

Boenning Morning Comment

This report is prepared for us by Tower Bridge Advisors

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Stocks fell again on Friday ending the week on a down note. But bulls may take a little solace in the fact that an important support level held, at least for the moment, and stocks finished off their worst levels for the session. The NASDAQ Composite, which has been hammered lately, actually crossed into the black at the close of Friday's session.

As I warned a few weeks ago, in the absence of a lot of new news, investors in August were likely to dwell on the uncertainties. It didn't take long for the media to convert those uncertainties into a negative tone. Look at The New York Times for just one example. The lead story yesterday on the front page, not just the front page of the business section, was about the apparent exodus of individuals from the stock market. The Times accurately noted that individuals have been huge net sellers of equity mutual funds so far this year and, in fact, they have been consistent sellers since mid-2008. Today's front page features a different story asserting that housing is no longer a creator of family wealth and isn't likely to be any time soon. Neither story is new news. Neither was particularly revealing. The housing story could have just as easily been written two years ago. For that matter so could yesterday's story. The point to be made is the following. In the absence of real news, the press has to conjure up something for readers to fret about. If the story is well written, fret they will. If they fret enough, the story could actually become a bit of a self-fulfilling prophesy but I suspect that won't prove true here because the news is so old and the story has been told and retold countless times. As investors, it is important not to get caught up in all the negativity but to look more closely at the facts.

So what has really changed over the last several months? The first place I look in an economy where the consumer counts for two-thirds or more of GDP is to see if there are any changes in consumer behavior. Frankly, I don't see much. I think the buoyant stock market early this year, tax refunds, the housing and appliance tax credits and some pent-up demand may have elevated spending early in 2010 a bit higher than what one would constitute as sustainable levels. Where there were direct tax credits, in housing and in appliances, clearly sales were brought forward by those credits and demand is weak on the backside. Perfectly logical. But elsewhere, business really doesn't appear to be changed much. Weekly surveys of sales at retail stores over the past three months have stayed remarkably consistent. Year-over-year growth has barely moved. Hotels and airlines are doing great. Yellowstone National Park, in the news this weekend, is having a record year. Auto sales have actually nudged higher over the past couple of months. If GM had a captive finance arm or if dealers didn't literally run out of inventory of several hot selling models, business would have been even better. We know housing is moribund and may remain so for some time. But it isn't going much lower from here and isn't a big drag at the moment.

The problems with housing aren't just related to the expiring tax credits. Steadily falling mortgage rates are keeping buyers on the sidelines waiting for a better deal. While it is possible to get a mortgage for conforming loans that can be sold to Fannie Mae and Freddie Mac, the paperwork is monstrous and is keeping some potential buyers away. New appraisal rules are also hurting business. Finally, without rising prices, many simply don't see the advantage of home ownership and opt to rent. That is why rental rates are very strong and accelerating while housing demand is almost non-existent. Thus, what is apparently happening is that the mix of owned/rented homes is changing and is likely to continue to change for some time to come. An excess supply of vacant homes, ineffective Federal programs

to remediate mortgages in default, and a reluctance of banks to purge balance sheets of bad real estate loans are probably going to keep the housing market dormant for at least several more quarters. But the process won't last forever. When mortgage rates stabilize or begin to rise again, buyers will jump trying to catch a bottom. As rents continue rising, the economics of home ownership improve. Population growth and net immigration will help to absorb oversupply. In addition, during the recession there was a lot of doubling up that will unwind as the economy recovers over time.

Thus, the bottom line appears to be that the consumer is alive and active. Next look at manufacturing. A lot was made last week about the downturn in manufacturing that appeared in the Philly Fed survey. On the surface, that is disturbing and worthy of note. But if consumer spending went from an escalating phase in the first four months of the year to one of stable growth in the spring and summer, it would seem logical that manufacturing would have to go through a brief adjustment period subsequently. In 2009 and early 2010, a good part of the manufacturing growth equation related to inventory replenishment. With consumer spending now growing in the 2% range, there are some inventory excesses appearing. On the other hand, there are still some areas where inventory remains tight. I mentioned autos. Everyone is scared of the possibility of a double dip recession because everyone talks about the possibility almost daily. No one wants to get caught with extra inventory. That's a margin killer. But too little inventory means lost sales and lost profits as well. That is true for auto dealers today. There is a shortage of smartphones mainly related to a shortage of one or two key components. Retailers are almost certain to order very carefully going into the Christmas season. They will keep margins up but will lose sales as a result. In short, conservative inventory management is likely to nick top line sales growth for the balance of 2010.

What about investment spending and exports? Both appear to be healthy. Economies in Europe are showing surprising resiliency and, although Chinese growth is slowing a bit, growth remains solid as it does elsewhere in Asia (except Japan) and in South America. While strong growth overseas won't have an overwhelming impact on U.S. GDP, it will be a big help to American companies doing business in that part of the world. As for government spending, declines by state and local governments are pretty much offset by increases (what else?) in Federal spending.

