

Boenning Morning Comment

This report is prepared for us by Tower Bridge Advisors

March 3, 2010

Stocks rose modestly yesterday as the recent three day rally started to run out of steam in the afternoon. There was no news to spark the selling but there was no sense that bears were about to regain control of the market either. Volume was light. Economic data was mixed. Car sales came in about as expected and, as noted, the numbers were so disrupted by weather and Toyota problems that it is hard to make any judgments on the data anyway.

This morning the ADP employment survey which most use as a forecast of Friday's big employment report showed a modest drop of about 20,000 jobs in February. On the surface, that may look surprisingly good given the weather issues this month. But there are two factors that must be considered. In the government data coming on Friday, if a worker missed work in the reference week due to weather, it will count as a job loss. In the ADP survey, as long as the worker remains on the payroll, there is no change. That could skew Friday's numbers in a negative direction by 100,000 or more. Second, the ADP survey excludes government workers. The government has begun to hire census workers. Those additions will be included in Friday's number. Thus, today's ADP report may vary by an unusual amount from the government numbers on Friday.

In some ways, the ADP numbers for February may offer a more accurate reading of the economy since they essentially eliminate a lot of the impact of harsh weather and a one-time jump in government employment related to the census. Weather does come into play particularly in the construction fields. A lot of snow cover and frozen ground clearly are disrupting business for more than a couple of days. But with that rather significant exception, the ADP data gives a pretty decent reading of where we are today.

And where we are is at a transition point moving in the direction of a slowly growing and recovering economy. Manufacturing employment is starting to turn positive but one can hardly label it robust. Many jobs lost in the past two years are not going to be recovered any time soon. Service jobs are also back in positive territory. Here the picture is a bit brighter. On the other hand, construction is absolutely anemic, even adjusted for weather. This is still not an economy that is creating enough new jobs to absorb fully growth in employment. The number of Americans who have simply given up looking for work is huge and it is going to be an economic drag for some time.

While this isn't entirely pleasant news, nothing I have just said is really a whole lot different than the path out of any post-war recession. American has been ceding jobs to low-cost overseas facilities for decades. Clearly parts of our economy, notably in the financial sector, suffered more this time around but eventually recovery will heal and restore most of the damage. Recessions are created by economic imbalances. Most recessions have been caused by an imbalance of supply and demand for goods and services. This past one was caused by an imbalance of financial assets and debt worldwide. Excess leverage and imprudent lending were the villains, not excess supply or too much demand.

The patterns of decline and recovery don't always change all that much but no two cycles are exactly the same. This time around, as recovery gets under way, there are two big unknowns that cloud the recovery. First and foremost, for the first time since the Great Depression, a recovery is emerging against a backdrop of falling real estate prices. Since home values are at the core of most personal balance sheets, it is hard to judge how Americans will react with

an economy primed for recovery if they continue to feel that their homes are (a) worth less and (b) whatever value is there can't be realized fully due to illiquidity in the credit markets. There are still millions of mortgage loans under water and millions more that are delinquent or will soon be delinquent as option ARMs reach a point in time where interest rates reset significantly higher. Second, our nation has never exited a recession with so much debt on the books. Although individuals and corporations have done a good job of resetting expense levels to live within their means and reduce debt loads, governments of developed nations have borrowed heavily to mitigate the impact of the recession. Today, you see the results in Greece. Whether there is a significant domino effect or not remains to be seen but clearly Greece isn't the only nation in economic jeopardy. At a minimum, huge debt burdens not only at the sovereign level but also at state and local levels are going to limit options going forward at a minimum.

I wish I could tell you how this is all going to play out. But I can't and I don't think anyone really can. We can all guess but no one has been here before. The real key is the housing market. More specifically, the key is housing values. A lot has been written about the state of credit markets, derivatives, CDOs, and securitizations. The reality is that some segments of the market have been restored to health. Thanks to TALF and just general market forces, there is a market once again for securitized credit card and auto loans. So why isn't there a market for securitized mortgages? Because within fairly narrow ranges we can accurately estimate the value of credit card receivables and auto loans. There isn't a lot of mystery about auto resale values. In a recovering economy, one can gauge the haircut needed for credit card receivables. But no one has any real confidence what real estate values might be 1-2 years down the road much less 7-15 years from now. At the moment there are a lot of signs that real estate values are trying to find a bottom. But that presupposes that the market doesn't get overwhelmed once again by a new round of foreclosures.

Make no bones about it. Declining real estate values and too much debt were the root causes of the last recession. The entire premise of mortgage financing is that the down payment provides a sufficient cushion to the mortgage lender to guarantee the safety of his loan. A 20% down payment isn't enough if the home declines 30% in value. If a home owner puts down only 5% and the home drops 25% in value, the home owner loses 5% of the value of the home (his entire equity) and the lender loses 20%. In dollars the lender loses 4 times as much.

Once burned, twice shy. No bank wants to put a home mortgage on its books until it gains enough confidence in the value of the underlying collateral. We can spend all the time we want to on job creation, health care legislation or Greece but the key to whether our economy regains solid footing or not all depends on whether home prices have bottomed or not.

So far, there is no evidence suggesting another leg down is upon us. But government programs to resolve the mortgage mess have been mostly ineffective and banks continue to kick the can down the road unwilling to accept any loss in principal as part of mortgage restructuring. The problem hasn't gone away.

If the resolution can be stretched out such that the number of new foreclosures can be absorbed by normal and existing demand, the economy will eventually heal. Normal housing starts are between 1.5 and 1.8 million. They are now about a third of that. The gap is being filled by new foreclosures and existing unsold and empty homes. Housing starts can't go any lower. If the pace of mortgage foreclosures accelerates, the result will be too much supply and another round of price cuts.

Over the next year or so, this issue should be resolved. By resolution, I don't mean that all the underwater mortgages will suddenly be in the black. But if home prices can stabilize and lenders can begin to trust the value of underlying collateral, they will lend again. The market for securitizations can reopen. The market won't have to be 100%

reliant on Fannie Mae, Freddie Mac, and Federal subsidies. That might be the most logical path. It certainly is the most hopeful one. But if homeowners underwater begin to walk away or foreclosures accelerate unabated for other reasons, then the fears of double dip recession will become real. Any one of us can place odds on whatever outcome you choose but (1) we are in uncharted waters and (2) government efforts to stabilize the housing and mortgage markets so far have been largely ineffective.

Thus, I and other investors will continue to celebrate a recovering economy on a path to record earnings. I will watch Greece and monthly employment reports with interest but my radar that is always searching for the next big problem is going to be glued on housing.

Futures suggest a fairly flat opening.

Today Jessica Biel is 28. Folk singing legend Doc Watson is 87.

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