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## Brakes or Accelerator?

The combination of strong earnings reports and guidance from giants like Alcoa, Intel, Microsoft, Ford, UPS, 3M along with better-than-expected economic data in Europe cheered equity investors this week. Despite the enactment of sweeping economic reform legislation, potential tax hikes promised by the White House and comments from Fed chief Ben Bernanke that “the economic outlook remains unusually uncertain” the rally continued.

Of the 137 companies in the S&P 500 reporting as of July 12<sup>th</sup>, 85% have beaten forecasts for earnings-per-share, but less than 70% have topped sales estimates. Earnings can be boosted in the short run by reducing workforce, inventory, and cost of capital. In the long run, sales have to increase. Increasingly, investors are turning toward revenue growth as the key metric for gauging corporate recovery.

The nation’s top economist, Ben Bernanke said the Fed would do anything in its power to sustain the recovery. He assured congressmen on Wednesday that the Fed would “continue to carefully assess ongoing financial and economic developments, and . . . remain prepared to take further policy actions as needed to foster a return to full utilization of our nation’s productive potential in a context of price stability.” He outlined three options to do so; affirm the commitment to keep short-term interest rates low for a long time, lower the interest rate it pays on bank reserves at the central bank to encourage more lending, and reinvest proceeds from maturing or prepaid mortgage securities, instead of letting them run off the Fed's balance sheet.

The index of leading economic indicators, as reported this week, fell 0.2% in June. Bloomberg notes that if the interest rate spread component was removed, it would have fallen a rounded 0.6%. The rate spread, exaggerated by near zero rates on the front end, has held this index up throughout the recovery. The factory workweek and vendor performance were the worst indicators in the report, hinting at trouble for the manufacturing sector, the sector leading the economy out of recession. The stock market and unemployment claims added to the decline.

Housing continues to suffer from the withdrawal of government support, but there was good news sprinkled in this week’s reports. Housing starts in June declined 5% which followed a 15% decline in May. The June annualized pace of 0.549 million units fell well short of analysts' expectations for 0.580 million units and is down 5.8% on a year-ago basis. However, building permits bounced 2.1% in June following a 5.9% drop in May.

Existing home sales fell in June, but not as much as was expected. The index was down 5.1% to a 5.37 million annual rate. A big positive in the report was that prices were up 5.2% for the median price to \$183,700. However, supply increased from 8.3 months to 8.9 months. The National Association of Realtors, which compiles the report, sees inventories rising to 10 months in the next report. In a separate report home builders said conditions are the weakest since last April. The housing market index fell to 14 in July, down two points from June. It is down eight points from its recovery high of 22 in May.

The S&P 500 is 12% off its 2010 peak reached April 23<sup>rd</sup>. Concerns over Europe's debt problems, continuing concerns with US banks, reduced lending, more restrictive regulations and the possibility of higher taxes all continue to weigh on the economic outlook. Bloomberg reported that the National Federation of Independent Business said last week that confidence among small businesses fell in June to the lowest level in three months as their projections for profits, sales and economic conditions weakened.

Even as the economic outlook grows more uncertain, the White House and Treasury Secretary Tim Geithner affirm their intention to increase taxes in 2011 on higher income earners. "We believe it is appropriate to let those tax cuts that go to the most fortunate expire," Mr. Geithner said at a recent breakfast with reporters.

But a number of leaders in the President's own party are straying from the company line, persuaded perhaps by sound reasoning, but more the looming mid-term elections. They are coming out one by one to agree with Republicans and many economists on the merits of extending the Bush tax cuts for earners over \$250,000 during a weak and uneven recovery. Rep. Gerry Connolly (D., Va.) said "I think given the fragility of the recovery, the timing is wrong for any kind of tax increase of this nature. I know that puts me out of step with many in my own caucus, but it's important for members to remember the top 5% [of earners] generates 30% of consumer spending." We would add that a significant number of small businesses pay their business taxes in their personal returns and are above the \$250,000 bracket. Raising their taxes will certainly not help growth or unemployment. Federal Reserve Chairman Ben Bernanke told lawmakers Thursday the U.S. "should maintain our stimulus in the short term." Extending the Bush tax cuts "is one way" of doing that, he said. "There are other ways as well."

The Bush tax cuts are set to expire at the end of this year. Congress must act if it wants to avoid raising taxes across the board. Bloomberg reports that political strategists say that could give the Republicans an edge, since they could essentially hold the entire package hostage unless Democrats agree to extend the cuts for high-income earners. As of now, neither a partial extension of the Bush tax cuts nor a full extension could win the 60 votes needed to break an expected Senate filibuster. Bloomberg says that liberals would try to block a full extension and Republicans would try to block an extension of just the middle-class tax cuts.

It is my personal opinion that nothing done by the government so far, save opening the financial spigots during the onset of the financial crisis, will have as great an impact on the financial recovery as their decision regarding the tax cuts. It is nothing less than the most important act of the 111<sup>th</sup> Congress. Write your congressmen and women. Tell them the best stimulus is less government. Tell them to leave the money in the pockets of those who create the services, the stuff, the jobs, and by the way, the profits they already tax. Allowing them to grab more of the life-blood (money) from the most productive group in the world makes no sense. This important decision will be made in the coming weeks by our currently elected leaders. Will it be *Brakes or Accelerator?*

Have a great weekend.

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