

Boenning Morning Comment

This report is prepared for us by Tower Bridge Advisors

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Stocks staged a modest rally yesterday although many companies that reported earnings before the session began lagged. For them, it was a return to the days of “buy the rumor, sell the news”. In some cases stocks of earnings reporting companies rose in the morning and quickly gave ground. Others were down right from the opening. But there was no contagion to the rest of the market. Goldman Sachs (GS-\$160) was one of those companies reporting excellent results. But the overhang of regulatory reform sent its stock price lower once again. Earnings will be an important factor again today. Apple (AAPL-\$245#*) had outstanding numbers after the close yesterday. Four Dow components have reported this morning. Three of the four look to open higher with United Technologies (UTX-\$73#) being the exception. We’ll see how they close this afternoon to discover what is already baked into stock prices and what isn’t. If yesterday is a guide, look for some profit taking among the reporting companies.

Given that the Senate is hoping to vote on regulatory reform within days, I want to revisit it this morning. The Goldman Sachs news surprisingly seems to be having little or no impact on either the direction of the legislation or the likely vote outcome. Although the public is clearly outraged and the media can talk of nothing else except Goldman and an erupting volcano whose name no one can pronounce, Senators rightfully are not going to be swayed by one isolated accusation of wrong doing whether it proves to be true or not.

With that said, let me review and comment on some of the provisions. Let me begin and suggest that there are a lot of new regulatory structures and political appointments that will be made as a result of this bill if it passes. Anyone looking backwards can see that many existing agencies, including OFHEO (responsible for overseeing Fannie Mae and Freddie Mac), the SEC (responsible for overseeing Bear Stearns, Lehman Brothers and the other brokers), and the Federal Reserve/Office Comptroller of the Currency (responsible for the banks) all failed to prevent disaster. AIG’s credit default swap unit seemed to be out of everyone’s jurisdiction and there hasn’t been any national oversight entity to regulate insurance companies. So to believe that a larger regulatory infrastructure per se is going to avoid future catastrophe flies in the face of history.

The big regulatory creation of the Senate bill is the Financial Stability Oversight Council (FSOC). It will be comprised of nine members and chaired by the Treasury Secretary. It will include heads of various agencies including the Federal Reserve, the FDIC and the SEC. It will have the task of designating which institutions are too big to fail (the bill calls them systemically important institutions) and can force the breakup of said institutions in concert with the Fed. Institutions deemed to fall in this category will have to develop living wills, plans to help dictate their orderly demise if insolvency threatens. The FDIC will supervise the orderly (?) liquidation. Note that the FDIC has never handled the liquidation of a large investment bank or insurance company. It is unlikely to be as vanilla as placing a deposit base with a healthy institution and working off the remaining assets over time.

One of the sticking points of the bill to date has been the attempt to create a pool of \$50 billion to fund the orderly dismantling of one or more of these large institutions. Proponents claim the pool will insure no taxpayer money is used to unravel a failed large financial institution. Opponents claim this fund is a tax on the

industry, big and small, that will provide a safety net to a handful of banks. The net result would be to actually promote risk-taking and create an unlevel playing field between big and small banks. There are merits to both sides. One of the big issues is that the decision to trigger government action is going to be subjective and, because the members of FSOC are mostly politically appointed, the decision may be highly politicized. Alternatively, there are market measures and mechanisms that could be used to trigger preemptive action such as the use of maximum leverage ratios or the size of credit spreads between the debt of any institution and Treasury debt. In my head, a rule based system might be a more effective early warning tool than a politically influenced subjective judgment. It certainly would have worked much better over the last five years.

Look at OFHEO, created by Congress with the sole task of overseeing Fannie Mae and Freddie Mac. It totally failed in its task even with countless warnings from the Fed, from members of Congress, and from almost everywhere in the private sector including recurring missives from the editors of The Wall Street Journal. Indeed, neither company was able to produce GAAP accounting statements for years before their collapse. Yet they were still allowed to increase both leverage and their risk profiles. All the regulators in the world won't solve any problem without enforceable regulatory rules with real teeth.

I won't review the portion of the bill that deals with consumer protection because it has minimal stock market implications. Obviously, consumer protection is important but there are already plenty of rules in place. If you didn't notice, read the next small printed message you receive from your credit card company. E-mail me if you read it from start to finish. I will live a very confident life that I won't hear from anyone.

