

Boenning Morning Comment

This report is prepared for us by Tower Bridge Advisors

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Stocks fell sharply once again after a report showed a drop in existing home sales in July of 27%. I have often said that markets go up as problems get smaller and go down as problems get larger. Clearly the perception right now is that growth is slowing and the end to that trend doesn't appear to be in sight. Bonds continue to rise as stocks fall. At some point equilibrium will be reached. But it certainly wasn't yesterday.

On Monday, I suggested that the consumer had shown much less change in his behavior than the media might lead us to believe. But data this week suggests I may have overstated the case. Most recent data, including the home sales figures yesterday certainly point to hesitation on the part of the consumer and reasons for concern are growing. Weekly retail sales have declined sequentially through August. That may be a real concern or it may be noise. Year-over-year sales are still up but less than in July. Labor Day is late this year and that may push back-to-school shopping back as well. Hot dry weekends may also defer sales. We'll see if the recent sudden cooler weather serves as a reminder that it is time to shop for fall.

As noted, existing home sales tumbled in July far more than most expected. July sales probably reflected contracts written in May and June right after the expiration of the home buyer tax credit so it may be an outlier. But clearly the size of the decline was disconcerting. One factor that is wrecking havoc with housing is the immense amount of paperwork and bureaucratic hurdles that now have to be dealt with to complete a sale. It may be a natural aftermath of the sub-prime crisis but clearly it is having a significant impact on activity. Although so far home prices have held up, the cost of home ownership keeps declining as mortgage rates tumble. Since it is a buyer's market anyway, prospective buyers have no urgency given the steady decline in mortgage rates. Prices aren't rising, inventories of unsold homes are high and mortgage rates are falling. There is virtually no catalyst to push buyers to move forward today.

Consumer spending and housing aren't the only pockets of weakness. Health care procedures are down as well. People are deferring elective procedures or not doing them at all. Confusion about changes in reimbursement are taking a toll. State and local governments are contracting as expenses have to be cut due to weak tax receipts and less money from the Federal government. Technology spending continues to grow but at a slower rate. On the flip side, there are few if any signs of acceleration.

All this suggests that the economy may still be growing but it is doing so at an anemic pace.

Here are the major problems we face. It isn't a pretty picture.

1. Jobs – Although the private sector has created some jobs this year, the prime creator of jobs, small businesses, are having a particularly difficult time. New regulations, including health insurance reform and FinReg, add significant costs to small businesses without any offsetting savings. Higher marginal tax rates on small businessmen and higher dividend taxes after the Bush tax cuts expire put even more pressure on small businesses. Indeed, all the new private sector jobs created already this year have been created by large companies.

2. Housing – Not only is there no urgency to buy today but the buying process has become significantly more cumbersome over the past year. A significant number of sales end up falling through as a result. Credit remains tight and fractured.
3. Savings - People are rebuilding savings but earning nothing for the effort. Lack of return is forcing more savings to compensate for the loss of income. Consumption suffers as a result.
4. Taxes – One can only plan based on the known or based on worst case assumptions. Regarding taxes that leads one to the same conclusion. Taxes are likely to rise for almost everyone in 2011 forcing the need to save more today. If Congress either extends the Bush tax credits or modifies the tax structure in 2011, that logjam could be broken.

None of this is new but none of these problems are being addressed or solved. New regulatory structures are hurting both employment growth and housing. The Fed's zero interest rate policy hurts savings. The tax issues are on the agenda for September but with little time left Congress may not act for months or even longer. The problem with an economy growing 2% or less is that it can't absorb any shock to the system. Another European debt crisis could be such a shock. So could a steep stock market decline.

Investors are reacting as you would expect running toward safety. Individuals have sold close to \$35 billion of domestic mutual funds this year and poured close to \$200 billion into bond funds. Not only are they fleeing risk; they are chasing yield. 10-year Treasuries paying 2.5% don't seem attractive on the surface but they beat virtually zero in money market funds and rising bond prices are elevating total returns. Bonds prices are surging as hedge funds cover short positions and as investors buy in front of an expected major quantitative easing action by the Federal Reserve. Buyers today feel protected by the increasing likelihood that the Fed will step forward and buy bonds in a major way. So far, the Fed hasn't stated that it would undertake a second major round of quantitative easing but it took a small step in that direction at the August meeting and public commentary since leaves most investors speculating when as opposed to if. It is no wonder that the bond rally accelerated immediately after the Fed said that it would use mortgage rolloff proceeds to buy Treasuries and the rally has remained strong since then.

Although talk of another recession is increasing, it would be illogical to believe that the Federal government is going to simply sit back and just watch. The Federal Reserve's only weapon left is to buy Treasuries in massive amounts. On the fiscal side, with an election just around the corner, it would seem logical that politicians would begin talking up a whole parcel of economic remedies. But so far, except for Republicans calling for Obama's economic team to resign, nothing constructive has been offered.

To date, the policies of printing money, keeping interest rates near zero, and tax and spend fiscal policy haven't worked. A large part of the money that the Fed has pumped into the economy sits in bank controlled accounts at the Fed earning 25 basis points. The non-productive parts of the big stimulus package created a sugar high for a couple of quarters but the benefit is now gone.

So what can be done? To be effective, any remedy must attack the core problems. Any plan must recognize that Americans still want to reduce debt, economic growth hinges on job creation, and something has to be done about the millions of homeowners who have mortgages that exceed the value of their homes.

Start with the notion that jobs are created in the private sector and small businesses are the primary creator of jobs. Therefore, plans have to be put in place to help small businesses reduce operating costs, gain access to capital, and minimize bureaucracy. Mortgage holders and homeowners need the right incentive to restructure mortgages in ways that are beneficial to both sides.

The economy cannot truly heal and an enduring bull market cannot happen until better solutions are in place. Stocks will rise before the results are evident if investors believe the right cure is being applied. If the Fed embarks on another round of quantitative easing, it could create another sugar high and a stock market rally. But quantitative easing isn't a cure; it's a Band-Aid. The real cure must come from the President and Congress. Hopefully, the elections will send a forceful enough message to force movement in the right direction but between now and then storm clouds are gathering and it may be a rocky time in the market.

As I said in the beginning, markets go up as problems get smaller. I don't see any problems getting smaller right now. Valuation constraints will limit the upside to bonds and the downside to stocks. Stocks of companies with solid cash flows and dividends are performing decently and should be superior long term performers once the economy is stabilized.

The near term driver is going to be the bond market. As long as the bond market surges, that is going to be where money flows. But beware. We have seen these spikes before, most recently in March 2008 and they can reverse very quickly. Bonds today are much more trading vehicles than prudent long term investments. Indeed, having a little extra cash until the smoke clears doesn't seem like a bad idea.

Time will tell whether we dip back into recession or not. Right now, the economy is still growing and there are few signs of sudden deceleration. Consumer spending is still increasing, corporations are investing and, of course, the Federal government is growing. My two-day rule clearly suggests a defensive positive. There are some important support levels traders will heed that are near current prices. If they hold, we may stay in the same trading range we have seen most of this year for a while longer. The best thing that could happen soon would be for the Obama Administration to lay out a comprehensive program to restore growth, build employment, and target incentives to benefit small businesses. Doing so right in front of an election may not work but it certainly won't hurt.

Futures point to a modestly lower opening today.

Today Claudia Schiffer is 40. Elvis Costello is 56. How many of you can tell me who his wife is without looking it up? Gene Simmons of Kiss is 61. Regis Philbin is 77. Finally Sean Connery turns 80 today.

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