

## Boenning Morning Comment

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

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Stocks fell sharply yesterday as fears rose that the economy was stalling and worries increased that a second recession was just around the corner. The selling started in Asia after a revision to a forecast of growth in China indicated growth is slowing. European traders picked up on the selling. It then accelerated as investors focused on a European Central Bank repo rollover due to take place tonight. The credit facility was put in place a year ago during the height of the credit crisis and was also meant to be a one-year security. The ECB has indicated it will allow banks to rollover their loans for an additional three months if necessary. It appears that the rollover total is likely to be rather modest in the vicinity of \$160 billion. That's good news. Perhaps European debt fears are a bit overdone.

That takes us to our market. It keyed off the weakness overseas and immediately plunged testing the 1040 lows in the S&P 500 first set last October and tested several more times since then. By late afternoon, the barrier was broken but stocks rallied modestly toward the close and managed to finish just over the 1040 mark, a moral victory at least for the moment. That leaves all of us with the \$64,000 question. Is the economy on the precipice of rolling over into a double-dip recession or is it merely slowing down temporarily after the expiration of home buyer tax credits and other fiscal stimuli? The answer to that question will determine whether a bear market rightfully began in April or what we are seeing now is simply an overreaction to a stumble within a transitioning economy.

We will continue to get more evidence to answer that question this week. The big number today is the ADP forecast of Friday's big employment report number. Since ADP issues roughly one out of every six checks to private sector workers, it clearly has a pretty good view of the employment picture at any moment in time. It showed a meager gain of 13,000 in June, a further deceleration for a disappointing report last month. Tomorrow data will be released on June manufacturing and auto sales. Manufacturing will almost certainly show growth but at a slower pace than May. Auto sales have flatlined in recent months and probably slipped a bit in June. Bulls and bears can each find evidence from those numbers to support their cause. Then, of course, on Friday comes the biggie, the June employment report. If you remember, a shockingly weak gain in private employment in May sent the markets into a swoon a month ago. Almost a year into recovery, private sector job gains of less than 50,000 is not good news. If today's ADP forecast proves accurate, Friday's report is going to be a bitter pill to swallow.

The bond markets around the world are also delivering messages and they aren't encouraging. Yields on 2-year Treasuries are now at record lows. This is not just about flight to quality. It reflects a composite belief that economic growth at best will be very shallow for the foreseeable future. The 10-year Treasury yield is now below 3%. Yields on German debt are at similar low rates. Importantly, however, credit spreads have not risen appreciably. LIBOR spreads have remained flat over the past month as stock prices have fallen. For the most part credit risk doesn't seem to be spiking. Rather, the drop in rates reflects a belief that economies around the world are headed for the blahs, little or no growth with little or no inflation. No growth and no inflation isn't a very good feeling.

If I can draw an analogy, think of driving on an interstate highway. In 2008, you were broken down on the side of the road with no help in sight. The view looking forward instead has you driving in the right lane with a defective engine going 40 miles per hour. You're moving forward but the whole world seems to be passing you by.

Two months ago, everything seemed to be coming together. What changed? In hindsight, the economy was beginning to improve but the wounds of the recession hadn't fully healed. Americans wanted to feel good about the future but they were rightfully nervous after what they went through. Steps to reopen credit markets got the auto industry back on its feet. It went from selling 9-10 million cars per year to selling 11-12 million cars per year. But the days of selling 15 million cars per year or more are a distant memory. As volume picked up, it felt good. As business started to flatline that good feeling didn't disappear, but it began to fade.

What I said about the auto business could be applied to many other economic sectors. Apparel retailing picked up. As the economy began to recover, shoppers returned. But not with any real enthusiasm. At the first whiff of trouble (e.g. a down stock market in May), they began to sit on their hands again, not nearly as firmly as they did in the fall of 2008 but enough for us to notice a difference. Restaurants aren't as crowded as they were two months ago. It's obvious.

There is no question that the recession did a lot of permanent damage. Many jobs lost during the period will never return. We aren't going to build 15 million cars or 2 million homes per year for a very long time. Our home values are unlikely to return to 2007 levels any time soon. Our 401k statements may not read like 201ks but full value hasn't been restored.

This is where the government comes in. A key role of government is to help to soften the blow of economic turmoil. When credit markets falter, the government steps in. When the private sector can't provide jobs, the government attempts to help. The government can't replace the private sector; it isn't big enough. But it can ignite the engine. Normal tools the government uses on the monetary side are low interest rates and rapid growth of the money supply. On the fiscal side, spending increases and lower taxes are stimulative.

