

## Boenning Morning Comment

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

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The Dow fell by almost 350 points yesterday but that is only part of the story. In mid-session, the Dow was down close to 1000 points moving down and then back up a total of close to 1300 points in about half an hour. Whether it was black box trading, a glitch or an error doesn't really matter. Whatever it was, it was scary. It was the second most active day in NYSE history.

But the technical factors aren't the real story although they may have created some extraordinary quant fund losses; we won't know that tale for another few days or more. The real story was Greece and sovereign debt. Everything that has happened today and all week has centered around what is going on in Europe. The euro has fallen sharply while the dollar, yen and gold are all up sharply. Interest rates on U.S., Japanese and German bonds have plunged but interest rates on bonds of sovereign European nations have risen sharply, in the case of Greece to absurd levels.

The crux of the problem is simple. Greece has too much debt and too big a deficit. In order to keep functioning, it can either default on or restructure its debt, or it can get some level of support from the European Union (EU) and/or the IMF. So far, EU efforts to provide support have been tentative and packages put forth have been deemed insufficient by the market. If Greece had its own currency, the drachma, the solution might be rather simple. The world would stand by while Greece defaulted and restructured its debt and put into place a set of austerity measures before offering sufficient economic support through the IMF to allow the country to continue to function. We have seen this story played out many times by many nations including Greece. But now Greece is part of the EU and that complicates matters. Essentially, the EU is left with just two choices not only because of the problems of Greece but because of related albeit less severe problems in Portugal, Spain, Ireland and several other nations. The EU can demonstrate solidarity and develop a strong unified defense of all weakened economies or it can allow the weakest nations like Greece to default and restructure their debt. If the latter proves to be the chosen path of least resistance, it could threaten the survival of the euro and the European Economic Community.

Several things have become readily apparent so far. First, throwing a lot of debt at a debt-related problem may kick the can down the road for a while but it isn't an effective solution. Look at General Motors. A year ago, it was a company losing lots of money, badly run, with a bloated cost structure overloaded with too much debt. It subsequently went bankrupt and emerged after an infusion, investment and loan package from the U.S. government. Its shareholders were wiped out and major losses were absorbed by debt holders and employees. But today, the company can compete on a level playing field. In contrast, look at Freddie Mac. It continues to hemorrhage and asked the government for yet another \$10 billion this week. That's what happens when the government simply takes over a flawed business and chooses to perpetuate it by throwing good money after bad.

Back to Europe. The choice between a constructive EU rescue and recapitalization of weakened nations simply throwing more debt on top of that which exists already isn't a choice that can be made overnight. In 2008, our Congress and the President passed the economic baton to two men, Henry Paulson and Ben Bernanke, and they moved quickly and boldly to engineer a rescue of the banking system. Today our banks are the best capitalized in the world. For the EU to act in the same way over 25 sovereign governments with very different economic, political and social models have to agree on a plan and have to choose a person or persons to implement them. Frankly, that

sounds almost impossible on the surface but then it looked pretty bleak here as Lehman, AIG, Fannie Mae and Freddie Mac were all failing simultaneously. I don't see how a simple loan backstop of any size is going to work. Everyone can see it is just a temporary stopgap. You already see riots in the streets of Greece in reaction to the modest steps they have been required to take to date. The only real solution is some sort of Greek debt restructure. An EU loan package may give Greece some time, which is OK, but in the end it won't solve the issue.

Obviously this is becoming a growing problem and, as I keep noting, growing problems are bad for stocks. I will be the first to admit that I didn't think this would spin out of control so quickly but it has and now we have to readjust. Stocks are off about 6-7% from their highs erasing most gains for 2010 but they are still far above year ago levels. The questions today are (1) is there a solution in sight and (2) how much damage will be done to the U.S. as a result. The answer to the second depends on the answer to the first. Markets don't have to wait for the final solution to be in place but it has to see that the direction is right. One step, which the European Central Bank (ECB) failed to implement yesterday, is for the ECB to implement some form of quantitative easing to help support Europe's economy. Whatever the outcome of the Greek mess and contagion might be, Europe is destined to face slower economic growth, and perhaps both a recession and deflation. At the moment it appears that Europe does have the mechanism in place to support crisis management. That has to change and it has to change quickly. Markets are also convinced that some nation(s) are going to have to do some form of debt restructuring. When it becomes apparent that the EU realizes this, markets will stabilize. That might be a matter of days or it might be a lot longer.

