

## Boenning Morning Comment

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

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Stocks fell once again on Friday closing out a rather dismal week for stocks. Investors were clearly spooked by both the Federal Reserve's actions last Tuesday and by its rather sudden change in outlook over the past two months. Is the Fed simply late in realizing what markets have realized for a while that economic growth was decelerating? Or was the Fed privy to economic data suggesting a more rapid deceleration than we all see at the moment? It certainly doesn't clear the air to hear some Fed executives talk of the need to keep a watchful eye on inflation while others talk of the risk of deflation. Granted, every Board member is entitled to his own personal opinion but as investors we are looking for a unified posture that makes logical sense.

On Friday, I talked about corporate vision postulating that IBM and McDonald's both have developed sound long term plans that investors buy into while Microsoft and Cisco are both growing as well but are far less successful expressing their forward looking game plans to investors.

Today, I want to take the same approach and apply it to the Federal Government. I just hinted in the opening paragraph that investors were spooked last week by both the actions and the statements of the Federal Reserve. What was most worrisome last week was the apparent sudden change in tone in just a few short weeks. Even though actions mean more than words and the Fed really didn't do very much by stating it would use proceeds from mortgage repayments to buy Treasury securities, both individuals and corporations base economic decisions, at least in part, on their economic outlook. Since government has so much economic control, directly or indirectly, Americans look to the government not only for direction, but for consistency and for an economic game plan that sounds realistic. In one word, that is a vision.

The Fed's vision isn't very complicated. Its mandate is to maintain price stability and help to foster sustainable economic growth. Mid-course adjustments are part of the process. Thus, I can't begrudge the Fed for the actions taken last week. Indeed, with the monetary base starting to fall at a time when economic growth is teetering makes a lot of sense. The Fed's logical vision is to stay accommodative until there are clear and enduring signs of economic recovery. The Fed, however, runs into trouble in two ways. First, it is unclear to some, including myself, why a focus on keeping interest rates near zero is the right approach to accommodative policy. Second, the Fed can't keep the economy growing by itself without compatible fiscal policy. I will get to that point in a moment. Interest rate setting is a tool; the Fed's primary task is to regulate the money supply generally to keep monetary growth in line with intended GDP growth recognizing that changes in monetary velocity play a major role in how fast the monetary base can and should grow. But by basing policy on interest rates at a time when rates are at virtually zero, the Fed provides an impotent vision. What can the Fed do if it can't lower interest rates any further? The answer, of course, is that it has the ability to print money if it wants to so there is no real end to its tool kit. Obviously, there can be nasty consequences from printing too much money but my point is that the Fed still has a lot of flexibility left if it wants to use it.

But right now what appears to be happening is a strong force pushing against an almost immovable object. Americans and businesses want to deleverage. They don't want to borrow. Sure if rates are low enough, IBM will refinance debt by issuing new 1% bonds for three years and wealthy homeowners who still have adequate equity in

their homes will refinance and increase their disposable income. But low rates are enticement when entities want to borrow. They are much less effective when everyone wants to save. In fact, they can be counterproductive then. Some argue that low rates force more savings at the expense of consumption because people cannot make any income from existing savings. Said differently, people have to spend less because their capital provides no supplemental income. Since Fed econometric models were all built in periods of inflation and leverage, they don't work properly in today's environment. What is the right solution? Time will tell but the Fed at the moment doesn't appear to be helping to support or spur growth in a significant way.

That brings me to fiscal policy. When President Obama ran for office, he offered a political vision, a social vision and an economic vision. He felt the government could and should take a larger role in the delivery of health care, had to strengthen regulatory oversight in areas where it was lax or virtually non-existent, wanted to end the wars in Iraq and Afghanistan, wanted to provide a cleaner environment, and wanted to shift the economic center away from the wealthiest classes toward the lower and middle classes.

All that is fine and he has accomplished a lot politically and socially in his first two years in office. Time will tell how effective his policy shifts have been. But where he has slipped a bit is in expressing and executing his economic agenda. Obviously, he entered office at a very difficult time. Some of the programs that helped to end the recession were already in place. The Fed had embarked on quantitative easing before he took office and TARP was already in place. But his administration orchestrated the bank stress tests that rebuilt confidence, it put Chrysler and GM into bankruptcy and got them back on their feet.