The government used these tools effectively to ameliorate the impact of the recession in 2008 and 2009. But it doesn't appear that the medicine is working today. Why? I would suggest that the government today and governments around the world today are taking seriously wrong policy steps.

To understand my point it is crucial to understand that the root cause of the 2008 financial collapse was too much credit and too much leverage. Once the credit bubble collapsed, asset values fell and people around the world scrambled to delever. They wanted to reduce debt. They don't want to be in the same mess again. Corporations acted most boldly and are now in excellent financial shape with great balance sheets, little debt and a lot of cash. But that improvement came at a cost. Corporations have limited hiring. They are trying to live as leanly as they can. When volume improves to a point where present work force can no longer produce all the needed goods or services, then they hire but only to meet current needs. They do this for two reasons. First, greater worker productivity maximizes profits. Second, they are as uncertain of the future as everyone else and don't want to hire just as an economy may be slowing down.

Individuals are also doing their part paying down credit card balances and largely learning to live within their means. Because their savings melted away during the recession, they have to save now to rebuild nest eggs. The savings rate of 4% today is a good solid number. But realize that every dollar saved is a dollar that isn't spent. Hence, a tepid economic recovery.

With that backdrop, let me now get to my point on government policy. It is critical to understand that Americans and corporations today want to save and invest. They don't want to borrow. Even with zero interest rates, they don't want to borrow. In fact, zero interest rates, rather than being the stimulant that they have been in most of the post-

War period, may actually be a deterrent. Low interest rates are a great incentive when Americans have a proclivity to borrow. When they have a desire to save, low interest rates are a handicap. See the conflict? Low rates are an incentive to borrow and spend but Americans don't want to spend; they want to save. If you hand someone \$100 and he puts it in the bank earning nothing what economic benefit did you create? Nothing!!! Banks aren't lending in part because of low loan demand, in part because they have bad memories, in part due to regulatory pressure, and in part due to lack of confidence in the value of underlying collateral.

So what is the Fed to do? Interest rates need to be higher. I know that is counterintuitive to everything we have learned for 50 years but for 50 years we have been borrowing to spend. Now times have changed and we want to save and invest. Banks also don't want to lend at low rates. There is no margin for error lending at low single digit rates. Bottom line is that Fed policy is no longer stimulating growth.

Fiscal policy is similarly flawed. President Obama came into office with a huge social and political agenda. It got shoved aside in 2009 because of the recession but it has moved forward in earnest in recent months with the passage of health insurance reform and the expected passage of financial regulation. However, even though we are out of recession, the economy remains weak. Job creation is subpar. Not only is the unemployment rate high, structurally there are more Americans permanently displaced than at any time since the Great Depression. Kids coming out of college can't find jobs because jobs normally available are filled by Americans who can't afford to retire.

America needs a fiscal policy focused on job creation. At the moment no such program exists. Health insurance and financial regulatory reform won't create jobs. In fact, they both destroy jobs. Oil drilling moratoriums destroy jobs. There were six major U.S. ethical pharmaceutical companies two years ago. Now there are four. The industry is consolidating trying to cut costs to maintain profits in a new world of health insurance reform. The Dodd-Frank bill is going to lower earnings of banks and brokers 5-15%. They will respond by reducing employment and raising fees. There isn't any reason reform has to result in fewer jobs but the programs put in place thus far are doing exactly that.

Jobs can be created through targeted government efforts. Investment tax credits are an obvious tool. Tax cuts are another. One time tax rebates or one time spending are patches, not a solution. Governments around the world, including our own, are saddled with too much debt just as everyone else was. Moreover, many governments had to take on more debt during the recession to help the healing process. European nations are responding with austerity programs. They believe cutting spending will cut deficits. But spending cuts alone won't work well without some initiatives to foster growth. Otherwise nations will end up like Ireland which is in severe recession. In a recession, revenues fall faster than spending. Deficits actually rise. The correct formula is spending discipline and targeted incentives to invest and to stimulate growth.

Here's a simple formula that just might work. Create permanent tax incentives to stimulate hiring and training. They can be targeted to areas of social and political needs if that suits Washington. Second, cut the payroll tax immediately for low and middle income families. Use other measures to stimulate savings and investment. Savings fund investment. Right now, trillions of dollars are sitting on the sidelines earning exactly nothing. Simply said, a Federal mandate designed to boost employment should be the nation's number one priority.

The bad news is that it probably won't be. None of what I have suggested appears to be in the DNA of the Administration or the Federal Reserve at the moment. They will talk about jobs a lot especially if the unemployment rate starts rising again. But talk is cheap without commensurate action. The good news is that might all change in November come elections. But November is a long way off. What happens now?

