

## Boenning Morning Comment

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

July 14, 2010

Stocks rose for the sixth straight session virtually reversing a similar losing streak begun about 3 weeks ago. Good earnings news from Alcoa, CSX and Chevron sparked the rally. But, as I noted on Monday, stocks have been gyrating all over the place while little has changed fundamentally.

That thought sounds almost inconceivable. Weren't we all talking about a "double-dip" recession just a few days ago? The answer is that, yes, we were talking about it but in reality there was no evidence to support that conversation. Investors and traders alike were letting the stock market dictate the conversation rather than let the facts dictate the stock market.

Let's step back a minute. The stock slide began in late April after sovereign debt issues erupted in Greece and other southern European countries simultaneous with reports of slowing growth in China. The ECB stepped in fairly quickly to calm the waters in Europe but equity investor angst continued. Turn on CNBC at any moment in time and someone will be yelling "The Sky is Falling". If the market goes down two days in a row big time you can almost guarantee that one of the world's leading permabears will guest host one of the big shows.

In reality, the subsequent slide in the stock market plus some other temporary factors including the need for states and local governments to shrink budgets, higher costs associated with health insurance reform, and expenses related to the BP oil spill impacted growth slightly in May and June. But traders proceeded to make a mountain out of an ant hill. Smaller than expected employment growth in May added a punctuation mark but the reality remained that the shift in U.S. growth rates has only been moderate. Granted, there are some forces that will slow growth further as we look forward into 2010 including winding down of Federal stimulus and higher taxes. But these have been known factors all along. The Bush tax cuts have been set to expire on January 1 for over 6 years!

What occurred that wasn't known in April? I would contend that employment growth has been slightly more moderate than one might have expected and perhaps retail sales have been a smidge below forecast. But that is about it.

The fact is that today fast money traders dominate this market. To them, long term is the next month, if that long. By example, before the market closed yesterday, they placed their bets on how other traders would react to Intel earnings announced last night. As it turns out reported earnings were better than expected. But whatever bets traders made prior to the earnings announcement, most will unwind today, win or lose. Tomorrow, the roulette wheel shifts to JPMorgan Chase's earnings which will come out before the market opens on Thursday. On Friday, the action moves to GE. Some will bet on specific stocks; some will make market bets via the e-mini S&P futures. That will continue throughout earnings season. Long-only investors can buy a stock and hold it for a long time, even many years, riding a long term wave of profit growth. Tax laws even encourage investors to hold for at least a year. On the short side, however, the picture is different. There are no long term gains for short sellers. Furthermore, there is no downside protection. Short sellers are exposed to infinite losses. Sophisticated traders often hedge themselves but short sellers who make the wrong bet cover quickly. In fact, very often short sellers who make the right bet also

cover quickly and move on to place another bet, often on exactly the same stock. That explains, in part, why volume spikes often happen on the downside. Buyers simply have longer investment horizons than short sellers.

Because traders and short sellers have such short term time horizons, fundamentals matter less to them and momentum matters more. They believe trading patterns are the secret that unlocks the vault to success. Maybe yes and maybe no. There is scant evidence to support the notion that aggressive short term trading works consistently. But that doesn't matter. What matters is that a lot of people believe these patterns work. So they chase. They all sell at once and they all buy at once. And because so much money is moving unilaterally at the same time, moves to both the downside and the upside get exaggerated and movements between individual stocks are highly correlated. Historically, cross correlation between stocks is under 0.5 (1.0 is perfect correlation). Today, correlation is running about 0.8. It is all risk on or risk off. The net result is that the May-June decline went too far and it probably means the immediate optimism we see today after less than a handful of earnings reports may be a bit robust than it might have been historically.

In my crude head, stocks are fairly valued right around S&P 1100 where we are today but traders have the ability to create 10% undervalued or overvalued state of minds at any given moment in time. As investors, you want to sell into euphoria and buy into weakness. The other factor relating to momentum investing is that it doesn't seem to differentiate much between good and bad. Good and bad go up together and they go down together. That's a result of high correlation. Once again, you can use this characteristic to your advantage as an investor pruning weaker names on the way up and buying gems on the way down.

**All this volatility is frustrating but it can be used to one's advantage if you behave as a disciplined investor.**

I want to switch gears and talk about what I choose to refer to as the government rape of seniors. Recently, I noted the damage zero interest rates on short term money has done to seniors who save in a conservative manner. Essentially, it robs them of income. The beneficiaries are the banks and the U.S. government. Banks benefit from the steep yield curve and the Government pays next to nothing on close to \$13 trillion in public debt. If that were all, it would be bad enough. But now, Congress is about to let the tax rate on dividends go to 39.6% with another 2.9% increase coming in 3 years. In President Obama's budget address last winter, he proposed only raising the dividend tax to 20%. Treasury Secretary Geithner reiterated that desire to Larry Kudlow recently. But nothing has happened that will instigate a 20% rate. Doing nothing, something this Congress is prone to do if not prodded forcefully, will see taxes rise on dividends by almost 200%. So the government is going to rob seniors of almost all interest income and tax a healthy chunk of the dividends. It also has enacted a new law that will reduce Medicare expenditures. About all that is left is Social Security.

In a world where excess use of leverage created so many problems, it seems both illogical and imprudent to punish those who want to save. Congress has less than 40 working days before the mid-term elections to act. If you want change, you have to speak up. Right now, it appears that fussing about immigration in Arizona is more important than dividend taxes. Communicate with your Congressmen and Senators if you want to change the agenda. It is voting season. If they ever are going to listen, now is the time.

Based on wonderful earnings from Intel, stocks should get a good start this morning. Analysts, commentators and pundits can talk all they want about the economy but earnings speak for themselves. We have had less than a handful of reports so far but it appears once again that results are on course to exceed expectations.

*Think about the world we are in. This year, GDP and corporate profits will be at record levels but the U.S. will have lost more net jobs over the last three years than any other nation on the planet. Corporations have almost \$2 trillion in net cash and individuals have about \$6 trillion in net cash. No one is earning a dime on that money yet no one is confident enough to invest it either.* It is nice that the Administration is beginning to hear the message that the back and forth bashing between private and public sectors isn't accomplishing much. Both are looking for common ground. The rhetoric is a good start but nothing is destined to change without action. This week's court challenge to the Arizona immigration law and the announcement of a new expanded moratorium on oil drilling in the Gulf of Mexico don't exactly constitute steps in the right direction.

A real effort to bring dividend taxes down to 20% wouldn't be a bad place to start.

Today Polly Bergen is 80.

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Additional information is available upon request.

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