

## Boenning Morning Comment

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

July 7, 2010

Stocks went on a roller coaster ride yesterday spiking higher at the open, falling steadily throughout the day, and then rallying in the last five minutes to post modest gains and break a seven session losing streak. There was little or no news to move stocks.

Although pessimism still reigns supreme along Wall Street and in the media (which is paid to be cynical and pessimistic), I find it rather fascinating that the economic viewpoint of most bulls and bears is now very much alike. Although there are a few who proclaim that a double dip recession is just around the corner, almost all noted economists now appear to agree that growth in the second half of this year will be about 2% give or take a percentage point and that it may fall as much as another full percentage point next year. Next year's growth estimate will still need to be adjusted by any changes in fiscal or monetary policy between now and then.

2% growth doesn't really feel all that good. That environment is unlikely to create enough new jobs to move the needle on unemployment far from current levels. It is unlikely to produce an environment that allows the average American to experience any growth in personal disposable income and that means spending growth will be a function of population growth and little more. Fed policy to keep interest rates near zero robs savers of any extra income. But with that all said, 2% growth doesn't argue for a smaller economy, lower profits or even lower stock prices.

But that doesn't mean the markets have hit bottom. Negative psychology can take stock prices below fair value in the short term. Momentum is hard to change. Earnings growth and rising dividends may be a counterweight to the trend over time but emotion and momentum dominate right now. So we have to tough it out, spending some time trying to pick off a few irresistible bargains until the market sends an all clear signal.

One irony is the thought that by the end of 2010, GDP will be back at or near record levels and so will corporate profits. But both will have been achieved with 7-8 million fewer employed Americans. Corporations have discovered that they can get the job done with fewer workers and small business formation is almost non-existent because there is no capital available to support startups. Thus profits are good and there is plenty of money on the sidelines to invest. But uncertainty is still delaying investment and jobs aren't getting created.

But that is the good news. Banks have adequate capital, corporations are flush with cash and there are 10+ million Americans ready and able to work. The potential for growth is there. What is missing is a game plan, any kind of coordination between Washington and the private sector to focus on growth and job creation. The big agenda items to date have not been designed to create growth or jobs. Health care reform morphed into health insurance reform. Tens of millions of Americans now have new access to health care but nothing was done to reduce per capita health care costs. As a result funds will transfer from other economic activities to health care in order to satisfy the needs of the new legislation. Financial regulation, presumably set to pass within the next two weeks, sets up layers of bureaucratic hurdles and tightens regulation. Some parts are good and needed but the net result will also be less credit available and higher costs to corporations who use financial instruments to hedge risks. Undoubtedly that will mean fewer jobs and reduced lending. There is a deep water drilling moratorium in the Gulf of Mexico courtesy of BP's oil mess. When and if the moratorium is lifted, it will almost certainly lead to very expensive and time consuming added steps to ensure that there is no repeat of what happened in April. As is always the case, the pendulum swings too far and the net result, even with a complete lifting of the ban, will be much less deep water drilling. If you want

further evidence, look at the real estate market today. Isn't it rather ironic that homes contracted to buy in April in order to qualify for a tax credit couldn't be completed in 60 days even though new construction is down roughly 80% from peak levels. The devil is in the details. Every government entity, from local to Federal now has a book of papers that must be completed before any mortgage loan can be done and yet 99% of the paperwork provides little or no additional protection to either the borrower or the lender. Simply put, in most cases, bureaucracy is an unnecessary burden. Bureaucracy is why all those mortgage relief plans perpetuated by the government since the housing crisis began never worked. No one could get through the regulatory barriers.

At some point, it will become clear that the way to create jobs is for the public and private sectors to work together in a way that protects the consumer but doesn't create so many bureaucratic hurdles that nothing can get finished. At some point, both sides will stop looking at the other as the enemy. The private sector wants to invest; there is no reason to sit on cash earning zero. The public sector wants to see employment growth. If they have a common goal they should be able to find a common solution. Should and will, however, aren't the same thing.

The good news is that we are probably at the low ebb right now. After health insurance reform and financial regulation, there is not likely to be any other major agenda item that will obstruct growth. If the economy continues to show signs of weakening, it is quite possible that unemployment insurance gets extended once again and it is quite possible that taxes get modified in a stimulative way (e.g. extending the Bush tax cuts for those making less than \$250K). Despite terribly weak home sales, home prices are hanging in near recent levels, a sign that values are near an economic bottom. Note that apartment rents have been rising steadily for the past eight months. Housing starts and new home sales literally can't go any lower than they are right now. They may bounce along the bottom in this seasonally slow period for another month or two but I suspect there will be some noticeable improvement by the fall if markets are simply left to their own devices.

