

Boenning Morning Comment

This report is prepared for us by Tower Bridge Advisors

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Stocks fell sharply yesterday afternoon for the second day in a row. Once again, soft economic news was the culprit, this time a disappointing report on existing home sales. Volume was very light and there was little panic. But the mini-rally that originated two weeks ago may be coming to an end unless economic data to come between now and next Friday's big employment report reinstalls some investor optimism.

Not much of the data recently have been good. Except for Memorial Day weekend, retail sales have been in a bit of a funk since the start of May. Consumers aren't necessarily going into hiding but they are buying to fill needs and little else. Shopping remains extremely promotional. Companies that don't price aggressively do so at their own peril. But travel spending is up a bit and when the product is right, people will buy. Witness the iPad which has now sold over 3 million units since it was introduced. Apple's new iPhone model goes on sale Thursday and should be received in similar fashion. Population growth is just under 1%. Consumer spending growth may be 2-3%. That pretty much sums up where the economy is today, recovering but at a very slow pace.

Although few businesses are still laying off workers, few are hiring aggressively. Europe is slowing down and China is growing more slowly. That should limit export growth. Housing is in a dip as the nation transitions from a world goosed by tax credits to one that must stand on its own two feet. Some high profile investors are screaming that a housing double dip is inevitable but there are few indications that prices are ready to fall another 10-20% and some of the same investors that bet against housing in 2007 and 2008 are buying residential land today. The President continues to bash business as he pushes for regulatory reform, tries to show he is getting on top of the Gulf oil spill mess, and warns insurance companies that he will not stand for significant rate increases of health care plans right in front of mid-term elections. He continues to try and convince the public that his health insurance reform package is a winner but few skeptics have been turned around yet. Despite his pushback, look for double digit rate increases in 2011. The last thing the President needs today is the General Stanley McChrystal situation, a no-win no matter what he does. While it is easy to bash the President, he didn't mock administration officials in Rolling Stone and he didn't create the oil well explosion in the Gulf of Mexico. There is no way for him to look good in either situation.

The good news in all this is that there are almost no signs suggesting the economy is about to move backwards and stocks aren't very expensive. My earnings forecasts essentially show only limited growth in corporate profits through the end of 2011 but even using my assumptions, far more conservative than analyst consensus, stocks still sell at less than 14 times earnings and yield close to 2%.

What I think lies in front of us is an extended period, perhaps into the fall, where economic growth slips toward a more sustainable 2-3% rate, savings rise, and analysts recast earnings expectations downward for 2011 to mirror the message already delivered by the stock market since the May swoon that growth is going to be slow for an extended period of time. Once the mid-course correction is fully understood and reflected, stocks should be able to recover. If volatility returns, stocks could move suddenly 10% in either direction. But unless we have a true second recession, this all becomes noise and eventually skies will clear.

Several variables can alter the picture. One is currency. As of now, the dollar has rallied over 20% from its lows against the euro, the only other currency of significance. US financial markets benefit from dollar strength because it draws in more capital. So far that capital has flowed almost exclusively to bonds but at some point that becomes an overly crowded trade and money will begin to shift to equities. Another possible catalyst in the fall would be a revival in housing activity. Future homeowners want to see prices stabilize without the need for tax credits, mortgage subsidies and other price supports. A steady increase in rents suggests that will happen and it may be evident by fall. Fall is a traditional buying season and could logically be the time when the beginning of a real recovery becomes evident. The numbers today are distorted. Activity in March and April was elevated in front of the expiration of the tax credit for new home purchases and it is obviously depressed in the weeks since then. It will take a couple of months for the dust to settle and for all of us to see what a normalized housing market might look like. To me the most important point is that prices seem to have leveled off. There are few signs, if any, that prices are suddenly falling further. If you try to get analytical, the tax credit was only about 4% of the average price of a home and only applied to new homes. If markets were to immediately adjust to the change, you might see a downward shift in prices of about 2%. I would contend that small a number is noise and will get lost in the data.

Another variable is employment. It is quite possible that the weak jump in private payrolls in May won't be repeated. The net gain of about 40,000 private sector jobs in the May employer survey stood at odds to other contemporaneous data. Any gain or significant improvement in the numbers to be reported next week would be well received. Of course, if the numbers weaken, it would strengthen the bear case. An actual loss of private sector jobs would be disheartening but that doesn't seem likely. If housing begins to recover in the fall, that could help the employment picture. Thanks to the end of the tax credit, construction activity in the weeks ahead will be unusually slow. Housing is very labor intensive and will affect the numbers immediately. But a fall pickup could provide a big boost.

Putting this all together, over the next 10 days or so, we are likely to see a lot of data suggesting continued growth but at a slower pace. The ISM reports will undoubtedly be positive but should be below elevated May levels. Auto sales will be fine versus last year but trends probably haven't changed all that much from recent months. Retailing has been weak in June but the reported June numbers may not be all that bad because of the late Memorial Day this year. Weekly jobless claims have been flat lately; no one can predict week-to-week movement so I will take a pass on that one. The employment report next Friday will be important to see whether May was an outlier or a confirmation of a much slower growing economy. Finally, we are near the end of the second quarter and earnings season is just around the corner. There have been almost no preannouncements to date suggesting companies won't make their Q2 estimates. But analysts will focus on the outlook and I expect most managements to temper their expectations. Thus, the numbers reported will be much less important than the tone of the subsequent conference calls. If this all sounds a bit wishy-washy, that is probably what the market is likely to look like for the next few months.

Futures are up a bit this morning reversing a part of yesterday's decline. Given the very weak behavior during both of the last two afternoons', the final hour is likely to set the tone for the next several days. But until things change, it would seem like the market is stuck in a trading range bounded roughly by S&P 1040 at the low end and 1130 at the high end.

Today Frances McDormand is 53

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