

Boenning Morning Comment

This report is prepared for us by Tower Bridge Advisors

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Stocks fell sharply on Friday in response to some earnings disappointments and a sharp drop in consumer sentiment in a University of Michigan survey. It was also an options expiration Friday in the summer and that, combined with some technical factors, probably created a drop that was bit outsized given the news. Yes, Google missed earnings by a couple of pennies but it was caused by a sharp jump in discretionary spending, not weak revenues or pricing. Bank of America and Citigroup reported results largely in line with expectations but both offered sober outlooks on the cusp of FinReg becoming law. GE's numbers were fine. You really didn't expect managements of either bank to tell us that there wasn't going to be a cost to FinReg, did you?

This week, earnings season will accelerate with roughly a third of the S&P 500 reporting by week's end. We will also get economic data on housing (guaranteed to be atrocious), leading economic indicators (likely to be down) and employment. On Wednesday, Fed Chairman Ben Bernanke will give his mid-year talk to Congress. Expect him to try and calm the waters about a possible economic downturn. Fed Chairmen simply don't talk down the economy in public testimony.

Overseas this morning, there are some rumblings about more fiscal problems in Hungary and Moody's downgraded Ireland's debt rating. But buried within that news are reports out of Germany that the second half economic outlook is improving not because of exports, but because of increased construction spending. Indeed, across Europe short term interest rates are beginning to creep up. As a gentle reminder, almost every country in Europe is focused on some sort of austerity fiscal measures juxtaposed to the U.S. policy of trying to accelerate government spending to support economic growth.

In my mind at least, one of the biggest problems here at home is that the private sector and the public sector appear out of synch. To give Washington its due, when one pushes forth a social and political agenda that contains major change, what will follow is always a period of uncertainty and adjustment. When that comes coincident with a fragile economic recovery, that is to be expected and might be a short term price to pay. There are aspects of Health Insurance reform and Financial Regulatory reform that will prove to be good and there are parts that will require adjustments or will be harmful to the economy. But that isn't really where I am headed other than to say that getting on the right common page amid so much change is very difficult.

Where I want to start is by trying to understand the psyche of the private sector. That is the place to start economically because it represents roughly three-fourths of the economy. In the wake of the financial crisis, consumers have already adjusted spending habits in order to live within their means. They are consistently paying down debt month after month and they are spending less on discretionary items. They are a bit worried about their jobs because the media harps on the employment picture but with so few layoffs taking place, those that remain employed today feel OK about their job security, at least for now. However, they are concerned about their assets. Home prices have stopped falling but, except for very few markets, they haven't begun to rise. That means there is a real out-of-pocket cost to home ownership today. Taxes, operating expenses and mortgage interest aren't offset at all by appreciation. It brings the concept of home ownership into question and is the chief reason that Americans today are hesitant to buy homes.

But homes aren't the only asset in question. Stocks rallied sharply from March 2009 through April 2010 and then stopped. Since then they have gyrated wildly giving back a bit of their gains. But holders of stock have gone from a mood of steady recovery to a questionable environment suggesting that the gains through mid-spring might be all we are going to see for a while. While market pundits talk of double-dip recessions and some of the most notable bears scream wolf for those still wanting to listen, most simply see an economy headed nowhere. It doesn't make them confident their stock portfolio is headed steadily higher.

Houses and stocks are two major asset classes. The third is fixed income. The environment there is no better. Conservative Americans own their homes free and clear and have most of the rest of their savings in fixed income. Today, it earns next to nothing, especially if one chooses to keep maturities short.

The average American family earns money from two sources, their wages and their assets. The reason Americans didn't save in 2006 and 2007 is because their assets performed so well.

Let's briefly look at the corporate world. Like the consumer, corporations have rapidly repaid debt and restored health to their balance sheets. They sit today on record amounts of cash. But with capacity utilization in the low-mid 70% range, there is little incentive to invest. With a stalled economy and uncertainty about regulation, there is little incentive to spend either other than to meet immediate demand.

