Boenning Morning Comment

This report is prepared for use by Tower Bridge Advisors May 8, 2017

A strong employment report drove modest gains for stocks on Friday. But, traders moved to the sidelines in the afternoon ahead of French elections yesterday and continued volatility in the oil markets. The French elections provided no surprises and it appears stocks will open fairly flat this morning.

For almost 8 years now, we have been in an economic recovery and for almost that entire time, many market watchers, including myself, have been looking for the moment when interest rates would start to rise in earnest back to historic norms. And while the Fed has finally begun the process of normalizing interest rates with two 25-basis point increases in the last four months, short term rates are still below 1% and 10-year Treasury yields hover near 2.3%, only about one percentage point above their all-time lows and about a half a percentage point below what they were in March 2009 when stocks hit bottom. Think about that. Longer rates today, at a time when the economy has been growing for eight years and the unemployment rate has fallen to 4.4%, are lower that they were in the midst of the most severe recession since the Great Depression. Unemployment at that point was over 10%. While some believe there is still some labor and manufacturing slack in our economy, everyone would have to agree that there is less slack today, particularly in the labor market, than there was eight years ago. Yet, presuming long rates reflect a collective consensus for future inflation expectations, they appear to be lower today than they were in the depths of the recession.

Does that make any sense? If one uses U.S. history during our lifetimes, it doesn't seem to compute. I grew up as a kid with passbook accounts yielding 4%. Even in the 1950s, when inflation was at low levels comparable to today, we could always get a real return from our savings accounts. Yes, rates then were fixed by law, not only for passbook accounts but also for other loans like mortgages. But the fact that banks willingly collected our deposits suggested they could felt they could make money holding my account. When longer term interest rates rose, banks stopped making mortgages with regulated ceiling caps. But the rates then were higher than the rates today. There was a period in the 50s when corporations could borrow longer term at exceptionally low rates but that period was relatively brief compared to the long period of ultra-low rates we have experienced over the past decade.

If there is precedence for today's markets, we have to look elsewhere. The obvious place to look is Japan. Japan was booming in the 1980s before a recession destroyed its economy, just at a time when demographics started to work against the country. Over the past three decades, Japan has moved back and forth between recession and mild recovery straddling the flatline. Stock prices today remain roughly half of what they were 30 years ago. Japan today is losing population, a combination of an aging population and a semi-closed door policy relative to immigration. Go to Tokyo and you don't see large Muslim or, for that matter, Caucasian, communities. While Japan hasn't been growing, and its high flying tech companies and banks appear to have lost their competitive edge, Japan remains a wealthy country. Just take a walk down Tokyo's Ginza and you will see that readily. Instead of growth being the dominant word, as it was in the 1980s, when names like Honda, Sony and Toshiba were set to dominate their respective markets, as Japan ages, savings and capital preservation have replaced growth and capital investment as key watchwords. The net result is that Japan's central bank has had to flood the country with money and the government has had to take aggressive fiscal actions just to keep the country out of recession. Over the past 30 years, deflation has insidiously infected the economy, accelerating savings without commensurate investment.

We aren't Japan, at least not yet. Our population is growing at about 0.75% per year, a combination of birth rate and immigration. While President Trump talks of closing borders, to date not much has changed. If it does, our population growth will fall, but only modestly at first. The other side of the growth equation is productivity and that has faltered. Last week, we learned that Q1 productivity was negative; that year-over-year productivity improvement wasn't far over 1%. That has been the recent pattern. The principal driver of productivity is capital investment. If productivity is the output per man hour, employers can work people harder or they can invest in equipment that will improve per capita output. The former alternative may work for a short period of time but isn't sustainable.

As we approach full employment, it would be expected that investment spending should pick up. There are early signs that (1) investment spending is starting to increase and (2) wage pressure is beginning to percolate as the unemployment rate edges ever closer to 4%. But, at the same time, the savings rate is moving higher (now just a whisker below 6%) and corporations still concentrate of generating free cash flow to return to shareholders. In other words, it remains a composite corporate belief that returning money to shareholders will improve corporate economic values more than new incremental investment at a time when capacity utilization still hovers well below the 80% level that we have historically considered a threshold to accelerating inflation, the point where demand starts to increase supply driving prices higher.

For decades, our nation has changes first from a rural agrarian economy to a manufacturing-based economy and, now, to a capital light combination of services and infrastructure built on intellectual property rather than bricks and mortar. The end result is that our economic model has changed. Eight years into a recovery, we still have excess manufacturing capacity and pricing power remains in the hands of the buyer, not the seller. While there are some hints that the days of zero inflation are gone, there are few signs that inflation is going to go back to where it was 10, 20 or 30 years ago any time soon. Intelligent farming and better seed and chemicals have raised crop yields. We know where there is enough oil and gas to supply the world for decades to come. A society that has learned, where applicable, to share resources has learned to get by with less. I don't know what inning we are in relative to this transformation, but it doesn't feel like the eighth or ninth to me.

That strongly suggests that interest rates will remain well below historic norms for a lot longer. Some day the shift from physical to online distribution will end. So will the movement to the cloud. Sharing resources will have run its course. The emergence of disruptive businesses will slow. But until then, we are in for a period of historically low rates because, the excess capacity will continue and buyers will retain the upper hand in the pricing equation.

If interest rates are to remain low for longer, then equity P/Es will remain above average for longer. Indeed, what appears to be happening is a gradual realization that what I have been discussing may, in fact, be right. Gradually, there is a growing acceptance that low for longer interest rates means higher than normal P/Es. If P/Es are going to rise at the same time earnings are going up, then stocks should provide superior returns to both bonds and real estate.

Of course, all of this might be wrong. To me the most obvious way that could happen is for Washington to embark on a course of extremely stimulative fiscal policy just at a time when it isn't needed. Tax reform is fine. Massive deficits are not. If deficits accelerate at a time when the Federal Reserve is just beginning to sell assets off its balance sheet, the net debt of the U.S. government could quickly move from below $15 billion to over $20 billion. Even for the U.S. there is a limit to how much debt investors are willing to buy. No one knows that limit but more supply, even with the same demand, means lower prices and higher rates. Rising rates, combined with larger entitlement payments mean ballooning deficits. Left unchecked this can spiral out of control. At some point, ever higher rates will cause a recession and skyrocketing deficits. The alternative outcomes all look ugly.

The bottom line is that, despite all the rhetoric coming from the White House, one should expect a modest tax reform package at best. Meanwhile, growth continues, P/Es rise, and inflation expectations stay low. Not a bad combination if you are an equity investor.

Today, Melissa Gilbert is 53.

James M. Meyer, CFA 610-260-2220

Additional information is available upon request.
* - Boenning and Scattergood may act as principal in buying this stock from or selling it to the public.
# - The author of this report or accounts under his management at Tower Bridge Advisors owns this security.