

Boenning Morning Comment

This report is prepared for us by Tower Bridge Advisors

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Given that Friday was a quadruple options expiration day and a day to rebalance leading averages, it was a surprisingly calm end to the second up week in a row. The economic news last week was rather subdued but stocks continued to bounce back from what appears to have been excessive pessimism during May. The market's general conclusion appears to be that growth will moderate going forward but that a double dip recession can and will be avoided.

Over the weekend, China announced a decision to drop its informal currency peg to the dollar. That has led to a sharp rally in equity markets around the world beginning in Asia and moving to this country in the form of higher futures this morning. The peg will be loosened in stages gradually so as not to create a sudden and unwanted impact of China's own economy and those of its trading partners. The move this morning has been an appreciation of less than 1% but psychologically, the decision would appear to represent confidence by the Chinese in a sustainable worldwide recovery.

This will be a relatively light week for data. The most important numbers will be housing related when both new and existing home sales get reported. They should be fairly good reflecting the end of the new home buyer tax credits. Homes had to be under contract by the end of April but closings could stretch to the end of June. Congress is deliberating extending the June 30 closing deadline. However, new contract signings have dropped significantly since the end of April. While that was expected, the declines have generally been greater than forecasts. In addition, it appears that banks, Fannie Mae and Freddie Mac are starting to accelerate foreclosure and short sale activity. Added together, this would suggest more supply and less demand raising fears of another significant decline in housing.

But maybe the picture isn't quite as bad as it might first appear. A healthy number of Americans have simply stopped paying their mortgages. If equity value is less than the value of one's mortgage, those homeowners are, in effect, renters. They have no economic interest in their homes and don't expect that to change any time soon. The foreclosure process is slow. Thus, homeowners realize that they can live in their current home "rent free" until banks force them out either via foreclosure or short sales. That might even take years. As the housing crisis unfolded, banks and other lenders were willing to kick the can down the road. Some made small adjustments to mortgage terms but very few went so far as to cut principal. As home values declined, owners/borrowers got further under water and more either paid less or stopped paying at all. With no income coming in, mortgage holders no longer benefit in any manner by deferring the inevitable. Thus, foreclosure acceleration and more short sales. However there is a silver lining to all this. Although the process can be disruptive, it moves homes from weak hands to stronger ones. Many of the homes are being bought at bargain prices by investors who turn them into rental properties. One of the old saws of real estate is that there are very few bad properties but there are many overvalued and badly financed properties, particularly during times of economic weakness. Sellers have bad deal structure; buyers have good deal structure.

The obvious conclusion would seem to be that homes will decline in value sharply once again as this process accelerates but that may not be true. For one, rental costs have been rising. What is happening is that the percentage of homes owned versus homes rented is changing. If I convert every home owned by a mortgage holder under water into a de facto rental property, then the ratio of homes owned to homes rented changes more dramatically and moves back to some form of normality. We won't end up with a market where rents continue to rise and home prices

continue to fall very long. Indeed, home sales prices show many signs of bottoming while rental rates are persistently rising. That will put a value underneath the price of homes sold. It may also accelerate the rate at which homes owned are converted to homes rented. That is exactly what is happening with homes being resold by Fannie Mae and Freddie Mac according to a front page story in yesterday's New York Times. Indeed, what is also happening is that with housing starts still barely enough to offset the normal rate of home decay and destruction, the growth in household formations and an improving economy are slowly beginning to reduce the inventory of vacant homes. Housing won't reach equilibrium until that inventory is back to a more normal level but it is moving in the right direction suggesting that housing is starting to heal, not ready for a second collapse. Housing markets are regional. Some are in better shape than others. Markets with strong demand in which most homeowners still have positive equity in their homes, like New York, are getting stronger. Others, with mammoth foreclosure rates like Las Vegas are still suffering.

Wednesday the Federal Reserve will conclude a two-day meeting and will undoubtedly leave interest rates unchanged. Everyone will watch the post-meeting statement but I doubt it will be very revealing. The economic data over the past six weeks suggests a very fragile recovery and the Fed is unlikely to give any hints regarding the timing of future rate increases. You all know my mantra that an interest rate increase from current levels would be strongly positive for economic growth but my point of view is such a minority that it won't even be considered. The Fed feels zero interest rates are stimulative. I believe they simply create distortions robbing savers while reducing the incentive for banks to lend.

Next week will be a big one for data and will likely show an economy growing more slowly in June than it was in early spring. My guess is the good mood equity investors suddenly find themselves in will begin to fade as the realities of 2011 become more visible. I am in no man's land in my head here. Too late to buy for an interim rally of moderate proportions and too early to sell. Certainly there is room for bargain hunting and profit taking among individual stocks but there are enough yellow flags out there to give me longer term concern. Very low bond yields suggest a very anemic recovery. The tough housing environment will continue to put pressure on the economy near term. Tax legislation is a mess as is fiscal policy in general. And it is logical to expect flair ups in Europe related to sovereign debt in the months ahead. We aren't stepping backwards but we aren't marching forwards very briskly either. I do like the fact that market volatility has subsided significantly over the past two weeks.

Stocks are going to open sharply higher. If this rally is more real than I expect, they need to end the day strong as well.

Today Prince William of England is 28.

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