Now let's compare the situation Americans find themselves in today to government policy. Logically, government policy should be directed toward meeting the needs for Americans. If policy were perfect today, the primary short term focus would be on job creation, rebuilding confidence, and restoring asset values. Spending, on the surface, seems like a compatible idea but when the world is trying to pay down debt and deleverage, borrowing in order to increase spending sounds rather illogical. Indeed, the government is not only trying to spend itself, it is trying to force the private sector to spend as well. Home buyer tax credits, appliance rebates and cash for clunkers are three obvious examples. While all these programs had some impact, the net result is to bring demand forward rather than to increase it. Thus, on the backside of these programs, there are dead air pockets. You see that with housing today. Federal Reserve policy is similar. Zero percent interest rates are obviously designed to stimulate borrowing to spend. But Americans are cured of borrowing and leverage. They are happy to spend, but only within their means. They are unwilling to spend beyond their means even at zero interest rates.

Without asset stability or appreciation, spending within one's means today means living entirely off of wages, Social Security and transfer payment like food stamps and unemployment benefits. The asset engine is idled. An activist government is tempted to try to ignite that engine. That is what zero interest rates and borrowing to spend are all about. But those actions aren't working because they are in conflict with the desires to reset spending at the consumer, corporate and government levels to live within one's means.

The reality is that government cannot force home prices higher and it cannot make people buy homes directly. Excess housing inventory will gradually be absorbed by population growth and demolition. It will take time. Once markets get back into balance, prices will eventually start to rise slowly. Federal Reserve efforts to keep interest rates artificially low are clearly not stimulating activity. Monetary velocity today is about where it was in the fall of 2009 at the depths of the recession. But low interest rates rob savers of income. **There is over \$10 trillion of money in our country sitting on the sidelines doing nothing and earning nothing!** If the Fed's response to a slowdown in economic growth were to pump even more money into the system, it would be counterproductive. With \$10+ trillion

sitting there, we don't need more money and we certainly don't need more borrowed money. What is needed is confidence to spend and invest.

I have said many times already that Americans will spend but only within their means to spend. For every 1% increase in interest income on that \$10 trillion in idle assets, \$100 billion of income gets created.

You can see my point in other ways. When stocks stopped going up, the economic recovery slowed down. Americans understand the connection between net worth and the ability to spend. When stocks dropped 15%, spending growth dropped as well, particularly at the high end. Toll Brothers is a high end home builder. In the three weeks after the expiration of the first time home buyer tax credit, its deposits rose. But then the impact of a bad stock market and news of a buyers' strike hit home and their orders stopped.

Washington directly, cannot make home prices go up. It can't make stock prices go up. But it can build confidence with a set of policies designed to meet our needs. Whatever you believe about health insurance reform and FinReg, the two cornerstones of Obama's agenda to date, they are not job creators and they don't reduce the deficit. The Gulf oil spill wasn't created in Washington but the response costs jobs. That's unfortunate. Rebuilding jobs doesn't begin with raising unemployment benefits. It begins with policies that put more money in the hands of those willing and able to spend, and it begins with a coordinated effort that Americans can understand. Germany is taking measures to build long term stability and that appears to be sparking new investment spending. China is trying to reduce speculation and redirect economic growth internally. When governments and the private sector are in synch, the proper response is created.

Focused increased investment leads to increased spending. Spending doesn't lead to more spending. Often it leads to less spending if a stagnant pot doesn't grow. If you don't enlarge the base or create more velocity, more spending eventually leads to bankruptcy. The President is touring the country trying to tout the benefits of government led investment (e.g. car battery plants). That kind of spending is great; there is simply too little of it. Lower marginal tax rates, particularly for low-middle income Americans or for corporations would also stimulate investment spending. So would permanent tax credits to invest.

Finally, I know 2010 is an election year but all the political sniping back and forth isn't a confidence builder. Hopefully, after November that may subside. But with that said, it would help both sides of the aisle if Democrats and Republicans could put forth game plans for economic recovery that made sense to most Americans. Simply criticizing the other side isn't a turn on for anyone.

What Americans find most frustrating today is that neither party has a coherent game plan. Therein lies the principal appeal of the Tea Party movement. While there are plenty of flaws within the Tea Party agenda, what is most notable is that the reason the movement even exists is that Democrats and Republicans alike are not responding to the needs of most Americans today. The party that develops a message that is more closely aligned to what Americans feel is needed to move forward is going to win big in November.

Futures today indicate a modestly positive opening. Earnings and subsequent commentary on the future outlook by corporate managements will be keys this week. While Friday's decline had scary elements, I don't think it meant a whole lot in and of itself. For now, markets seem range bound until economic policies become better aligned to the needs of America.

Today Vikki Carr is 69. George McGovern turns 88.

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