

Boenning Morning Comment

This report is prepared for us by Tower Bridge Advisors

May 21, 2010

The only word to describe yesterday's trading session is ugly. Stocks fell big and acted the worst near the close. About the only positive one can add about the technicals affecting the market is that everyone is suddenly bearish and when everyone is on the same side of the trade, it's a set up for a sharp move in the opposite direction. But it's a Friday and options expiration day. Traders must decide whether to keep negative bets on through what will be a three day weekend in much of Europe. At best, expect another very active and volatile session.

Let's start this morning and try and put into some perspective what has been happening over the past three weeks or so. Investors decided that some weaker European nations, notably Greece, had pushed their fiscal and monetary envelopes too far and no longer wanted to invest there. Interest rates on Greek debt got so high that no one would buy its debt creating both a liquidity and solvency crisis that could spread across Europe and from there across the globe. The EU responded with a package of loans and guarantees that appears to insure Greece's liquidity in the short run. Indeed, Greece received its first package this week that allowed it to roll over some of its borrowings.

But quickly investors began to have doubts once again. The loan package bought time but by itself didn't solve any problems. Sentiment against the package spreading across Europe suggests doubt that the amalgamation of 20+ nations that calls itself the European Union (EU) can hold together and continue to support a nation or nations that if independent would collapse and be forced into a state of austerity and debt restructuring. The concerns have demonstrated themselves in the financial markets in a variety of ways including falling stocks prices, falling commodity prices, a drop in the value of the euro and a flight to quality which generally means gold, cash and bonds of nations deemed most secure.

One small nation, Greece, clearly cannot bring down world economies but Greece is just one example of a larger problem, namely a world structure of too much debt and fiscal policies that cause many major nations to spend well beyond their means.

There have been reactions. Spain is cutting wages and taking other austerity measures. Ireland has taken many rather bold steps. France talks of a freeze on spending. These will be followed by others. The message of the market is that these are necessary steps that are likely to alter the economic outlook and perhaps send some countries back into recession. It is also increasingly likely that the United States will be more than marginally affected in two ways. First, any major slowdown in Europe will impact us as a key trading partner. Second, the United States isn't going to be immune from the same belt tightening. Current budget and economic projections suggest our debt could rise to \$20 trillion by the end of this decade. The markets aren't going to let that happen. Not only will we have to find ways to pay for any new programs, we are going to have to finally come to grips with our escalating entitlements deficit.

It may be worth taking another look back to September 2008 when in short order, Lehman Brothers collapsed and the U.S. effectively took over Fannie Mae, Freddie Mac and AIG. Markets briefly spiked when the Fed and Treasury talked of a massive liquidity solution but stocks then collapsed until TARP could be passed and implemented. Just to jog your memory, Congress failed to pass TARP on its first attempt and stocks fell almost 10% between that point in

time and final passage. My key point is that the passage of TARP proved to be the beginning of aggressive action by the government to fix what at the time was the underlying problem, namely the ability of our financial system to survive. TARP wasn't the only step taken. The Fed guaranteed all deposits up to \$250,000 and set up structures to protect money market funds and the commercial paper market. Within a month, the bond markets bottomed. Stocks didn't bottom for several more months as it took that long for banks to begin to raise capital that ensured survival and stress tests demonstrated that the banking system as we knew it could survive nationalization.

In other words, Paulson and Bernanke came up with a plan that settled markets. Europe, or for that matter any other country, hasn't done that yet. TARP took \$700 billion in hard capital and used it to backstop key financial institutions in the U.S. Europe essentially is now in a position where it will have to do the same thing. It is inevitable that Greece at some point will have to restructure its debt. Other nations might escape but they will still have to undergo austerity measures. Austerity isn't a solution; it is part of a solution. Austerity reins in costs but it can also can revenues to fall even faster if recessions ensue. Thus, the right package would be an exhibition of fiscal prudence on the part of certain nations coupled with EU liquidity support via some form of quantitative easing. But instead of moving forward in a unified fashion, European leaders and nations are trying to attack the problem in different ways. Germany is pushing loans and guarantees that few want to support. It wants to impose trading rules in financial markets unilaterally, something that was destined to fail from the start.

It remains unclear whether European nations can act boldly in a unified fashion. Certainly, they can make brief stabs at the problem in ways deemed to be least costly such as through the loan guarantee package. But as tentative efforts hit market disapproval, the unity quickly dissolves.

The longer the problem continues, the worse the economic outlook across the globe becomes. What we all must fear is a freezing up of financial markets similar to September and October 2008. So far, we aren't there but the widening of Libor spreads and the slowing of monetary velocity certainly raise fears that the situation can get out of hand quickly.

This all seems pretty gloomy. But maybe that sets the stage for better news. Governments rarely act boldly except when they are in crisis mode. Markets are increasingly demanding bold steps. No one wants to return to the world of 2008. The demands on the EU are clear. First, it must pump massive liquidity into the system to shore up governments and its banking system. Second, it must stop kicking the can down the road. Each nation or bank with structural financial issues must set a game plan in place to solve the problem. It means some nations have to restructure debt. It means some banks must raise capital. The bottom line if the correct action is almost certain to be a period of significantly slower economic growth in Europe. That may not be pretty but it is a lot prettier than a meltdown of the European financial community. Lastly, I should note that proper corrective actions will almost certainly lead to further declines in the value of the euro. That is probably good news, not bad.

How does this impact us here in the U.S? In many ways. Obviously, we already see it happening in our stock market. Lower growth and greater uncertainty mean lower asset prices. Is a double-dip recession inevitable? Not at this point in time but if financial markets lock up again as they did in 2008, that is a possibility. At a minimum, it suggests that employment growth going forward is going to be very slow at best and consumer optimism, which has finally gotten stronger in recent months, is going to suffer as well. Again, let me repeat that we are still far from Fall 2008 crisis levels by any measure and escalating fears in Europe are bound to elicit a bold response sooner or later. You can be sure that G-7 finance leaders are putting heavy pressure on their European counterparts to move in a unified way.

As equity investors, what do we do know? We are officially in a correction with all leading averages down more than 10% after yesterday's freefall. Fear is extreme and there is a lot of capitulation selling going on. But there are also a lot of values being created. The easy trade is to sell stocks and buy 10-year Treasuries. But the 10-year Treasury yield of 3.1% is now close to the yields on stocks of many blue chip companies with great balance sheets and regular annual dividend increases. In other words, we are getting closer to levels where values gets compelling even with dire economic assumptions. Are we there yet? In a world this volatile, emotion always trumps reality and the fear remains out there that the mini-crash of May 6 can rear its head again. We are actually back near levels seen at the bottom that day. Perhaps that will be the bottom again. Then again, maybe stocks will fall further.

In an uncertain world, it pays to be true to your asset allocation ranges. When times are most uncertain and no solution is in place, stepping back isn't a bad idea. A few weeks ago, I suggested to take some money off the table. Clearly, values today are better but so is uncertainty. On one hand, EU leaders can institute a step of steps over the weekend that markets believe in and may begin to set a path toward stabilization. On the other hand, maybe they will continue to act tentatively failing to come to an agreement and financial markets will quickly fall into further disarray. No one knows and that is why uncertainty is too high. Cash is never a bad place to hide. You only lose opportunity cost. Thus, even if today is a bottom, taking a more conservative stance until we see proper steps put into place makes some sense.

Futures point to another lower opening.

Today Mr. T is 58. The new "A-Team" movie (without Mr. T) comes out next month.

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