

Boenning Morning Comment

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I noted on Wednesday that I was impressed with the leadership in Tuesday's rebound. After sharp morning losses related to a North Korea missile launch and the aftermath of Hurricane Harvey, stocks staged an impressive rebound led by the risk-on NASDAQ names. I pointed out that one day does not make a trend but all trends have to start one day. Stocks have continued to go up over the last two sessions but the real news was the continued strength of the NASDAQ. The key to take away is, at least for now, risk-on is back in favor.

Certainly the economic data supports that. Almost all the recent economic data has been solid. This morning we will see the August employment report. If Wednesday's ADP prediction is even remotely accurate, August was another solid month for job gains. The latest revision to Q2 GDP raised the number to 3%. While that probably overstates the sustained rate of growth, it nonetheless was an encouraging number. We are now two-thirds of the way through Q3 and all signs point to sustained improvement. The hurricane may knock 1-3 tenths off the final growth rate for the quarter but that will be overlooked. On the back side, rebuilding expenditures will help growth over the next two-to-three quarters.

Despite the improved growth picture in the U.S., there is still no sign of inflation. Analysts will look at this morning's jobs number for signs of wage acceleration but even if there are some signs, it is clear that wages are growing slowly and companies still don't have the pricing power to pass these added costs through to consumers. The low inflation is reflected in further declines in long term bond yields and the relative weakness in the dollar. As I have said often in recent months, good earnings, low interest rates and a weak dollar are a perfect recipe for rising stock prices.

But the skies aren't bright blue to the horizon. There are two semi-dark clouds in the picture. The first is the one related to the aftermath of Harvey. The second relates to the full legislative plate awaiting Congress when it returns for recess next week.

Let's start with Harvey. The flooding in Texas has knocked as much as 30% of the U.S. refining capacity offline. The Port of Houston has been closed for a week. A key gas pipeline is shut down. This all means some period, probably measured in months, certainly not days, when these disruptions are likely to cause both shortages and a spike in certain prices. Gasoline could rise \$0.10-0.40 per gallon depending where you are located. There are already long lines in the Dallas area. Hundreds of ships wait outside of Houston to load or unload. A lot of Gulf shipping traffic will be diverted to either the East or West Coast. As I noted earlier, these disruptions, plus all the lost business in the Houston area will impact GDP growth in the third quarter and possibly into Q4. As long as the damage is temporary, markets will overlook the impact. But sometimes problems after a natural disaster as large as this one find funny ways to impact earnings of thousands of different companies. What sets up as a really strong Q3 will end up getting tempered a bit. Managements will try and isolate the Harvey related one-time costs. Problems arise, however, when companies overplay the story and use Harvey as an apology for less than stellar corporate performance. At best, the numbers this quarter will be a bit more confusing than they might have been if Harvey was just another rainstorm.

But the bigger looming cloud, one that could even possibly pour drenching rain on our parade is the one hanging over Washington. Before Republicans can get to considering tax reform, they have to pass a budget, approve

spending, finish the approval process for hundreds of Federal appointees, and raise the debt ceiling. Messrs. Ryan and McConnell say there will be no problem. But didn't they say that healthcare reform was a no brainer? Didn't Treasury Secretary Mnuchin say tax reform would be done in August? Now he promises it will be done this year. I'm not sure his confidence is shared by many outside the Republican leadership.

It's nice to listen as President Trump stumps for a simplified tax code that favors the middle class and allows corporations to bring home trillions of dollars to invest on infrastructure. But without any details, this is all just a fairy tale. Just to put an exclamation point on what I just said, this week House Ways and Means head Kevin Brady put forth a piece of the plan that would disallow corporations to deduct interest costs as an expense. The uproar that ensued could make the earth shake on Capitol Hill. Always remember one person's loophole is another's tax deduction. Every effort to pay for cuts in rates will be met with resistance by someone. Given that the game plan is to accomplish tax cuts or reform entirely with Republican backing, the task will be daunting.

Passing or not passing tax reform is one thing. Not getting a clean bill to raise the debt ceiling or authorize spending beyond the fiscal year end of September 30 is another. In a perverse way, the hurricane may life just a bit easier for the Republican leadership. One of the first issues Congress will confront is the need to provide emergency funding for victims of the hurricane. If you can remember back to Superstorm Sandy, southern conservatives balked at approving relief creating a lot of anger and angst among Northeast Senators and Representatives. One of the most vocal back then was Senator Ted Cruz of Texas. No doubt he will be one of the strongest proponents this time around and you can be sure that he will be pressed to account for every dollar he requests by those representing the Northeast. That's the way politics is played today. The public, however, is almost certain to be turned off if this childish behavior persists. If it gets out of hand, it is hard to imagine that the subsequent spanking the public and media dish out to all sides won't lessen the desire to continue the bickering as the budget and debt ceiling debates begin.

Thus, the business news is all pretty good. Harvey is a disruption but one whose pain will pass in time. Washington is the wild card, both for September and beyond. This market would like well crafted tax reform but doesn't need it to continue to climb upwards. Perversely, 2% growth allows slow and steady progress without the threat of overheating. It almost seems we could live in that world indefinitely. Washington, therefore, doesn't have to improve our lot, it just must avoid disrupting it. I suspect we are likely to see some volatility in September associated with what goes on, good or bad in Washington. Once we see a budget and the debt ceiling is raised, the risks decline significantly. Tax reform or infrastructure spending would be nice plusses but, since they are not discounted today, they won't be big minuses if nothing happens.

Today, Gloria Estefan is 60. Barry Gibb of the Bee Gees is 71. Lily Tomlin turns 78.

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