Boenning Morning Comment

This report is prepared for us by Tower Bridge Advisors May 5, 2017

Stocks fell once again yesterday but gained back some of their losses in the afternoon tracing the path of oil prices throughout the session. Oil futures fell sharply in the morning as new U.S. supply has more than offset production cuts from OPEC nations. Slower growth in the U.S. and sluggish gasoline demand suggest that it will be some time before oil is in short supply.

The other big event yesterday was House passage of a healthcare bill that significantly modifies funding mechanisms. While there will be winners and losers if this bill becomes law, there is very little chance of that happening without substantial changes. Article I, Section 7 of the Constitution starts, "All bills for raising Revenue shall start in the House of Representatives". Since the Republicans in Congress decided to follow the path of reconciliation in order to seek passage of the first phase of health care reform by only a simple majority in the Senate, the Constitution required that the House take the first shot at reform before passing it on to the Senate. The bill that passed the House yesterday is likely to be revenue positive over the next 10 years through a substantial reduction in Medicaid support coupled with the elimination of taxes imposed by Obamacare. The 3.8% capital gains surcharge would disappear immediately while the 0.9% increase in the so-called Medicare tax will phase out in about six years. The reduction in Medicare funding will increase pressure on states to support healthcare needs of the elderly and frail. Other losers would be hospitals that would likely see both lower volumes and higher costs. But given that the bill is likely to be altered substantially, investors are unlikely to attach too much meaning to the specifics of what was passed yesterday. Virtually everyone in Washington knows that the real work on healthcare reform was destined to be done in the Senate. But before that could happen, the House had to find some package to pass on to the upper chamber allowing them to get started. Whether anything passes the Senate is in doubt. If something does pass, it will likely be much more supportive of the elderly, frail and economically needy than the House version.

From a stock market point of view, excepting those in the health care sector that would be obviously affected, whatever passes (or doesn't pass) isn't likely to move the economic needle a great deal. In other words, Wall Street isn't wrong to largely ignore all the emotion about health care reform to date. Some believe the ability to repeal some of the taxes imbedded in Obamacare will make efforts to achieve tax reform, following health care reform, easier. But that is questionable. Tax reform will be judged on its own merits and will be scored by the Congressional Budget Office on a standalone basis. The taxes being repealed within healthcare reform only apply to a relatively small high income segment of the population. To the extent overall tax reform goes beyond some changes to corporate rates (including repatriation of offshore income), more of the benefits are likely to accrue to the middle class.

While President Trump and Republican leaders celebrated their win yesterday, the market's muted reaction suggested that there is a long way to go for fiscal policy revisions to move the economic needle. While most believe the current economic lull will end soon as cold weather fades and summer looms, there are few signs that what lies ahead is much different than what has happened over the past 7 years, namely 2% real growth combined with modest inflation. For that reason, if you compare economic data from November 9, the first day after the Trump victory, to today, you see very little change. A lot of the post-election euphoria has evaporated. 10-year bond yields are about 25 basis points higher. The unemployment rate is virtually the same. Commercial and industrial loan volumes are actually slightly lower. Auto sales are down a bit and housing sales are a little higher. Consumer spending has been flat throughout the first quarter. Oil prices are very close to where they were last November. With this week's drop, they are actually a bit lower.

Simply said, we are on the same glide path and, for now, there is little change anticipated in the economic trade winds to move that needle. Investment spending has picked up a bit but productivity over the past few quarters has fallen. Major changes in spending probably await legislation that will determine whether money trapped overseas can be brought home. Marginal investment decisions could be altered if the marginal tax rate is lowered. Even with the House victory on healthcare yesterday, it will probably be months before the Senate will act. The shape of tax reform almost certainly will await the outcome of healthcare. If the White House felt healthcare reform was tough, wait until they have to deal with tax reform. Every deduction taken away will bring another special interest group crying to the Capitol steps.

But, against this backdrop, there is good news. Corporate profits are accelerating. They are accelerating not because of what is happening in Washington, but what is happening overseas. The effects of very easy money in Europe and Japan are flowing through to earnings. In Q1, most U.S. multi-national companies reported more growth overseas than in the U.S. Since money flows to strength, the dollar weakened in the first quarter. A weaker dollar makes foreign earnings more valuable and enhances the value of overseas revenue.

Over time, Trump efforts to peel away constricting regulations may help raise our growth rate. But the changes, at best will be modest. What our economy needs to accelerate growth is more certainty. Corporations welcome change if it improves their ability to grow but, most importantly, they want to know the rules of engagement. The tax reform battle takes center stage and it is a battle that won't be settled until late this year at the earliest. Right now, we don't even know the content or context of the debate. The recent White House one-page missive was a repeat of campaign promises, not a serious outline of actual tax reform requests. The House Ways and Means proposal based on border adjustment taxes appears dead on arrival. Trump claims not to care about deficits but many in Congress do. Lowering rates without meaningful offsets will never pass. Thus, we still know very little of the shape of the debate, much less the outcome.

So far I haven't mentioned two big events this week. The first is today's employment report. Whatever the numbers are, they will have to be measured against a previous months heavily impacted by weather. If today's number is as low as last month's, that would be concerning. Other than that, the key number to look for is the rate of wage increases. If we were actually approaching full employment, wage rates would start to accelerate in a meaningful manner. That hasn't happened to date and I would be surprised to see a big jump reported in today's April data.

Second, the Federal Reserve met this week and, while it chose not to raise interest rates, it set the table for another increase in June. Of course, a decision in June will depend on the data at that time. But the Fed this week chose to slough off the recent poor data as a temporary aberration. Whether that is fair or not depends on trends over the next six weeks. Markets would worry if the Fed raised rates against a backdrop of weak data. That isn't this week's concern but it could become a worry as the June meeting approaches if the data doesn't start to improve

We are approaching the middle part of the quarter when earnings and news flow starts to slow. Today's employment report is the last big number for a while. Stocks will most likely mark time until some unexpected event provides a spark to change direction. Right now the most concerning cloud in the sky is the one related to commodity prices. Financial markets don't like sudden change. If oil marches down toward $40, markets aren't going to like that message. Note, I said "if".

Today Adele is 29.

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