

Boenning Morning Comment

This report is prepared for us by Tower Bridge Advisors

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Another day, another triple digit decline. Over the past three weeks, 75% of the trading sessions have ended with a triple digit gain or loss. Volatility and angst have grown, but so far, there hasn't been a real crescendo, suggesting that while a temporary bottom may be near, it isn't here yet. We have seen these declines within bull markets many times. They are scary and purge weaker players from the market. To an extent, that is healthy. On the other hand, they tend to happen later in bull markets, not at the beginning. Needless to say, everyone is focused on the negatives and, unfortunately, there are suddenly a lot negatives to focus on. There is European sovereign debt, a Chinese economic bubble, a collapsing euro, falling commodity prices and what promises to be a very onerous financial reform package. Add in a German ban on naked short selling and pending SEC "circuit breakers" intended to prevent another May 6 thousand point crash and you have the seeds for a lot of nervousness.

The headline story has changed a bit over the past few sessions. The declining euro continues to be a primary negative catalyst. Greece has met its near term debt payment needs and bond yields of key European nations are stabilizing. For that matter, European stock markets have begun to act a bit better than ours although they were spooked overnight by the German ban on naked short selling. China is another problem out there that while serious doesn't seem to be becoming more inflammatory. I think it is very obvious, just from the law of large numbers, that China cannot grow at 10%+ forever. Moreover, it is quite obvious that China has overbuilt parts of its economy and real estate prices are set for a fall. But the Chinese don't borrow 80-100% of the price to buy a home. 0-60% is the norm. Moreover, both commercial banks and the Chinese central bank are well capitalized. That suggests that while sharp price drops may hurt homeowners and speculators, they aren't likely to turn an economy growing 10%+ per year into a recession.

As some problems fade, others become more important. One is financial reform. The legislation making its way through the Senate right now is intended to reduce the future risk exposure of financial institutions, dramatically increase regulation, and, to some extent, pushing the banks and investment banks for past wrongdoing. But there are many moving parts not yet in place and what are intended to be safeguards may end up raising the cost of doing business. Both the Senate and House bills are going to be quite different. Therefore, we can only guess at the final structure. With that said, there are some distressing components and some good features. Attempts to increase reporting requirements for derivatives and push trading of standardized products onto exchanges are good features. Steps to separate true banking from risk taking and certain forms of proprietary trading are admirable but the devil will be in the details. Attempts to control credit card and debit card pricing will almost certainly have unintended consequences. The end results will be less credit available for those who need it the most. Banning swap desks at banks makes little sense.

I don't want the market's action to force me to be too negative but I am concerned how 2011 is setting up. Taxes are due to rise sharply. Even if Congress enacts new tax legislation between now and the end of the year, taxes for most are headed higher next year and beyond. I will get back to that in a moment. Health insurance rates are rising sharply, an intended or unintended consequence of health insurance reform legislation. Insurers are implementing increases of 20% or more to cover costs they must bear under the new law. Companies will respond by providing smaller benefit

packages, increasing deductibles and hiring fewer new workers. Financial reform could lower bank earnings power by 20% or more for money center banks or 5-10% for regional banks. It will almost certainly stifle loan growth. Banks will respond by either laying people off or hiring less. It isn't rocket science.

Exports are also going to be impacted by what is going on in Europe and a weakening euro. The most likely economic path in Europe is for countries to focus on fiscal policies that are more conservative. Nations will work to move in the direction of balanced budgets. Some nations, like Greece, may be too far gone and will ultimately have to restructure debt. There may be others but right now the paranoia that suggested that everyone from the U.K. to Italy would have to restructure almost immediately has died down a bit. In order to escape from the choke hold of high debt and deficits, the best medicine is growth. For Europe the best path to growth will be via a weak euro. That isn't a long term solution but it will stimulate exports and lower imports. Since the world is somewhat of a zero sum game, if trade flows in the direction of weak currencies, it is logical that U.S. exports to Europe will decline and U.S. imports will expand. What we import from Europe may come at the expense of other trading partners like Japan. The net effect is a modest moderation of future U.S. growth. By itself, it won't stop our recovery but add it onto the headwinds of higher taxes, higher fringe costs, and higher regulatory burdens and it is likely that U.S. growth in 2011 will be less than in 2010. Not negative, just less. That probably means that earnings per share estimates for next year are getting too high and need a downward adjustment.

