Boenning Morning Comment

This report is prepared for us by Tower Bridge Advisors April 5, 2010

Stock markets were closed on Friday on a day when the Labor Department reported that March saw job growth of 162,000 jobs, the best single month in almost three years. But the numbers were fairly consistent with expectations and included the addition of over 40,000 temporary census workers and a rebound from storm related job losses in February. Still, the three month average for the first quarter showed job growth averaging about 54,000 per month. That isn't a big number on a sustained basis but it looks beautiful compared the numbers in the first quarter a year ago.

There are some analysts and economists who will try and twist Friday's data into a negative story. Some will make the point that 162,000 new jobs a month is too low a number for a sustainable recovery. Some will harp on the one time factors I just mentioned. Some will point to the impact higher job growth has on inflation expectations and interest rates. Some will note that the unemployment rate was unchanged at 9.7%. All have some merit or, better said, are partial truths. But the baseline fact is that the more jobs created in this economy, the better off we will all be. Period. Job growth doesn't mean higher inflation when the unemployment rate is 9.7%. The unemployment rate stayed where it was because more people were out looking for jobs, a signal of hope, not despair.

Thus, the bottom line from Friday's report is a positive. Combined with the strong auto sales numbers reported on Thursday and the very strong ISM manufacturing report and it is clear that the economy is making a decent comeback. Now the key question ahead is the following:

Can solid economic growth continue if small and medium sized banks remain reluctant lenders, when Washington starts to remove fiscal and monetary stimulus, and in a year (2011) when tax rates on higher income families spike upwards significantly?

The answer is an unqualified maybe.

Let me address each one at a time. The past recession was a financial one and banks were hit especially hard. So it shouldn't be a surprise to anyone that banks are even more reluctant to lend than they normally are at this point in a recovery. Many still are heavily exposed to real estate loans and they remain a serious concern. But time always proves to be a remarkable healer and, over time, banks will begin to lend again. It may take a little longer this time around, but the direction is set. There are already signs of improvement. Jumbo mortgage loans are being made once again. There is plenty of money to fund mergers and acquisitions. But at the moment small companies, even the good ones, are having difficulty getting capital for expansion and that is the basis for solid job creation. So while I expect a jobs recovery, it is likely to be less than normal at least until bank lending gets back to normal.

Clearly, Washington is getting to the point where stimulus has to be withdrawn. The Fed has already raised the discount rate once and there are rumors it may do so again as early as today. The Fed has stopped buying mortgage backed securities in the open market. Money supply growth is almost flat at the moment. Ultimately it will start raising interest rates. As for the fiscal side of the equation, the main fuel generated by the stimulus package passed last year will wane this year. There is no appetite for an encore with Congress facing a $1+ trillion deficit. It is a

normal and obvious process for stimulus to be withdrawn as an economy recovers. Given the severity of the recent recession, it would seem obvious that the Federal Reserve would take special care to ensure that stimulus is withdrawn carefully. Some may argue that waiting too long will seed a new wave of inflation. That's true. But while some fear those seeds have already been planted, there is little evidence to date of any inflation beyond the commodity level and commodity inflation is only evident so far in oil and some metals. It is even dubious whether that relates to normal supply and demand factors or financial speculation.

As for taxes, that is my biggest concern. Right now it appears that the top bracket rises to 39.6% next year from 35%, that capital gains are headed for 20% or more, that certain payroll taxes are going up, that states and local governments are increasing taxes wherever possible, and that taxes on dividends are going from 15% to a minimum of 20% and a maximum of 29.6%. Then there is the estate tax which will go from zero to something between 40% and 55% for people with estates as low as $1 million. While President Obama is trying to keep taxes down for families making less than $250,000, there are some tax increases affecting everyone and the higher income families are often the one who create or operate small businesses. Rising tax burdens will limit their ability to grow. One of the cardinal rules of economics is the regressive economic impact of higher taxes.

We face record tax increases next year early in an economic recovery. Will the economy stall as a result? I suspect that growth will stall, but it won't cease. I am hopeful that a more rational tax structure for dividends and estates than is on the books for 2011 at the moment will be passed by Congress. But this Congress has been woefully ineffective so nothing can be taken with any certainty. I also think that Washington will get a revenue windfall over the next twelve months giving it some slack to provide additional economic support if needed. The windfall will come from higher tax rates, record corporate profits, rising personal income and the likelihood that investors will cash in some capital gains this year before the rates rise in 2011. If there is one bet I would be willing to place it is that the deficit in 2011 will be less than anyone is forecasting today. Note that bet is for 2011 only.

The bottom line is that the economic data right now are as good as it gets. It may continue at current levels for another several months but then the headwinds start to kick in. My guess is that stocks will react accordingly remaining on a high for a bit longer and then struggle sideways until tax issues are resolved, investors get a better handle on inflationary trends, and monetary stimulus begins to get withdrawn. Normally, investors react instinctively in a negative fashion to the first interest rate increases. I suspect this time will be no different. But, as I say rather repetitiously, bringing rates back to normal isn't the same as monetary tightening intended to slow a runaway economy down. I think the economic benefits of raising short term rates to 2-3% vastly outweigh the negatives. In time that will be reflected in stock prices. But the next 1,000 points in the Dow will be a lot tougher than the last 1,000. I am not getting bearish. I think the economy is moving in the right direction and problems are getting smaller, not larger. But the rate of forward progress is going to slow later this year and more markedly in 2011. Together with rising interest rates, that will limit the rate of appreciation in stock prices. Good dividend paying stocks that can perform well in a slow growth economy are probably a great place to be.

Futures suggest a higher opening courtesy of Friday's employment report.

Today Colin Powell is 73.

James M. Meyer, CFA 610-260-2220

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