

Boenning Morning Comment

This report is prepared for us by Tower Bridge Advisors

July 9, 2010

Stocks rose smartly yesterday finishing at their highs for the day. It was a stunning performance on the back of Wednesday's gains of almost 3%. Over the past three sessions, stocks have recovered everything lost during last week's crushing five day decline.

So what happened? Is anything suddenly different today than it was a week ago? Did some new data spark the rally?

The answer, economically, is that nothing has changed. Absolutely nothing. As I noted on Wednesday, economists are in virtual agreement that the economy is growing a bit more slowly than it did in late 2009 and early 2010 but the odds of a so-called double dip recession are very small. There is simply no data whatsoever available today to support the notion that another recession is imminent. There has been no new data this week and there haven't been any earnings reports of note either. All the near term issues that we and others have discussed are still on the table. Employment growth is slow, inventories are in line, consumer spending is sluggish, regulatory reform requires some adjustment, taxes are headed higher, the BP well still isn't capped, housing stinks, and exports and manufacturing are solid. There are some factors weighing on the economy that might be temporary in nature such as the rising and falling count of census workers, the economic consequences of dirty beaches along the Gulf Coast, and state and local budget cuts coinciding with June 30 fiscal years. But there are some good temporary influences as well. Exports are strong, a strengthening dollar attracts capital, and hot dry weather stimulates activity.

But the bottom line is unchanged. Most forecasters now see growth in the U.S. in the second half of this year in the 2-3% range with some slight further moderation in 2010 as the impact of Federal stimulus fades, taxes increase, and the costs of regulatory compliance rise. The rhetoric in Washington is changing slightly amid somber economic data and criticism from the business community but the actions are the same. The administration is continuing to pursue its political agenda and the economy takes a back seat. Obviously, if the data turns sufficiently negative, Washington will step up the rhetoric and, if necessary, make adjustments. But so far, that hasn't happened.

So if the economy hasn't changed, what has? On Wednesday I noted three factors that could turn the market around. One was better economic data and another was policy change. Neither happened. The third, and the one that I was banking on, was valuation. In a word, stocks simply got too cheap. The pendulum had swung too far. On Wednesday morning State Street Bank reaffirmed its revenue guidance. Some ascribed that to be the trigger for the rally but stocks don't rise over 4% because one moderate sized bank reaffirms earnings guidance. It is the nature of market bottoms that psychology turns 180 degrees on a dime, usually for no immediately recognizable reason. In a much grander scale, that is what happened in March 2009. Stocks had fallen well over 20% just since the beginning of the year. Within weeks that decline was reversed.

One of the truths today is that the marketplace is dominated by momentum trading. Black boxes, fast trading, hedge funds, whatever, move money around at speeds never seen before. To many of them, long term is measured in days. The NYSE Euronext has over 8,500 listed issues. 100 of them account for 50% of the volume. This is where the big money plays every day. Long term investors typically hold stocks of 2-3 years. Many shares are held for decades. In 2008, the average holding period was 109 days. The average holding period was four months. The most active issue, Citigroup, has seen as much as 20% of its float change hands in a day! Fast traders step in front of existing orders by a tenth of a cent in order to trade. It is not uncommon for a trading program to trigger thousands of simultaneous trades within a single second.

I don't want to go off to far on a rant on fast trading, etc. other than to say that is disruptive, it increases volatility, and it creates temporary periods where stocks are overpriced and underpriced. That is what momentum focused trading does pure and simple. As investors, not traders, one can use this to his or her advantage but it requires discipline and a strong stomach. We all realize that when stocks are falling hard, it is very easy to second guess yourself and to capitulate at exactly the wrong time. But every stock has a fair value at any given moment in time. When trading euphoria lifts prices to a level where very little upside remains, it is time to sell. I think, with hindsight, we reached that point in late April. Conversely, stocks can reach a level when they discount all the bad news and then some. That reached a crescendo last week. You could see that selling was exhausting itself. We pointed that out earlier this week.

I am not suggesting that I saw a 4%+ pop coming in just three days. Those kinds of moves usually happen out of the blue. But we did note the values and it was right to start to nibble. Investors, ourselves included, don't really like the trade. In utopia we would like stocks to rise slowly mirroring the rising underlying enterprise value. But as long as momentum trading is allowed to dominate, we are left with two choices. We can buy for the long term, riding the waves of euphoria and pessimism up and down along the way, or we can lighten up a bit at peaks and use the reserves to go back in when pessimism becomes obviously overdone.

Where are we now? Jeremy Siegel notes that stocks over the long term should generate a real return of about 6%. Right now inflation is about 1.5% so nominal returns need to be about 7.5%. Dividends are close to 2%. Earnings have to provide the other 5%. But GDP may only rise 3-4% over the next 12-18 months. Where will the difference come from? The IMF forecasts global growth of 4.6% implying faster growth outside the U.S. The balance will come from productivity and net share repurchases. The implication is that stocks are probably fairly valued at the present time, perhaps a slight bit undervalued if one assumes 5% earnings growth next year. Said in a different way, the pendulum swung too far to the right in April and too far to the left in June. At S&P 1070 where we are today, it seems about right plus or minus a few percentage points. If you didn't buy on Monday, don't hurry up and chase. Be selective. Clearly, my two-day rule suggests the wind is now at our backs, at least for now. Just because the market as a whole is fairly valued doesn't mean there aren't underpriced stocks around. Scrutinize the names that are lagging and ask yourself why. Search for solid dividend growth, strong overseas presence and bona fide growth stories. As bull markets mature, and I think we are still in a bull market that began in March 2009, fewer and fewer stocks move higher. I think the winners will all share the characteristics I just mentioned.

Futures suggest a modestly lower opening. We are back in the S&P trading range of 1040-1130 and could be locked in the range for some time. Next week starts earnings season. The reaction to earnings of key reporting companies next week (Intel, GE, JPMorgan Chase and Citigroup) will tell us a lot of what to expect over the next several weeks.

Today Courtney Love is 46. Jimmy Smits is 55. John Tesh is 58. I wonder if he and Courtney Love ever sang together. Frightening thought.

James M. Meyer, CFA 610-260-2220

Additional information is available upon request.

* - Boenning and Scattergood may act as principal in buying this stock from or selling it to the public.

- The author of this report or accounts under his management at Tower Bridge Advisors owns this security.

Additional information on companies in this report is available on request. This report is not a complete analysis of every material fact representing company, industry or security mentioned herein. This firm or its officers, stockholders, employees and clients, in the normal course of business, may have or acquire a position including options, if any, in the securities mentioned. This communication shall not be deemed to constitute an offer, or solicitation on our part with respect to the sale or purchase of any securities. The information above has been obtained from sources believed reliable, but is not necessarily complete and is not guaranteed. This report is prepared for general information only.

It does not have regard to the specific investment objectives, financial situation or the particular needs of any specific person who may receive this report. Investors should seek financial advice regarding the appropriateness of investing in any securities or investment strategies discussed in this report and should understand that statements regarding future prospects may not be realized. Opinions are subject to change without notice.