

## Boenning Morning Comment

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

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After a miserable opening, stocks rallied throughout the day closing at their best levels. The theme in the morning was that some companies reporting second quarter results were coming up a bit short on the revenue line. By the afternoon, investors seemed to conclude that too much fussing was creating bargain prices. Said differently, traders with a horizon measured in hours were jerking the markets around. The bottom line is that stocks remain stuck in a range. Neither bulls nor bears seem to have enough momentum at the moment to change that.

Americans live economically by spending money from two different buckets. The first one is filled with money from wages. That bucket is growing very slowly but it is growing both because more people are working and because wages are still rising slowly. The other bucket is what I will call the return on capital bucket. For most Americans their "capital" is comprised of three sources. The first is their home, the second is their stock portfolio, and the third is fixed income securities including everything from bank deposits to long term bonds.

In normal times, the capital bucket generates pretty nice returns. Over the last century, stocks have generated total returns in the high single digits. Fixed income returns have been more like middle single digit numbers. Over the past decade, however, stocks haven't returned anything. In 2008 and early 2009, stocks got crushed. Not only did stocks generate no returns, Americans have to dip into other resources to begin to replenish that part of the bucket that was evaporating. But beginning in March 2009, stocks began to rise. By the end of April, some investors were even within sight of where they were just a couple years earlier. As values improved and confidence came back, they began to spend a little again from this segment of the bucket. But in May, the rally stopped. For a few weeks, it looked like the stock market was going to do a replay of the fall of 2008 but they have begun to stabilize in recent weeks as little data supported the notion of a double dip recession. More on that thought later. But a stabilized stock portfolio isn't a growing portfolio so this part of the bucket isn't generating much of a return.

On to real estate. For most people that means their homes. Obviously your home doesn't generate income for you but for decades the rising value of your home created substantial equity. In a period of declining interest rates, which we have lived in for almost three decades, that increased value was extractable via mortgage refinancings. Thus, American home equity appreciation became a good source of spending money. Today, home values have started to stabilize but they aren't going up yet. However, lower interest rates are generating moderate refinancing activity. Therefore, this part of the bucket is making a small contribution in some cases but not much overall.

As for fixed income, we all know that it is paying much less than it did just a year ago. For Americans living off of their fixed income holdings, the drop in income is jolting. Some are dipping into principal to meet needs but that isn't a viable long term solution.

Therefore, the wages bucket is making its contribution and the return on capital is almost empty. It has been empty for many months. Until interest rates rise, homes begin to appreciate or stocks go up persistently, return on capital is going to be subpar and that will keep overall spending down. The good news from my vantage point is that I can't make much of a case for stocks, home values or interest rates to go much lower than they are today. The one scenario that really messes the picture up would be significant deflation. While the subject is broached a lot in the

media these days (when you run 24/7 you constantly have to find worrisome things to discuss), it is hard to make a solid case for deflation. Capacity utilization is rising and very little capital is being spent on new bricks and mortar. Apartment rents are rising and have been for six months or so. Wages are still increasing slowly. Clearly there isn't much inflation in the system but there isn't a sudden new downward pressure on prices either. During the recession, Americans relearned the art of haggling and bargain hunting. That clearly pressured prices, fees, etc. But while that pressure remains, it clearly isn't accelerating. Inflation of 0-1% appears likely for some time, at least until capacity utilization goes up by another 4 or 5 points. But deflation, where workers accept annual salary cuts and Americans live hand to mouth waiting for ever lower prices, still seems like a stretch to me.

As for all the talk of a double dip recession, that seems to be more media hype than reality as well. Americans are spending more, corporations are spending more, the Federal government continues to spend a lot more, and exports are rising. Spending continues to grow for education, health care, and technology. These offset modest drops in state and local government spending and rising imports (mostly oil price related). If there is to be a recession, Americans have to decide to spend less per capita. For that to happen they need to be frightened into sitting on their hands. In 2008, the collapsing banking system created that fear. For a few weeks in 2001, the World Trade Center attacks triggered that fear. Something similar could happen again but I don't see anything visible at the moment. With the catalyst that creates the fear to spend, I don't see how one gets from a forecast of slow growth to a forecast of recession.

It leads me to the same conclusion I have been expressing lately. Slow growth will continue. With no inflation and very low interest rates, short term bonds will continue to yield near zero and longer term bonds will generate low single digit returns. For stocks to compete they have to be priced to return 6-7%, below normal returns of 8-10%. With dividends near 2%, that implies about 5% growth. Nominal GDP will grow 3-4% leaving 1-2% to come from share repurchases and international growth. That seems reasonable implying stocks are reasonably priced. What will make them go higher? If one can project growth and dividends to exceed 7%, stocks will have to be repriced upward assuming bonds and interest rates stay where they are.

That could happen. I think a very good case can be made that we are near a point right now of maximum uncertainty. Housing activity barely exists today in the wake of the expiring tax credits. But this is a slow season. By fall some level of activity should return. The BP oil spill should be plugged permanently within another month and restoration of semi-normal life along the Gulf Coast might return within months. States had to approve balanced budgets by June 30. Most had to make significant spending cuts. Those will be largely history before Labor Day. The Census workers will have come and gone by then. Unemployment claims extensions will keep some money flowing to people out of work. We might even get some clarity on tax policy by the fall. Right now it is no one's focus at all. No tax increases for couples making less than \$250,000 was a cornerstone of President Obama's agenda. If nothing happens right now, that promise will be blown apart once the Bush tax cuts expire. It will be very hard for Democrats to run for office this fall while breaking that promise. That doesn't mean that any tax legislation will pass but I will be shocked if nothing is put forth to realign the Bush tax cuts in a way consistent with what President Obama proposed last winter which was to preserve current top bracket rates for those earning less than \$250,000 and to set capital gains and dividend taxes at 20% each.

Greater clarity means less risk which means higher asset values. Let's hope.

Futures this morning point to a mildly positive opening. Apple will be a headline story after reporting great earnings last night. Note the absence of long lines to return iPhone 4 units with bad antennae. Another overhyped 24/7 media tour de force. At least it didn't knock Lindsay Lohan's perp walk to jail off the front page.

Today Robin Williams is 59. Jon Lovitz is 53.

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Additional information is available upon request.

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