Boenning Morning Comment

This report is prepared for us by Tower Bridge Advisors February 5, 2009

The only word I know to describe yesterday is ugly. A lot of little things all combined to have a big trading impact. Weekly jobless claims remain persistently high and signal a worse than previously expected employment report today. We'll know soon enough. Sovereign debt problems in Greece sent stocks falling in Europe and got U.S. markets off on the wrong foot. Those problems escalated throughout the session and spread to other countries like Spain and Portugal. By day's end investors began to fret whether a sovereign debt crisis in southern Europe was a second coming of the banking system collapse that began in 2007. Strong earnings reports from Cisco (CSCO-$23#*) and others were ignored. When stocks can't go up on good news, there is only one direction to go. Retail sales numbers for January were good but they too were largely ignored. There was more fuel for the fire. Seasonally, a weak January is almost always followed by a weak February. February itself is the second worst month historically for stocks. Add in big drops in commodity prices and a strong dollar and we got the decline yesterday that we saw.

Are we headed for a double dip recession? There are certainly no current economic indicators I see to suggest that. Retail sales of all kind have been good. That includes autos. Capital spending has been fine, particularly for computers and software. Growth in Federal government spending pretty much offsets any decline in state and local spending. There are weak spots to be sure. Housing is one. It isn't improving although it isn't getting much worse either. As noted, the persistent high level of weekly jobless claims suggests that unemployment will remain elevated well into 2011 and maybe beyond. Although some say Americans cannot continue to spend like they are, I would note that consumer credit is getting reduced each and every month and the savings rate near 5% is both healthy and normal. Final demand isn't growing at a robust rate to be sure, but it is growing and so is the economy. To the extent that it is only growing slowly and the dollar is strengthening, inflationary pressures are dissipating. If anything, inflationary pressures will lessen as the government withdraws both fiscal and monetary stimulus throughout the year.

But yesterday, the big focus wasn't on our economy, it was on Europe. More specifically, there were some who wanted to paint the European sovereign debt issue as having the potential to send the world back into recession. Most of the trader action centered on credit default swaps tied to the debt of Greece, Portugal, Spain, Ireland and even the U.K. and Italy. The game never seems to change. Take a seed of doubt. Place your bet via over-the-counter credit default swaps. Water that seed and fertilize it. Set panic in motion and then sell when panic crests. I am not trying to trivialize what is happening in Greece and other countries. The problems are serious enough to create a high level of angst. But it is hard at the moment to see the actual linkage from speculative trader and hedge fund gamesmanship into worldwide economic collapse. Greece isn't Lehman Brothers. Even though it may have a troubling balance sheet, it is a sovereign nation. It can print its own money. It is a member of the EU. The EU will have to force Greece's hand. Either Greece will acquire fiscal discipline with or without the support of major EU partners or it will be kicked out and left to swim or sink on its own. The former is much more likely than the latter. As far as the Germans are concerned, and they are the EU's 800 pound gorilla, a weak euro resulting from the current fears only helps Germany's export economy. Clearly, many of these southern European nations let themselves get into a bit of a mess during the run up in the 2-005-2008 period and failed to regain control on the way down. As a result, each will have to face the piper in its own way over the next few years. The comeuppance may nick European GDP growth by a point or two and international growth by a fraction of a percentage point. But on a practical basis, that is all the damage that one can rationally see right now.

What went on yesterday highlights once again the cancerous evils that can churn in the credit default swap marketplace. By late yesterday, credit default swap prices on Greek sovereign debt mirrored those of Lehman near the end of its life. But unlike the fall of 2008, when the financial markets were near meltdown, LIBOR spreads have barely budged. Indeed actual interest rates on debts of countries like Portugal and Spain remain modest. U.S. 10-year Treasury rates are still around 3.6%, not 2.1% as they were when Lehman collapsed. Indeed credit markets have barely moved all week. They are more focused on the U.S. Treasuries huge funding of over $80 billion in debt next week than they are on what is happening in Greece. But the credit default marketplace still resembles the Wild West. While some may use the market to buy insurance on sovereign debt they hold, others simply are making bets that panic will rise and they can profit. Indeed, speculative buyers are quick to spread any germ of news or half-news to fan the flames and perpetuate panic on their own. That is what happens when you make a bet on failure without any insurable interest. It is akin to buying life insurance on a feeble old man and then trying to agitate him to the point of heart attack. That is why you can't buy insurance on anyone without an insurable interest. If the same logic were applied to credit default swaps, the fears that spread yesterday would be muted.