I want to switch gears and talk of the SEC's proposed steps announced last night to prevent a repeat of the May 6 "flash crash" that sent stocks down more than 700 points in minutes. While they may prevent the absurdity of sending stock prices to pennies per share, they don't get to the root of the problem, namely market illiquidity caused by an explosion of high-frequency trading. Indeed, I think the risks are extremely high that markets could become much more volatile than they have been lately. My conclusion is both conceptual and simple. There may be as many as 100 high-frequency trading firms. These firms together account for roughly two-thirds of all trading. They all operate in similar fashion. Very smart mathematicians program very fast computers to spot trading patterns that history suggests shift the odds in their favor. It is very similar to card counting in black jack. Indeed, early fast-traders were former card counters. The computers produce orders to trade millions and millions of shares according to the programmed algorithms making pennies at a time often in the matter of seconds. In balanced markets, you only notice their influence via the high volume. But in volatile times, given that many of these black boxes are chasing similar patterns, the trading can get very one-sided and cause violent swings in stock prices. May 6 was an extreme but only time will tell if it proves to be an exception.

Unchecked, high-frequency trading and variants thereof are destined to account for an ever greater percentage of future volume. Because size and capital matter, there is also likely to be a greater concentration of large traders. It is hard to see how this won't lead to ever greater volatility.

It is important to note that:

1. High-frequency traders add volume and volatility. They subtract liquidity. I repeat, they subtract liquidity as one big trader supplants thousands of smaller ones.
2. High-frequency trading or any variant provides no societal economic value. To the extent that they raise volatility without raising total return, they add both risks and cost to the market.

What can be done? Anything that levels the playing field. Anything that broadens the number of participating investors. The SEC needs to understand who it represents. It represents the public and it represents the United States

financial markets, markets that are designed to be the most efficient forum to raise and distribute capital. Anything that prevents that from happening efficiently is suspect. It is that simple.

Finally, I can't close without talking politics. The obvious message last night was simple. Americans said no to the way Washington is being run today. It didn't make a pro-Republican or pro-Democratic statement. It said no to status quo. Voters went left in Pennsylvania and right in Kentucky. Two incumbents have already lost primary battles in the Senate for the first time in 30 years and more might fall. But don't think that we are headed for reconciliation. That is in doubt. Democrats are nominating liberal candidates and Republicans are nominating very conservative candidates. You will be able to drive a monster truck through the middle. But the American public does not want the next Congress to simply yell and scream at each other across a widening aisle. That's why incumbents are losing today. Somehow, a middle ground needs to be found, not on all issues, but on some.

For the President, however, his free ride is just about over. He got health insurance reform and will almost certainly get some form of financial reform passed. Elena Kagen is likely to become the next Supreme Court Justice. Then he faces some hard choices. What is he going to do about taxes? Doing nothing adds 6 million lower middle class Americans to the tax rolls. He certainly doesn't want to do that. Capital gains goes to 20% and dividends to as much as 39.6%. Estate taxes go from zero to 55%. All these need fixing. He is running out of time before mid-term elections but there is a lot of doubt whether a lame duck session will do anything, particularly if the complexion of Congress is going to change a lot next January. He has some tough choices to make.

As for the market, the world simply hasn't gone from hopeful to rotten overnight. Hewlett-Packard (HPQ-\$46#) reported good earnings overnight and said Europe is fine and shows no signs of weakness. China is great. Markets have a way of forecasting recessions that never happen. My best guess is that we are in for a rally soon, probably a pretty healthy one. The month before earnings season has been a good one for the last several quarters. I think a move back in the direction of early April highs is a reasonable expectation. If I am right, we will have a chance to reflect on the economic outlook then and decide whether onward and upward is the path of least resistance or whether all the clouds we have been talking about are about to produce some rain.

Futures suggest a weak opening but they are well off their overnight lows.

Today Grace Jones is 58. Whatever happened to her? Peter Townshend is 65. He's still active. Nora Ephron is 69.

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