

## Boenning Morning Comment

*This report is prepared for us by Tower Bridge Advisors*

May 10, 2010

The EU acted over the weekend and the market has already reacted overseas staging a sharp rally. On Friday, stocks continued to fall in a very active and volatile session. What surprised me the most was the finish as the market tailed off modestly in the late afternoon. I would have expected a rally into the close on the premise that traders would cover short positions going into the weekend not wanting to make a big bet on what steps politicians might take to stem the European sovereign debt meltdown. Clearly, they let their negative bet stand.

Late last night, the EU members reached a final accord on a total package of about \$1 trillion aid to support the liquidity needs of some of its member states. The package serves to buy time more than acts as any solution but allowing 2-3 years to do the appropriate restructuring seems a lot more practical than being forced to do it overnight at the mercy of bond vigilantes armed with synthetic CDOs and credit default swaps. Markets have responded quickly and positively to the move. As I noted last week, the EU either had to act boldly to stem the attacks on sovereign debt via credit default swaps or it risked running down the path of dissolution. Markets overseas are up 4%+ and U.S. futures are up by similar amounts. The steepness of the rally is a clear indication that traders ended last week on the wrong side of the trade and have to scramble and cover short bets this morning.

Don't be deceived by trading action. That includes both late last week and this morning. What is going on in Southern Europe is significant. It is a game changer for the specific countries at the center of the storm but it is also a game changer for any country with significant debt or deficits. What has been happening in recent weeks is a clear and unequivocal message that no country can carry too much debt without subsequent adversity. Greece is the poster child and remains in an unsustainable position even as the EU support gives it some time to attempt to resolve its issues. With that said, it remains highly likely that Greece will have to undertake some formal debt restructuring before all is said and done. Will any other country have to do the same? The support package announced last night gives countries like Portugal or Ireland more time to work out of their particular problems. But, as noted above, the rescue package doesn't solve any problems. Only direct action to reduce debt and live within one's means will do the trick.

The financial chaos in Europe clearly demonstrates how heterogeneous the economic picture is across the member nations of the EU. It isn't just balance sheets or debt ratios. Germany's unit labor costs are much lower than those of Greece or Spain. As part of the EU, countries like Spain or Greece have been able to take advantage of Germany's low cost of capital (which gets translated into low cost of capital for the ECB) to borrow cheaply. Unfortunately, that has fed the excesses that now serve to penalize the Southern European nations.

The message of the market isn't aimed entirely at Europe. The U.S. for decades has paid little attention to debt or deficit levels. Indeed, it is a bit ironic that as we move to a political and economic model with higher government revenues and services, the pressing costs of socialism are causing pressures in Europe to cut services and pull back from government centric activities. While members of Congress will cry out for reductions in domestic discretionary spending as a path to reducing our burgeoning debt, that will barely make a dent. The three causes of our huge and continuing deficits and rising debt, in order, are an overwhelming imbalance between income and expenses of our entitlement programs, rising interest costs to cover the cost of our escalating debt, and defense spending. Without a

massive realignment of the economics of our entitlement programs, there can be no resolution to U.S. sovereign debt concerns. And unless they are addressed, it is only a question of when, not if, the U.S. faces the same grim reaper than Southern Europe faces today. It isn't a 2010 problem or even a 2011 problem but market forces move very rapidly as we learned in recent weeks and Washington can only kick the can down the road for so long risk-free.

Today, the heads of NASDAQ and the New York Stock Exchange are scheduled to meet with the SEC to try and explain what happened last Thursday. The details of what triggered the sudden drop and recovery are less important than the fact that (1) computers took the market hostage for some period of time, (2) there was no regulatory authority capable of stepping in and either stopping it or slowing it down, and (3) without proper reporting requirements we don't even know after the fact what happened, who won, and who lost. Computers are only as smart as the people who program them. There is no such thing as perfect software. Computers appear smart because they can process data at incredible speed. But if they process data incorrectly, they are capable of making mistakes at incredible speeds. Without some oversight framework, you get what we saw last Thursday. Software fixes will repair one set of problems but won't prevent others from happening. When events go awry, humans have to be able to step in and slow things down.

I don't want to spend too long on this topic but I want to repeat one key notion. Volume and liquidity are not synonyms. If high volume trading does anything, it reduces liquidity. Liquidity relates more to the number of market participants than the size. Today, a substantial percentage of market trading is done by less than two dozen participants. That is far different than it was historically. When these small number of traders lean heavily in one direction, you get sudden and violent moves. Lest I use this point to explain down markets, it will also show itself this morning on the upside. There are times when markets under any circumstance will rise or fall sharply even with lots of participants. But the impact of high frequency or black box trading has been to chase small investors away. They provide breadth and liquidity. Almost every regulatory step taken in recent years has been in favor of facilitating high volume trading as opposed to protecting the needs of small investors. The results are obvious. High volume trading has increased and small investors have headed for the hills.

Where do markets go from here? I think markets are transitioning from the early phase of a bull market when skies are clear, problems are fading and there are not new problems surfacing to a phase where there are an increasing number of clouds likely to appear. The European debt crisis is just one potential rain maker. It seems to be in the process of passing without much damage but over the next several months we face higher taxes, the likelihood that the Fed will begin to raise interest rates, a mid-course economic correction in China, weakened governments in the U.K. and Germany, and the impact of our own mid-term elections. On the positive side earnings continue to increase, housing appears to be near a bottom and employment is starting to improve. Overall, fundamentals should continue to drive markets forward but any of the potential speed bumps mentioned will slow down the rate of forward progress. The net result is that stocks should begin to advance more in line with historic norms than they have done over the past 14 months and I would use today's close as the base, not Friday's.

As noted, futures are up sharply. Stocks could reverse a good part of last week's losses quickly. But there will be some repercussions. European growth is likely to slow. The euro is likely to remain weak (after today's sharp rally). Pressure will remain on commodity prices and gold should remain strong until nations collectively repair their balance sheets.

Today Paul Hewson, better know as Bono, turns 50.

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Additional information is available upon request.

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