

Boenning Morning Comment

This report is prepared for us by Tower Bridge Advisors

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Stocks vacillated all day Friday before a modest late afternoon rally lifted them into positive ground at the close. But it was far from what anyone could label as robust. Although the week ended in positive territory for the first time in a while, Friday's rally wasn't one that puts the bulls back in command, at least not yet. Futures point to a higher open today but we need to see a solid day and a nice ending before we become comfortable.

At the beginning of the year, we suggested that stocks might rise 5-15% for all of 2010. Although earnings were destined to rise at a much faster pace, we believed much of those gains were already baked in and that clouds would begin to emerge by the end of 2010 that would moderate the pace of economic recovery going forward. Among our concerns at the time were the ongoing process of deleveraging, persistent high unemployment, and the lack of recovery in housing, an important component of early cycle growth. At the time, we did not perceive the extent to which sovereign debt would become a front page issue nor, obviously, did we see the BP oil mess occurring. But all in all, the economy so far has played out pretty much according to plan.

Stocks, after a nervous start in January, took off in early February. By late April, the S&P 500 was up 9% for the year. Using 10% as the mid-point of our 5-15% prediction, it suggested at least the possibility that the entire year's gains might already be realized. A range of 5-15% is admittedly a wide one and if the top end of the range is to be achieved, that still left a reasonable amount of upside room to go. But it wasn't to be. The sovereign debt mess was by itself enough of a reason to spark a mid-course correction. A steeply falling euro, worries about China's exports, the oil mess, Washington's urge to spend and reform, and the lack of a cogent tax agenda all weighed in.

By the time last week began, instead of a 9% gain in hand, the S&P 500 was challenging the 1040 level on the downside, a loss for the year to date of almost 7%. Yet despite the gyrations and the wild swings we have witnessed over the last six weeks, not a whole lot has changed economically. We still look for solid earnings gains this year modified only by non-cash foreign translation adjustments. We have said all along that we were a bit more bearish about future economic growth due to deleveraging, Washington's misguided fiscal policy, and the removal of stimulus as 2010 rolls into 2011. Nothing has changed in that regard. Sure, the May jobs report was a disappointment but we have long ago learned not to make long term economic decisions based on the employment report of any one month. All indications continue to suggest more jobs are being created than lost, that profits will be up smartly this year, and that European debt contagion will only knock a few tenths of a percentage point off of our own growth rate. So we stubbornly stay with our target of 5-15% appreciation for the market this year. Even if it is only 5%, that suggests a nice pop of 10%+ between the lows of early last week and the end of the year. If the gloom pervading markets today lifts at all, gains between now and year end could be significantly higher.

That's the good news. The economy is good and there are nice values in the stock market. But the longer term systemic issues remain. U.S. entitlement spending is way out of control with no real effort to rein it in. The President bounces from one blockbuster spending program (health care reform) to another (is the President going to use the BP disaster to make one more stab at climate change?) oblivious to longer term deficit issues. Tax policy is still a mess. State and local governments are unwilling to face a reality that isn't going to work right once Federal stimulus money fades away. But except for the local government issue which demands attention today, these

problems are deferrable in the short term for one basic reason. Investors around the world don't have a better place to park money today than in U.S. Treasury bills. The eurozone is worse than the United States and the euro is falling. Japan is an economic mess with large deficits, deflation and no growth. Many emerging nations like China are in much better economic shape but governance issues limit the likelihood that anyone is going to put vast sums of money seeking safety to work there or in India or Brazil or, hold your breath, Russia. Ask yourself which large liquid markets offer greater safety. The answer is none. Maybe some time, sooner rather than later, traders and speculators will push up the price of U.S. Treasury credit default swaps to a level that will command attention and push rates higher. But not today.

So therein lies our quandary. The near term picture is good. Yet we all see these dark clouds out there. It's like watching a nasty hurricane beginning to form off of the west coast of Africa. Will it become a big storm? Will it track to the U.S. mainland? It causes angst but it might never form or go out to sea. Analogy aside, there is no question that our government will have to deal with entitlement reform. At some point it won't be about big speeches, partisan politics and deflecting blame somewhere else. It will take leadership with a vision and a Congress with a spine. That isn't in place today. Will the mid-term elections make enough of a change? Probably not but I am getting ahead of myself.

What we seem to face today over the investable horizon of 1-3 years is an old-fashioned economic recovery tempered by ongoing deleveraging, higher taxes, and elevated unemployment. Using the post World War II period as a guide, it is almost certain that growth this cycle will be lower than average and it may stay that way for a very long time. That will be hard to swallow in a financial market where daily moves of 2-3% are no longer uncommon. Indeed, traders who thrive on volatility probably like to see that behavior. 5% per year is only half a percent per month or so. That averages to about 0.2% per day, about 20 Dow points on average. That's like watching paint dry. Investors don't mind that at all; they are much more interested in the cumulative effects. But its slow death for traders.

The end result is what we see. The pendulum is going to make wider swings. As investors, you can simply wait out the ride, because in the long run valuations matter, or you can back away when traders get too exuberant and buy back when they get wildly pessimistic. I am not trying to convert investors into traders, but moves approaching 20% probably shouldn't be ignored.

Right now, it appears the pendulum is at one of the transition points swinging from negative to positive. We are getting near the end of the second quarter. Since the March 2009 rally began, the last month of a quarter has been a very good one for stocks. Unless there is an extraneous event I don't foresee, I suspect the same will be true this time around. If things move too far too fast, there will be another correction but rather than predict we will do what we always do. Watch and react.

As noted, futures suggest a positive opening. If the correction is over for now, today has to have a happy ending.

Steffi Graf is 41 today. The Donald is 64 as in Trump.

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Additional information is available upon request.

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