Many times I have said that markets go up as problems get smaller and go down as problems increase in size. Slowing Chinese growth is not exactly a big problem. It is still going to grow 5-8% and we don't export very much to China. The European debt crisis is a problem but it isn't on the front burner right now. But LIBOR rates have flattened out for a month and Europe appears likely to muddle along even if it doesn't slip back into a modest recession along the way.

To me the big problem is right here at home and it centers on jobs. Two months ago, it appeared that the economy was on a sustainable path of 3-4% growth. But as just a few whiffs of fear began to circulate, the flaws in our economic structure have gotten revealed. We aren't creating good productive jobs. Spending hundreds of billions of dollars for temporary projects of no long term value is a waste. Cash for clunkers may have reignited an auto industry on the brink of collapse but what really got the auto industry back on its feet was the restoration or normal credit channels. Home construction is going to stay anemic until excess supply is absorbed. Without a recession, that will happen in the next 1-2 years. If there is another recession and another decline in home prices, it will take longer.

When you watch the President speak, he speaks of his agenda. Health care. Financial Regulation. Punishing the "fat cats". Cleaning up the Gulf (not his fault!). There was a time when he declared that his stimulus package, passed in the heart of the recession, was going to create millions of jobs. It didn't because it was never designed to do that. What it did was to extend the pain of the recession longer. State and local governments retained workers last year because of stimulus funding. Now they are being laid off. Temporary home buyer tax credits helped in the spring but now there is a void. Extended unemployment benefits are a transfer payment. They serve an obvious social purpose but don't create jobs.

The future of this economy and the stock market is all about jobs. The November election is all about jobs. Whether growth falls to 1-2% or we slip back into recession, we are not in for a repeat of 2008. But an economy limping along at anemic rates of growth is going to take a very, very long time to heal. There are seeds of growth that can be nurtured. America is a leader in technology, medicine and education. The internet and mobile communication is opening up vast new markets and opportunities. Our manufacturers are becoming more competitive.

Stocks will go up when investors gain confidence that we are on the right track. According to a Wall Street Journal/NBC poll, today 62% of Americans believe we are on the wrong track. Everything is tied to jobs. We have to get Americans back to work. If there isn't a better program in place by November, Americans are going to vote for change. In 1994, it did exactly that. Republicans were swept into office and worked well with a Democratic President. The stock market boomed from 1995-2000. That's our hope.

Until then, we will muddle along going 40 mph on that Interstate in our sputtering automobile. As investors, we are left with few choices, and none are very good. We can hide in cash or government bonds. That will save principal value but earn next to nothing. We can buy blue chip stocks that pay solid dividends. That's not a real bad idea. We can invest in emerging markets focused on growth without the burden of a lot of debt. But that isn't a risk-free bet and depends a lot on good governance, not always a solid bet. I should note that stocks and bonds rarely move in opposite directions for very long. Buying bonds that yield 3% or less and selling stocks with yields nearly as much or more is usually an unwise trade.

What doesn't seem to be a great bet right now is a bet on sustaining growth of 3-4% or more. The artificial tailwinds and temporary programs that supported that growth are disappearing. Corporate profit growth is decelerating. I don't think it is going to disappear but I suspect that 2011 earnings won't be much higher than 2010 results.

For the economy to continue to grow, consumers don't have to spend more per capita but they have to keep spending at a reasonable pace. Auto companies can make good money today selling 11-12 million cars per year. But if consumers get scared and go back to the bunkers like they did in 2008, all bets are off. Investors are clearly scared today but consumers aren't real afraid yet. What will increase confidence right now is leadership telling Americans that Washington is focused on today's most important issues. Right at this moment, I don't want to hear about greenhouse gases or why Goldman Sachs pays its executives too much. I am not real interested in Elena Kagen's views on esoteric legal issues. As an investor, as a consumer and as an American I want to know how we are going to create and restore good jobs permanently. Since the Great Depression, the single most important American statistic has been the unemployment rate. It isn't going down. I may be headed back up. If that doesn't serve as a wake up call, I don't know what will.

I don't know where the stock market is headed today or tomorrow. Data over the next three days will tell us whether markets will bounce off the 1040 low or whether we are in for another sinking spell. Good stocks paying good dividends will hold their value. Cyclical companies that require economic tailwinds face tougher times. When Wall Street hears the right message, it will react quickly and positively. Until then, the path of least resistance is down.

Futures are flat right now.

Today Michael Phelps is 25. Mike Tyson is 44.

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