By itself, the economic data isn't cause for the downturn but the economy isn't providing much of a tailwind either.
2. Although central banks outside the U.S. continue to employ easy money as a policy tool, the time is nearing when that might cease. China has already pulled in its horns and Europe could slow down its easing pace by the end of the year. More money means more buying power. Again, this is more about the absence of a tailwind than the emergence of a headwind.
3. While employment growth has been one of the economy's positives, the growth last month was less than expected and early signs suggest the possibility of a tepid reading this morning. Numbers will be out by the time most of you read this note.
4. However, despite the relatively soft economy, the Fed is sounding downright hawkish. It has raised short term rates three times since mid-December and could do so again before year end. It also wants to begin liquidating its balance sheet. While it has said in no uncertain terms that it intends to move slowly, it still is moving in a tightening direction. Its dot plan for the next few years still points to a 3% short term interest rate target. But we live in a world where inflation can't seem to get much above 1.5%. Short term Fed Funds rates over 2% represent loose money normally but with growth sub-2% and inflation also below 2%, that doesn't look loose at all right now, especially since most borrowers have to pay a significant premium to the Fed Funds rate. Said differently, it is almost unheard of for the Fed to be tightening with both growth and inflation below 2%. Then again, the Fed rarely starts a tightening cycle from zero.
5. Then there are the politics. No one logically suggests that North Korea is about to launch a nuclear weapon or that the U.S. is ready to go to war to stop their nuclear program. But tensions keep heating up and the verbiage from Kim and Trump gets louder and louder. Both are unpredictable. Wall Street doesn't like uncertainty. Add in Putin to stir the pot and you have a recipe for high anxiety. That will probably cool a bit once this weekend's G-20 meeting ends and everyone goes home but it doesn't help the markets at the moment.
6. One thing many observers thought they could count on was Trump's progressive economic agenda. But yesterday Mitch McConnell said he isn't so good at solving Rubik's Cube and he needs to do that to get 50

Republican votes to repeal and replace Obamacare. The bill before the Senate prior to the Fourth of July recess has zero chance of passing. Repeal now (to be implemented a year or more later) and replace before the implementation date may sound OK but it leaves us with Obamacare in place while the exchanges are collapsing and the insurance companies running for the hills as fast as possible. Senator Ted Cruz has offered an alternative that allows insurance companies to offer both Obamacare compliant and non-compliant insurance. The thought is that the offer of slimmed down cheaper insurance would retain younger Americans. That is probably true. But it poisons the well for all others by removing the lowest cost members. The cost for elder frail Americans seeking insurance would skyrocket. This alternative won't help Leader McConnell solve Rubik's Cube. Therefore, back to square one. No repeal and replace means no capital gains tax cut. That's bad for the investment class, another negative for stocks. It also both delays and questions the possibility of any significant tax reform.

7. I didn't check precisely but Congress has about 60 actual days in session before the end of the year. I guess you can't call our Congressmen overpaid, can you? Besides healthcare reform and tax reform, Congress has to approve an increase to the debt ceiling, pass a budget, approve appropriations to fund the government, and pass year-end tax extenders. That's an awful lot for a Congress that has accomplished absolutely nothing of substance except for a Supreme Court appointment during the first half of the year. Heck, the vast majority of the positions that Trump has to appoint that need Senate approval haven't even been nominated yet.

With all that said, it's amazing the market is as good as it is! But, alas, the market isn't a barometer of Washington efficiency; it is a barometer of earnings and interest rates. The big negative of the last week is the rise in interest rates which began in Europe, a combination of hints from ECB head Draghi that the time is within sight when it will start to provide less monetary accommodation, and better economic data from across Europe. The news from Asia is also good with growth continuing in China, India and Japan. Hopefully, the evidence will show in good Q2 earnings which should start to be reported in about 10 days. Expectations were high but the recent sloppiness in the market has erased some of that excess.

That means we remain in limbo with a negative bias for the next 7-10 days. Today's employment report and the outcome of the G-20 meetings could swing markets either way. Earnings season should be good but that could be tempered by a cloudy outlook given current economic weakness and lack of any success on fiscal policy. After that, we get to the dog days of August when anything is possible. But that is a story for another day. Let's get through the G-20 meeting and, hopefully, a good earnings season first.

Today, Ringo Starr is 77.

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