

Boenning Morning Comment

This report is prepared for us by Tower Bridge Advisors

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Stocks traded up and down Friday in a fairly narrow range for this market environment until a short covering rally in the final 15 minutes sent the Dow up 125 points. No one moans about a rally like they do about a decline but few were willing to read much into the late afternoon rise. Indeed, futures this morning suggest that the market will take the gains back this morning.

Over the past month, most of the attention has been focused on Europe whether it be the particular problems of Greece, the decline in the euro or the systemic problems of many debt heavy nations along Europe's southern tier. On a higher level, what is happening in Europe is that the huge social agenda which Europe as a whole has undertaken since World War II is now becoming economically exposed. It's wonderful to have a framework that allows relatively early retirement on big fat pensions, fully paid medical care and other comforts but that structure disintegrates as debts pile up and demographics interfere. As with most developed nations, the countries of Europe are growing more slowly and aging. Simply said, the path they have chosen is unsustainable and each nation in its own way is now being forced to redefine its future. Debts have to be repaid, government spending has to be cut, Europeans are going to have to work longer and harder, and many are going to have to contribute in some way to the social services they are used to receiving for free.

If this all sounds familiar to our own argument here about entitlement spending, you are right. Indeed, under President Obama, our own country is making a shift to the left as Europe begins to make a shift out of necessity back to the right. The difference is that while Mr. Obama is trying to make a hard left turn, he isn't anywhere near where places like France, Italy or the U.K. are today. I am not talking about Greece which is an outlier, a country with a notorious history of economic mismanagement and one destined to face further troubles no matter which direction the rest of Europe heads. Rather, my central point in economic turns is that Europe is going to have to undergo an extended period of realigning economic needs to economic resources. It, in effect, is being forced by the markets to ration its long cherished benefits. Each nation can decide for itself the proper mix of taxes, spending, services and life style. But, except for Germany, most are out of whack.

We are too but we have a bit more time. Nonetheless, our problems won't fade. In fact, if we continue on the path we are headed, adding more services without the revenue sources to pay for them, our day of reckoning is going to come sooner rather than later. But we will have to adjust. Social Security is going to have to be balanced and we are going to either have to raise more taxes to fund Medicare and Medicaid or we are going to have to make sharp cuts in what gets covered. It is that simple. Markets, not Washington, will ultimately dictate that decision.

While Europe has been the focus over the past month, it is only one piece of the economic picture. Right now GDP is growing about 3-4% annually spurred on by investment spending, modest growth in consumer spending, and exports. Housing is still very weak although probably past a bottom. The economy is being buoyed by heavy government stimulus spending, very easy and accommodative monetary policy, and low interest rates. As we look forward, the consensus forecast from economists is for more of the same, namely real GDP growth of 3-4% for as far as the eye can see. Simply said, it appears to most that we are entering a classic economic recovery held back a bit by very difficult credit conditions but now in a process of healing.

But the markets are saying something different. Markets look 6-9 months ahead so they are now speaking about the start of 2011. Here is what they see. Besides the pressures on European growth which will have a modest negative impact on our own growth rates, they see record tax increases, sharply higher benefits costs courtesy of the recent health insurance reform bill, higher costs associated with financial reform, a more difficult lending environment courtesy of the same bill, the withdrawal of fiscal stimulus, and, perhaps, higher interest rates and more restrictive Federal Reserve monetary policy. The offsets are a very slow reduction in the unemployment rate and perhaps a recovery in housing from extremely low levels. Add the numbers together and it appears that the minuses exceed the pluses suggesting that GDP growth next year will be something less than 3-4%.

Could we see a double-dip recession? It is probably premature to predict anything like that although it cannot be ruled out. Some of the pieces of the puzzle remain incomplete. Financial reform in its final version may not be as onerous as the Senate bill and banks may, therefore, be in better shape to lend. Please note that while the White House and others have blasted banks for not lending, that is entirely populist rhetoric. Banks want to lend. It is how they make money. Banks are not lending today to small businesses because regulators essentially won't let them. They are required to take immediate balance sheet haircuts on any "risky" loans and that puts all banks, big and small, in a huge risk adverse mood. When and if regulators let up, banks will lend again. As the number of bank failures begins to subside, perhaps in 2011, maybe that will finally happen. The other big incomplete puzzle piece is taxes. Right now as things stand today, about 6 million low income families move back onto the tax rolls in 2011. Dividend taxes more than double for many. Capital gains taxes go to 20%. Estate taxes revert to 55% with only a \$1 million exclusion. Millions of families including many with small family businesses become subject to estate taxes. These are contrary to the stated wishes of the Obama administration. Although leadership certainly wants to raise taxes by a lot to pay for its other agenda items, they see the flaws in the picture I just painted. But the only way to change the picture is through Congressional action and nothing has even started within Congress which still has to finish financial reform and then approve a Supreme Court nominee. Tax legislation must begin in the House so that is where we have to look. But so far, there isn't much to see and it is unlikely that anything as important as taxes will be dealt with after the August recess.