However, there is another difference between Lehman and Greece. Big hedge funds literally could accelerate the downfall of Lehman by pulling money and prime trading away from the firm. They cannot directly affect the outcome of Greece's economic crisis. They can make bets and raise the angst. But they cannot force default. In the end, real world economics and political reality will rule.

Thus, combining what is happening in Europe with fear of all the unknowns that are natural as an economy lurches from recession to slow recovery is giving us an old-fashioned correction, one that could reach the 10% range before all is said and done. The S&P 500 got up to about 1150. A 10% correction would bring it to the 1035 range. I can't be that precise so I will put a wrapper on that range and say 1000-1050. True corrections generally bottom with some cathartic capitulation, a big one or two day move down on heavy volume that gets the last of the fence sitters to give up. It doesn't require a real catalyst although market reporters will always find one at the time. A 10% correction in the averages may mean drops of 20% or more in individual stocks. I think the only reason to expect more than that would be if one either expected a swift retracement into double dip recession territory or a sharp change in either interest rates or currency values. Right now, the economic data only suggests recovery. There are no leading indicators (except perhaps stock prices) pointing lower. Given the problems in Europe in particular, it is hard for me to expect a sharp near term correction in the dollar and I see no near inflationary or other source that would send long Treasury rates up to 5% or higher. Indeed, the best argument for sharply higher long term Treasury rates is an economy that grows much faster than expected. That would be a big surprise to me.

At some point, and probably all of a sudden, markets will stop going down on bad news and respond to good news. Usually a solid bull market correction ends like a bear market ends with high volume and capitulation. For investors who still remember 2008 vividly, fear comes easily. My sense today is that today's employment report won't improve the market's mood. Good news (anything with a plus sign) may create a bit of a relief rally but losses equal to or worse than December levels will set us up for another leg down. January employment numbers are always tough to guess and there is a big seasonal adjustment factor that distorts the number further. I don't think one month's numbers will change the overall economic picture of gradual improvement. A lot of companies either are starting to add people or on the cusp of beginning. Few are laying people off anymore except for seasonal reasons (e.g. retailers post-Christmas). I think the first quarter of 2010 has a chance to be the first that will see an increase in jobs in over two years. Stock market corrections like this one aren't very pleasant to endure but they tend to last for a relatively short period of time, perhaps a month or two. I noted Wednesday that the two day rally earlier this week took the defense off the field but yesterday's rout eradicates that notion. We need to see something stronger on the upside than a 70 point rally to change the mood. Thus, we will stay defensive for the moment but still believe the recovery that began in March 2009 remains in tact.

If one looks at all of 2010, I expect the market will perform at its best in the last quarter, mostly after the election. By then, a lot of the current economic question marks will be answered. The Fed will have begun to shrink its balance sheet and may have even begun to increase short term rates. Earnings should still be rising. Inflationary fears should remain subdued. The President's big budget busting agenda items should all be dead. Banks may have reached the point where lending resumes. Some companies will have begun to raise dividends anew. Unemployment should be below 10% and falling slowly. Housing could be at a well formed bottom. Maybe the election can add some hope if there are a lot of new faces in Washington. Until then, stocks are likely to behave erratically with a lot of mood swings but not much in the way of net gains or losses. Last year, there were so many unpredictable pieces to the puzzle that we ended up pleasantly surprised when more good pieces fell into place than anticipated. There were no colossal failures and far fewer meltdowns than we saw in 2008. This year, the roadmap is less confusing; good earnings, modest growth, very slow economic recovery, a Fed that will tighten a little as opportunities present themselves, little in the way of new legislation, and benign inflation. Much of that is already priced in. Probably what needs some correcting is inflated expectations for 2011. That process is probably already beginning. As it runs its course over the next few months, stocks will stabilize and be set for the next leg up. *If you divide bull markets into fourths, the second quarter is the toughest. It corrects some of the exuberance of the first quarter and provides the time to remove remaining doubts about the recovery. We are in that stage right now.*

Futures suggest a lower opening. That could be reversed if there is a very strong employment report later this morning but my guess is that the main focus of markets today will continue to be on Europe.

Today Henry Aaron is 76.

James M. Meyer, CFA 610-260-2220

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