Another important aspect of the bill is the so-called Volcker rule which sets the framework for restricting some proprietary trading at bank holding companies. Those rules should be set within 15 months and would apply to the largest bank holding companies. Clearly those that are investment bank oriented (e.g. Goldman Sachs) would be most impacted. The essence of the provision is to separate true market making activities from being allowed to bet the house's money. It is the intent of this provision to ban the latter.

The bill also proposes that packagers of asset-backed securities such as residential mortgage pools, auto loans, or commercial real estate loans, retain 5% of the credit risk. Bravo!

Central clearing would be required for most derivatives. There is some today but there will be much more if the bill becomes law. Bravo again. Today, no one has any idea what the total notational value of credit default swaps even is. Those cleared through DTCC total more than \$22 trillion (about 1.5 times the U.S. GDP and almost twice our national debt) but the actual number could be 50% higher or even more.

Under the new bill, credit rating agencies could be subject to private lawsuits if they act recklessly. You won't find many opponents to that conclusion.

There are other provisions but these are the key ones, at least in my view. Most members of the Senate on both sides of the aisle support a majority of what is in this bill. The key sticking points surround how to dismantle those large financial institutions that pose serious systemic risk in the most efficient manner. The Democrats want to impose an infrastructure; the Republicans want market forces to dictate the action. Wall Street wants to retain proprietary trading without limits but there will be a lot of populist pressure to erect some limits. There seems to be a sense within Congress that limiting a bank's ability to gamble its own equity on the prop desk makes sense but there needs to be careful wordsmithing to separate what is market making, what is hedging, and what is speculation. My guess is that there will be some compromises that lead to the passage of a bill

because it isn't in anyone's economic or political interest for nothing to happen. There is a high likelihood that the \$50 billion bank-funded kitty for failing institutions won't make it into final law. As we learned last September and October, too much structure, however well intended, may hinder crisis management at a time when time is of the essence.

I don't think this bill will prevent the next bank crisis because history shows that regulators simply are too cautious, too slow and, in some cases, too incapable to react quickly enough. Actions that could have been taken in 2005-2007 weren't. By 2008 it was too late. But what this bill will do is slow down the crazed explosion of unregulated and unsupervised derivatives. To argue, as some do, that the explosion in derivatives had nothing to do with the financial crisis we just went through is foolish revisionist history.

It would be nice if good legislation passes. Bad legislation is often worse than no legislation at all. If Congress can get the procedures for dismantling failing institutions semi-correct, it will be a net plus.

With that in mind, let me point out a very distinct contrast in the way Washington has worked to rescue the nation from financial calamity. I want to name 12 institutions broken down into two pots of six each. The first pot contains Goldman Sachs, Morgan Stanley, Bank of America, Citigroup, Wells Fargo and JPMorgan Chase. The other six are GMAC, General Motors, Chrysler, AIG, Fannie Mae and Freddie Mac. All 12 received Federal Funds that saved them from imminent failure.

The first six received TARP money, have largely repaid it, and are now all profitable once again. The rescue of these six didn't result in any cost to taxpayers. In fact, the government made billions on its investment.

The second six collectively are all still in dire straits. GM may see a path to salvation but the others are all in a mess. Several still require cash infusions and only GM offers any hope of repaying the government in full.

The first six celebrated by paying its executives and employees galling sums of bonus money thereby infuriating the general public. To them, living up to their end of the TARP contract and repaying their debt with interest was sufficient. Money was more important than image.

The second six operate under the rules of Ken Feinberg, pay czar. Employees are generally unhappy campers. But the public is appeased that they aren't being taken for a ride.

The first six never ceded management control as part of the TARP payments. Managements were left in tact to execute the turnaround albeit with some oversight from Treasury and the Fed. Those turnarounds largely succeeded.

The second six all have seen a revolving door at top management. Some were fired; some quit. Only GM is stable today.

The government never owned a majority interest in the first six.

The government has majority control in the second six without any firm game plan for an exit strategy with the possible exception of GM.

The moral of the story is that capitalism seems to work far better from a financial perspective than public ownership. Maybe the problems at the first six were less severe. But I am not sure that is universally true. The public may hate the first six for their avarice and greed but they are paying heavily for the mismanagement of the second six. Capitalism requires some oversight. But too much may be worse than too little. That is the dilemma the writers of the Financial Reform legislation face today. In the end, Goldman Sachs will provide more value-added to America than AIG. Ford, without government assistance of any kind, will provide more economic value than Chrysler. Fannie Mae and Freddie Mac need to be dismantled completely.

Futures point to a fairly flat opening.

Today, Tony Danza is 59. England's Queen Elizabeth is 84.

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