Thus my bottom line is that despite all the noise and negativity out there, not very much has changed in the economy and what little has changed is very explainable.

Government policy hasn't changed either, for better or worse. Federal spending remains at levels one would have anticipated last spring with modest increases in safety net some expenses like unemployment payments. The Bush tax cuts are still expected to expire in January. While only a minority of economists suggest a big tax increase is the right medicine for the moment, there is vast disagreement as to what might be the outcome. I have discussed this issue enough lately. Clearly the resolution is the biggest near term economic uncertainty, one that won't be resolved in the next 30 days for sure.

Fiscal policy hasn't changed either with the one modest adjustment that the Fed plans to use funds accrued from mortgage paydowns on its balance sheet to buy back Treasuries. The Fed remains committed to a policy of extremely low interest rates for some time to come although voices that question a zero interest rate policy are starting to increase in volume. You know where I stand on that issue. Perhaps the most important event this week will be a speech at a Fed conclave in Jackson Hole, Wyoming on Friday by Ben Bernanke. The Fed has moderated its forecasts a fair bit in recent months and investors will be looking to see whether Mr. Bernanke becomes increasingly negative.

Readers of these commentaries know that I have persistently been looking for final demand growth in the range of 2% plus or minus a point and for elevated savings rates until the American consumer feels comfortable once again with his or her balance sheet. I have seen nothing to date to change that. However, if that forecast is accurate, it means that unemployment will stay uncomfortably high. In a nation where employment is the number one data point and with mid-term elections less than three months away, staying the course isn't a real nice option.

There is nothing President Obama, Congress or the Fed can do to change the employment picture before Election Day and with Congress only likely to be in session for a few weeks before the first Tuesday in November, any major new initiative would simply be grandstanding and the public would see right through it. The Fed might discuss some sort of quantitative easing but won't act to implement it unless the data deteriorates from current levels.

But that doesn't mean 2011 is going to be a wipeout. Indeed, investors today should be looking at 2011 as they make decisions. As a starting point, it is logical to expect more of the same; slow consumer growth, moderate investment spending and persistent high unemployment. If the Bush tax cuts expire, that will clip up to a point off of GDP growth. But as much as we and others pick on Washington, clearly no one is going to simply sit back and allow the economy to deteriorate without some attempt to fight back. On the fiscal side, the Fed can be a more aggressive buyer of securities. I am in the camp that says a modest increase in rates will help, not hurt.

On the fiscal side, the story is different. The current administration believes that more taxes and more spending at the cure. But it appears increasingly likely that there will be enough of a change in Congress in the mid-term election that an economic solution will have to focus more on targeted tax cuts and tax realignment. Virtually no one believes that tax cuts are stimulative. CEA Chair Christina Romer now has a published paper reaffirming the negative growth consequences of tax increases. But raising rates to high income individuals while offsetting those increases with cuts to low income families would be stimulative. So would targeted cuts or credits given to corporations. My point is that the government next year will have weapons to combat any further weakness and it will be necessary for Congress and the White House to work together to come up with a solution. It is skeptically proper to suggest that can't happen but historic reality suggests exactly the opposite. Mutual self-destruction by Democrats and Republicans doesn't do anyone good. That, in part, is why there is likely to be so much Congressional turnover this year. If the economy, for whatever reason, weakens further the American public and financial markets won't tolerate inaction for long.

History also suggests that if my scenario plays out that we are indeed in a slow recovery, over time employment will rise. At some point, even housing will find a bottom and start a slow recovery. We think that will begin before the end of 2011. If the rest of the world grows faster than the U.S. demand for exports will increase. So it is quite possible that the malaise we apparently are in right now will slowly end some time in 2011. If housing can begin to come back even a little bit and fiscal policy can be targeted better toward growth creation, there is plenty of room for upside surprise.

I have not talked much about inflation/deflation. Everyone talks today of deflation. It's back - my August tale of creating news when none exists. There is exactly no evidence of pending persistent deflation. Wages are still rising. So are commodity prices. Go to the supermarket if you doubt me. Wait until you see your health insurance premium. FinReg is going to cost you money as well.

But the bond market doesn't seem to agree. Not with interest rates at generational lows. Money is pouring into bonds driving rates ever lower. Money always chases what works and moves away from what doesn't. I will have more to say about that on Wednesday. But for now, ten year Treasuries pushing down toward 2.5% yields represent a big bet

on no inflation and persistent economic weakness for the next decade. It isn't a bet I'm willing to make. Success begets success and it is quite possible that the flows into Treasuries may accelerate over the short term, particularly if the Fed becomes a more active buyer. But we have seen this tale play out before and it always has an ugly ending.

Futures point to a modestly higher opening. Right now the market's upside seems capped by slow growth and money flows into bonds. The downside seems supported by valuation unless I am wrong and we really are rolling over into a new recession. In two words, we appear range bound.

Today Kobe Bryant is 32. Barbara Eden is 76.

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