

Boenning Morning Comment

This report is prepared for us by Tower Bridge Advisors

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Stocks suffered their worst one day decline in three months yesterday. There was a perfect storm of bad news. Interest rates on the debt of Greece, Portugal and Spain rose once again reflecting skepticism that the Eurozone bailout of Greece is going to move forward as announced. China raised reserve requirements in yet another attempt to rein in growth and inflationary pressures. The oil spill in the Gulf of Mexico continues with no near term solution in sight. Oil and other commodity prices fell amid a weakening euro. The VIX volatility index spiked to its highest level since February.

I have said often, probably too often, that stocks go up when problems get smaller and go down as problems increase. Since the bull market we are in began in March 2009, problems related to the recession have been declining and few new problems have appeared. Today, we are probably past the bottom in housing starts and Friday's employment report may show the first month of significant jobs growth in three years. But finally we have a new problem, a real one. It is called Greece. Some might argue that the sovereign debt crisis making headlines today is just an aftershock of the recession. In that regard, maybe it isn't a new problem at all. Central banks during recessions almost always respond with easy money and a sharp increase in fiscal spending to buffer the impact of sharp declines in the private sector. That is part of their role. But even sovereign states that have the ability to print money have certain financial limitations. No one is ever forced to buy the bonds of Greece or any other nation, even the United States. At the moment, there isn't much appetite for Greek debt and that puts the nation in a big bind. It doesn't have the cash flow to meet its needs and short term borrowing costs to fill the gap are simply too high. Hence, the need for a bailout.

Greece has been a fiscal mess of one sort or another for decades. While many of us know it for its antiquities, olive oil and beautiful beaches, Greece has been a fiscal and monetary mess marred by corruption, frequent government changes and financial mismanagement for a generation or more. In good times and bad, sovereign nations are forced to restructure debt. Some default outright. Greece by itself is too small to matter. But if it isn't a big problem directly, it is symptomatic of potential big problems to come. So what makes the Greek picture different? There are two important factors. First, Greece is now part of the Eurozone and Eurozone solidarity has never been tested. Greece is the weakest link at the moment but not the only weak link. The stronger nations in Europe plus the IMF clearly realize that they must step in and backstop Greece. But no one wants to put in any more money than necessary and Greece doesn't want to travel down the austerity path any farther than it has to. That give and take is ongoing and while the process continues there is going to be ongoing angst in the marketplace. Right or wrong, the rest of Europe must stand by Greece or accept a complete collapse of the European Economic Community. No one seems ready to face that alternative right now.

The second factor is contagion. Daily, reports are written that suggest that Portugal, Spain and Italy are next in line, in that order. Much of this is hype and fear mongering. Yes, all three and others are debtor nations but none has problems comparable to Greece. There is little doubt that bond vultures and vigilantes are going to try and attack the debt of the most vulnerable countries using all those unregulated new derivative tools like credit default swaps to wage battle. Stronger nations will have to rise and defend the debt under attack. The battles may leave scars but anyone suggesting a domino like collapse of various European economies is moving many steps ahead of where we are today, steps that may never be taken.

But there is a message and it is a powerful and strong one. The message is simple. If any nation allows its deficits or debt levels to rise too far, investors will no longer support it. A subsequent spike in financing costs will require a massive austerity program to correct the situation. Debt is a zero sum game. For every borrower, there is a lender. One of the problems in Europe today is that most of Europe's sovereign debt is held within the European community, much of it by the largest banks on the continent. In Japan, another country with massive debt levels, much is held by Japanese individuals who have developed into notorious savers. Here in the U.S. our debt is held worldwide. We are still considered the world's reserve currency. Indeed, the dollar has strengthened notably against the euro in recent weeks and yields on U.S. Treasuries have fallen. But note that the dollar is not strengthening against a bread basket of currencies of the larger lending nations. The real sign of pervasive currency weakness is the steady rise in the value of gold suggesting that even the dollar is losing value as countries around the world print money.

Therein lays the tale. Just as the fall of a few sub-prime lenders predated the fall of Lehman Brothers and others by almost a year and a half, the big picture question is not whether the Eurozone nations can find a temporary fix for Greece but whether the Greek sovereign debt crisis is a precursor of others to come.

We don't know that answer. But what we do know is that no nation, and that includes the U.S., can borrow beyond its needs forever. Trillion dollar plus deficits are clearly not sustainable forever. At some point, one year or ten years down the road, there will be no more buyers for debt to support that kind of deficit. Where is that point? No one knows. But what we are learning today is that no one really wants to find out. No one wants to be forced without choice to cut spending by 10% or 20% or more and no one wants to face a crushing new tax burden or a major currency devaluation.

If there is a message buried within the Greek mess it is that the time is now to begin to move the fiscal and monetary policy of any debtor nation toward debt and deficit reduction. I am not saying the Fed must raise interest rates tomorrow or that government discretionary spending has to be chopped overnight. But we have been kicking the can down the road for decades. Our entitlement spending is completely unsustainable. Will Congress tackle the problem before it becomes too late? History strongly says no. Congress almost always waits for a crisis to act.

If that is true and governments throughout the free world act in the same manner, then the symptoms being displayed now in Greece are going to spread. Increasing problems are a headwind to stocks. At the moment that headwind is fighting a powerful tailwind called earnings growth. But as it grows, winds will start to swirl. Sometimes good earnings will push stocks up; sometimes sovereign debt fears will push them down. In the short run, before the real problems spread to the U.S., our markets actually benefit because capital will fly to safe havens and the U.S. is still considered just about the safest. The tailwinds are still dominant. But remember that we spent years sloughing off the housing bubble as a non-event delighting in a booming economy that couldn't last.

Greece's woes by themselves won't end our economic recovery. They will barely make a dent. If you fight a disease early on, you can prevent major harm. The Greek mess is the first warning sign. It won't be the last. But the message is clear. Debtor nations must begin to live within their means. All debtor nations. Those that choose to ignore that message do so at their own peril. The cure isn't pain free. As a nation, we have to generate more tax revenue and spend less. We have to accept slower rates of economic growth. Those are not the easiest pills to swallow. But they are a lot better than the alternatives.

We have had a sharp rally unabated since February. The big rise in the VIX, several down days on big volume, and the absence of much good news after Friday's probably employment report all suggest that some sort of correction is

upon us. I will leave it to others to give you exact support levels or buy and sell points. But cashing in some profits and giving yourself a little liquidity for the next good entry point probably makes some sense. This isn't the start of a bear market or anything like that. But it is a time for sober thought. The best of times, earningswise, is upon us in the first half of 2010. Many stocks have recovered to or even past 2007 highs. Many of the dull tortoise-like companies have been left behind. They might well offer the best values today. Watch for changes in leadership and be prepared to move from companies closely tied to the economic cycle to those that can grow through any cycle.

Futures point to a lower open as weakness in Europe and Greek fears continue.

Today Brian Williams is 51.

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