Stocks have fallen sharply for two straight sessions and for the whole week. The two-day rule boldly says stay away. Don't be cute and buy as problems get worse. On the other hand, don't panic either. There are actually a few constructive things happening. The dollar strength is going to attract capital to the U.S. particularly to government bonds. The strength in government bonds is going to lower interest rates further and will lower mortgage costs. A weaker European economy will keep the Fed not only on hold as far as interest rates are concerned but will keep it active funneling liquidity into the system as needed. Added liquidity is good for stocks and bonds. While American companies will obviously feel some effect from economic damage in Europe, it might not be enough to abort our recovery. What markets want most is visibility. Right now there is almost none and that has created a bit of panic. Hopefully, world banking leaders over the weekend can come to some coordinated agreement on direction that begins to add visibility.

But with that said, being on the sidelines until the dust settles isn't a crazy idea. I have no idea what to say about today's trading other than it will be volatile. The big employment report due out this morning suddenly has very little meaning. Of course a good number will be better than a bad one but markets look ahead and the real question for us is what will our economy look like in 6-12 months. If Europe doesn't grow at all, worldwide economic growth can still be closer to 3%. That doesn't mean bear market. I suspect traders might want to go into the weekend flat. At a minimum, expect volatility to remain elevated for the next few weeks.

I can't end without discussing yesterday's midday trading. Some attribute it to multiple black box selling programs. Some label it a computer glitch. Others suggest a trader entered billion when he or she meant million. The cause really doesn't matter. What matters is that massive computers kidnapped the market and sent some stock values down literally to zero. How does that happen? When one black box says sell massive quantities at the market at any price and the other black box drops its bid by ever wider increments, you end with the ludicrous final trade where the seller is still placing market orders and the buyer puts forth a bid of zero.

This morning operators of those electronic platforms have annulled the most outlandish trades. I am not sure of their rationale. Was it a glitch? Were they simply embarrassed? Were they saving the hides of some quant funds whose

computers went amok? We will probably never know. Nor is it important. What is important is that the system broke down and no one could do anything until after the fact.

Here is what we do know. Volume and liquidity are not synonyms. In fact, as perverse as it sounds, in the stock market high volume almost always coincides with high volatility and low liquidity. That happens because trading becomes concentrated into fewer and fewer entities and they overwhelm the system. Yesterday was a perfect and extreme example. One of the hot buttons today is something called fast trading. It is fast because computers take over and move money in nanoseconds, speeds way beyond the ability of humans to interact. Trading doesn't mean investing. Fast trading systems look for technical anomalies and try to capture a few pennies a trade. The computer is trading something labeled PG. It isn't investing in Procter & Gamble. It has no idea what Procter & Gamble even does.

Financial markets are designed to facilitate the creation, transfer and investment of capital. Days like yesterday don't add value. Yes, I realize the big decline was quickly reversed and I am not blaming the trading situation for the down market. I made it clear up front that the European debt crisis was the root cause. But as Congress debates financial reform, it needs to make sure that markets serve those they are meant to serve. Days like yesterday are going to chase away legitimate investors who no longer see a level playing field. They see a market grossly distorted by runaway machines. It was only a half hour and it got corrected. Fine. But just as Greece is a warning to all debtor nations to come to grips with their problems, yesterday was a warning sign that if you allow machines to rule markets those markets will disintegrate in some fashion. Stop it before it gets worse.

In my view there is no economic value contributed to the marketplace by fast black box trading. I am not saying it doesn't work nor am I saying that fast traders cannot make a lot of money. I am saying that fast trading doesn't facilitate value creation, capital formation or force securities to their true investment value. They add volume but suck liquidity out of the market. They add risk (volatility) without adding value. Congress or the SEC isn't going to ban fast trading because there is too much money involved. But they need to set rules to contain it so that it doesn't interfere with markets' true functions.

Now let's all take a deep breath and reflect. Stocks have risen for about 14 months without any serious correction. In Wall Street parlance, a correction means a decline of 10% or more. It is perfectly normal to have them in bull markets. They purge the excesses, get rid of the froth. A 10% correction would bring the Dow back to about 10000 in round numbers. Parenthetically, that is just about where the market turned yesterday in all that craziness. People have short memories. Everyone who was complacent and bullish for the past several months is now going to raise cash on any substantive rallies. That isn't wrong. Just Monday I suggested profit taking wasn't a bad idea. I expect a choppy market probably through the summer as moods settle down and as the resolution of Europe's problems become more apparent. Such behavior is perfectly normal mid-cycle. The news going forward won't be all one sided as it has been for some months. But don't ignore the good points. Earnings are good and growing. Valuations are modest. We added almost 300,000 jobs in April. Housing is recovering and low interest rates will support further growth. A Greek default is not the same as the collapse of Lehman Brothers. Let's not treat it that way.

Futures have begun to rise after the surprisingly good employment numbers. But expect a lot of volatility today.

No birthdays of note today. My wife and grandkids saw "Iron Man 2" last night and liked it a lot.

James M. Meyer, CFA 610-260-2220

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