There is no way that economic structure I just laid out is going to stimulate a continuance of the world we are in today. States for the past two years have used stimulus proceeds to balance budgets. As the stimulus disappears, they are going to have to make collectively hundreds of billions of dollars in cuts. Look at two states, New Jersey and California. Chris Christie, the new Governor of New Jersey, understands the issues. He may not be charming and a lot of people are going to suffer as New Jersey puts its fiscal house back in order. But make no mistake about it. 49 other Governors, conservative and liberal, are rooting for him because if he can succeed, the path New Jersey is trying to create will be the cover other Governors need to get their own houses in order. Some are already doing fine. Minnesota is a good example. But then there is California, the American equivalent of Greece. Many in California are simply oblivious to the world around them. So far, efforts at fiscal responsibility have failed to overcome the passionate cry for more handouts. Many feel the Federal government will simply rescue them just as the EU has come to Greece's aid. But Americans living in 49 other states certainly don't want their hard earned dollars headed to Lalaland. That is a very slippery slope for anyone in Washington to even consider and I doubt whether anyone will seriously do it.

So add it up for 2011. Higher personal income taxes. Higher medical premiums. Continued lack of credit for small businesses. Less growth in exports to Europe. Not good. As noted, however, there are offsets. Weaker economic growth should result in lower commodity costs and very low inflation. Gas prices may fall. Housing will benefit, perhaps enormously, by super low mortgage rates. There will be population growth and productivity may continue

upward albeit at a much slower growth path. The biggest missing piece is taxes. But if you add it together, I think a growth rate of 1-3% is more logical than 3-4%. That almost certainly means the analyst forecasts of \$90-100 per share for the S&P 500 are way too high. Consensus forecasts for this year are \$84. Financials may do a lot better as loan loss provisions decline. Investment spending will still aid the tech sector. And don't forget the boost from population growth still over 1% per year. But basic materials companies, energy companies and industrials face darker futures. My guess is that earnings next year will be \$80-90 per share. At the lower end of that range, the P/E would be 14.7, about normal, suggesting stocks probably have done a pretty good job over the past few weeks readjusting to a new expected (but yet unstated) normal for 2011.

How should one reposition his or her portfolio? Certainly in a more conservative direction. I would favor companies that can continue to grow in a flat environment. With real GDP growing at 1-3% and inflation barely visible, nominal top line growth for U.S. centric businesses will probably be in the 1-5% range, a tough environment for most companies to achieve earnings growth. Obviously, those companies with large businesses overseas away from Europe and Japan can add to those numbers. *Thus, I would seek companies least sensitive to the economy, companies with their own non-cyclical growth characteristics (a lot of tech names fit here), and companies with large international sales away from Europe and Japan. Dividends will matter.* Many top names today have yields higher than 10-year Treasuries. They are appealing. I would avoid those companies most affected by a decelerating economic growth rate, by Europe's issues, and those directly affected by onerous Washington regulatory pressures and costs.

What is most important, in conclusion, is that we are not at the beginning of any kind of meltdown. Changing direction worldwide isn't going to happen overnight. Indeed, it is better if it doesn't. Nothing has to be that gut-wrenching. What we are facing, however, is a long cycle of reduced debt, reduced spending, and reduced growth. Markets are seeing it and repricing assets accordingly. Future returns for all asset classes are likely to be less than they have in the past. Bond yields will be lower. Stock P/E's will adjust to reflect lower rates of growth. U.S. companies with high free cash flow returns will be rewarding places to hide.

Futures are down but well off their lows. After last week's frantic trading, I expect more choppiness but less volatility in the weeks ahead. I think too many investors are now lined up on the same side of the trade betting against stocks, against the euro and against commodities. That trade was great a month ago but probably isn't right today. In a flat environment, investors are going to separate the wheat from the chaff. There are many companies that can grow within the environment I just described either because they do things better or because they offer products people want (Think iPad). Low commodity prices may be bad for producers but great for consumers. Keep that logic in mind.

Today Bob Dylan is 69. "Times, They are A-Changin'"

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