But as crisis passed, the President took his eye off the economic ball. Most of 2010 to date has been tied up with health care and financial reform. Both, rather than stimulate the economy, slow it down. Health care reform is going to increase per capita costs via higher insurance premiums and FinReg will reduce the availability of bank loans. That is OK if there is an economic offset, something within fiscal policy to compensate for the pressures invoked by reform legislation. The two possible alternatives are increased investment spending and lower taxes. Unfortunately, there is confusion right at the moment rather than a vision.

Much has been made of the relative success or failure of the big stimulus package passed in early 2009. Heavy in transfer payments, block grants to the states and a fair amount of good old fashioned political pork, it doesn't seem to have been as effective as it would have been with some economists in control. Reality is that much of it hasn't even been spent. Government bureaucracy has been so extreme that many requests for stimulus projects simply never got done. Government bureaucracy has also stifled many programs to alleviate mortgage foreclosure or loan resolutions. Government spending policy appears to be more reactive than proactive. On the tax side, one of the cornerstones of President Obama's master plan was no tax increases for American families making less than \$250,000 per year. Yet the Bush tax cuts are due to expire at the end of 2010 and if they are allowed to, there will be major tax increases for all Americans down to the poverty line.

In September, Congress will start to consider what has essentially boiled down to three options:

1. Extend the tax cuts for some period of time (probably 1-2 years) recognizing that economic weakness precludes for now the desire to transfer wealth from the rich to the middle classes.
2. Extend the cuts to all making \$250,000 or less but raising taxes for those making more. That would be in synch with the President's ideals but the timing may be lousy and the Democrats may not be able to muster the required 60 votes to get the job done in the Senate.
3. Fail to reach compromise and simply let the tax cuts expire.

Without giving odds for the moment, let me be crystal clear what the choices mean for investors. The first option would be most favored. Stocks would probably enjoy a healthy rally. The second choice would probably slow the economy a bit next year but it wouldn't be dire. Markets would probably find that choice tolerable, not great but not a disaster either. Clearly, if government spending is going to be higher than normal for some time, some form of tax increase is inevitable.

As for the third choice, it would be political suicide for all incumbents, particularly the Democrats and it would cause a major decline in stock prices worldwide.

That's the bad news. The good news is because the consequences I just expressed are so obvious, I think the odds are rather short that Congress will go into recess before elections doing nothing. Indeed, if Congress even threatened to go home for elections without taking action, the subsequent reaction in financial markets would change their minds very quickly.

Let me bring this all together and go back to vision. If everyone took a deep breath and looked around they would see an economy that is destined to grow slowly for an extended period of time until Americans have rebuilt savings sufficiently to allow them greater confidence that they could spend a little more without wrecking their abilities to live and retire in relative comfort. Policies aligned to that reality will be the most effective. The President's social and political agendas do not have to conflict with the American desire to increase savings and live more moderately. But it must understand that if Americans want to save and you force them to spend more in other ways (e.g. taxes, health care premiums), then they will be forced to spend less in other ways. Businesses will be less willing to hire. It is a natural consequence.

The realities, therefore, are that the best of worlds for a while is what Pimco's Muhammad El Erian describes as the "new normal". Those in debt (individuals, corporations and sovereign nations) want to borrow less. Growth will accelerate in the developing world and be slower in the developed world. Pushing too hard to change that won't work and will lead to undesired consequences (look at Greece). For a while, excess supply will mean higher unemployment, excess capacity, lack of pricing power and little or no inflation. Accepting and adjusting makes more sense than fighting back. That doesn't mean government can't do anything. Bringing troops home and investing in rebuilding American infrastructure sure makes sense. Fostering faster development of clean energy is a great idea. Trying to double exports in five years is a noble goal. A vision needs to accompany the words.

Right now investors, indeed most Americans, are lost. The Fed is confusing us and Washington, at best, deserves a grade of "incomplete", one that can morph to an "F" if the Bush tax cuts are allowed to expire.

Investors are racing to buy Treasuries at record high prices and record low yields because Washington hasn't been able to provide a sane vision for tomorrow. Germany, on the other hand is booming because it has a sensible and sound economic agenda in place.

One final P.S. if I may. Remember in the wake of the sovereign debt crisis this past spring how Germany was ridiculed for banning naked short selling in its financial markets? Want to know which financial market has been the best performer since then? The SEC still can't figure out what happened during the May 6 flash crash much less what to do about it. No wonder roughly \$50 billion has exited domestic equity mutual funds since May.

Futures suggest a moderately lower open today.

Normally, I don't mention deaths in this letter but both Elvis and Bela Lugosi died on this date. Today Madonna is 52. Happy Birthday to my daughter Sarah.

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