Even the employment numbers may not be quite as bad as they appear on the surface. A lot of fuss has been made about the addition and subtraction of census workers but they aren't the only government employees that impact the head count. State and local governments are mandated to prepare balanced budgets. With less stimulus money available going forward, many have had to make personnel cuts. A lot will take place in June and July coincident with the start of new fiscal years. The employment numbers also must reflect the loss of tens of thousands of jobs along the Gulf Coast not just among those who work in the oil business but also among those impacted by the dramatic drop in tourism along the Gulf Coast this summer. Those impacts are likely to be one-time in nature. Indeed, once the well is plugged, beaches should be cleaned up over the next few months and life will gradually return to normal. Construction jobs are also near a low coincident with the expiration of the tax credits I just talked about. By the fall, there should be some pickup. Today, the President is going to talk about the possibility of exports doubling in five years. While that speech may be political hyperbole, directionally, exports are rising and that will add to employment.

This week there is no significant economic news. The one big day will be tomorrow when chain stores report June results and weekly jobless claims are released. Expectations for both are for disappointing numbers. Next week is the start of Q2 earnings season. The numbers themselves should be good but will mean little. What will matter most is management commentary in the conference calls that follow earnings releases. Some managements will try and sound optimistic; others will express fear of the unknown. Given the sour mood of investors, it is unlikely that earnings themselves will give stocks overall a lift although they could dilute the excessive pessimism that has crept into markets over the past two months.

That leads to the obvious question. What will turn stock prices around? The answer is one of three things. The first is valuation. At some point, valuation trumps all and stocks will move up if they get too cheap. Valuations are already rather compelling both in an absolute sense and related to alternatives like government bonds low yielding

less than 3%. Even if I only apply a 13 P/E to \$80 earnings per share for the S&P next year implying a no growth year for earnings, I still get a price higher than stocks are trading today. The second catalyst would be good economic news. In the short run, the news is likely to continue to point to a slowing economy. Without knowing for certain when the slowing stops or whether it can stop before we fall back into recession, it is unlikely that news events themselves will give stocks a quick lift. That leaves the third possibility which is a shift in policy from Washington, one designed to help create rather than destroy jobs. It clearly isn't there today but that doesn't mean it can't happen sooner rather than later. With Labor Day just two months away, it would seem that jobs ought to get someone's attention in the White House before long. The time is long past when the President can simply blame someone else for the lack of new jobs. But until we see action rather than rhetoric or blame shifting, we can't count on policy to lift stock prices.

In the short run, therefore, the best hope is valuation. As the 10-year Treasury yield slips, bonds look less and less appealing. If corporations use some of their cash horde to increase dividends, stocks will become more appealing. Over the past few sessions, the selling pressure seems to be exhausting itself. For certain, it can reappear if more unexpected negative news appears. But Europe seems to be calming down without any further hint of disaster. Chinese growth is slowing but it isn't stopping. In this country, the economy is growing more slowly but there are few indications to suggest it isn't going to grow at all. Markets cannot continue to discount the same news over and over again. If stocks are headed materially lower from here, the picture I have just drawn has to deteriorate further. News that simply confirms slowing growth won't be enough to push prices lower and keep them down. Markets are trading in a very highly correlated way consistent with momentum trading. That is an unfortunate consequence of fast money trading tied strictly to technical behavior. Right now traders everywhere are fixated about the 1040 level in the S&P. When that level was violated, everyone turned violently negative. 1040 is now impenetrable resistance according to their mantra and the downside can be anywhere for 950 on down to near zero. But that is all psychology talk based on nothing fundamental. Still, it creates its own momentum and that momentum has to be broken for markets to turn the other way. As we have seen, that can happen overnight. Indeed, that is exactly what happened in April when euphoria suddenly turned to fear.

Thus, we look for a bottom in absence of more negative news but we don't want to fight the tape too much. Nibbling at irresistible bargains is fine and prudent, but trying to pick the bottom can be painful if you are wrong. So be patient and keep some cash in reserves. Hopefully, better times lie ahead.

Futures are mixed this morning but well off their lows.

Today Ringo Starr is 70.

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