

Boenning Morning Comment

This report is prepared for us by Tower Bridge Advisors

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Despite favorable jobless claims data, stocks fell once again on concerns that economic growth was fading. Today Fed Chairman Ben Bernanke is going to give a highly publicized talk to a Federal Reserve retreat in Jackson Hole, Wyoming. Since early summer, the tone from the Fed has gotten increasingly negative and traders will be looking for further forecasts from Mr. Bernanke as well as hints of any change in Fed policy. We got the first revision to second quarter GDP data earlier this morning, and it came in at +1.6%, slightly higher than consensus forecasts but still well below previous estimates and below Q1 growth. Final sales rose 1.0%, anemic by any standard. Many will connect the dots from Q4 of last year through the new Q2 number and continue to arrive at some sober conclusions for the rest of the year. Also today is a University of Michigan confidence survey. I don't pay much attention to these fundamentally, but a negative reading today will just add fuel to a media lusting for more tales of woe to tell.

If I just step back a minute and accept moderate slowing in economic growth is taking place, I think it is important to understand that we are not headed for anything like what we went through in late 2008 and early 2009. Banks are in fine shape. No big companies are on the brink of bankruptcy, a la General Motors, and the consumer displays no sense of panic. There isn't any reason for it. Next week we will get a lot of data for August. Car sales should be pretty good. Retail chain store sales might be lackluster once again. It is hard to tell because the last week of August is the most important part of back-to-school season. The late Labor Day this year won't help the August numbers. Indeed, last evening J. Crew's management warned that sales started to slow noticeably in August. Whether that can be extrapolated to the whole retail space or not is questionable, but it isn't a good harbinger. On Wednesday the PMI manufacturing index is due out and it should show growth but at a measurably slower pace than July. Next Friday is the big August employment report. No one is ever good at guessing that number precisely but August isn't logically a month for either big layoffs or major new hiring. At best, it won't be a very exciting number; at worst it could fan the deceleration flames a bit more. The bottom line is that the next six business days will offer us a lot of economic data. My guess is that most of the numbers are likely to be neutral to negative leading economists to ratchet down further forecasts for 2010 and 2011 further.

As for the economic solution, I think it is fairly simple in theory. There isn't much the Federal Reserve can do. It can print lots of money, but there already are trillions of dollars idly looking for a productive home. Granted, if the Fed prints enough new money, some will circulate and get spent but the ultimate solution to a struggling economy lies with better fiscal policy, not monetary policy. On the fiscal side, the focus has to be on jobs and small business. Small businesses are the natural creator of jobs. They have been shedding jobs during this recovery. It isn't hard to see why. Confidence is down, credit has not always been available, tax policies in Washington remain uncertain, and costs are rising as small business feels a direct hit from health insurance reform and FinReg. The solution, therefore, must be a Marshall Plan to foster growth of small businesses. Using tax policy and other tools, law makers need to build a set of incentives that will encourage small businesses to invest and to make more money. If that happens, everything else will fall into place. Employment will rise, confidence will increase, and even the housing market will improve. People with jobs pay their mortgages. People with good FICO scores can refinance existing mortgages.

When Washington puts forth a sound plan for small business development, business confidence will rise and the stock market will go up. Washington spin, like making up a number of how many jobs might have been created by the

stimulus package won't move the needle. Investors quickly separate fiction from fact. The financial markets are wonderful barometers. When Washington is headed in the right direction, markets respond immediately. When it is off in the wrong direction, it becomes obvious and markets respond negatively.

I know the skeptics among us don't believe a sound game plan can take shape any time soon, but it will and here is why. I am presuming a major shift toward the center in Congress after the elections with the likelihood that Republicans regain control of the House. If they do, they will no longer be able to simply criticize and say "no". Tax legislation must begin in the House as required by the Constitution. It is an old saw on Wall Street that gridlock is good for stocks but it is only good within a favorable environment. In other words, investors don't want Washington to ruin a good situation. But when there are problems, gridlock is the enemy. Therefore, Republicans, Democrats and the President must find common ground. Crisis will force resolution. I don't know whether that is January or June, but ultimately, and not that far off, both sides will compromise out of necessity. Markets will tell them when they are on the right path.

Look back to 2008 and 2009. Almost all the stock and bond market damage had been done by mid-October 2008. When TARP passed (on the second attempt!) and the Federal Reserve vastly increased the size of its balance sheet, the bond market reached bottom. When the House voted against TARP the first time, markets collapsed forcing Congress to quickly rethink its posture. Within five months, all other major capital markets had bottomed. The stock market finally set a low when it became clear the banks could pass stress tests and raise capital. The solutions didn't have to be fully implemented for markets to bottom. Markets hit their nadir as soon as the plan was in place. The same will happen this time around.

I said earlier that even if we tip into recession, this time around will bear no resemblance to 2008-2009. Valuation will provide a big cushion this time around. Unless you have been hibernating for a number of months, you know that the bond market has been on a rampage. 10-year Treasuries now yield 2.48%. At the bottom of the stock market in March 2009, they yielded 2.87%. On the day of the exact bottom, I wrote a piece comparing the dividend yields of the 10 most important Dow Industrial components to the 10-year Treasury. I noted that 6 of the 10 stocks had increased dividends for 31 consecutive years or longer. The remaining four, IBM, United Technologies, Exxon Mobil and Chevron, were no slouches. The spread in yield on that date between these top 10 and the 10-year Treasury was 75 basis points.

I did the same calculation for the same 10 companies last night. Their average yield was 2.99%, 51 basis points higher than the 10-year Treasury. Thus, based on comparative yields, they offer close to as much value today as they did in March 2009. That may surprise a lot of readers given that the Dow today sits at just under 10000, almost 50% higher than it was at the March 2009 low. Part of the reason is dividend increases. Every one of the 10 names that were at the top of the Dow in March 2009 have raised their dividends in the interim. More than half increased them by at least 10%. If bond prices were to rise further and stock prices continue to decline, the yield spread would widen further. **Today the yield for the entire Dow Industrial average exceeds the yield on 10-year Treasuries.** The last time that happened was in 1962 at the bottom of a bear market. Whatever happens to the economy, I don't see the composite dividend paying power of the Dow leaders to be in peril.

There is an obvious conclusion. Gathering storm clouds could well push stock prices lower in the near term. The spread between the dividend yields of Dow stocks could widen beyond the 75 basis points seen in March 2009. But valuations suggest equities of companies with high free cash flows that are consistent dividend payers and persistently increase payouts are getting extremely cheap compared to bonds and other asset classes. In the end valuation matters.

I continue to want to own quality companies with high free cash flows and solid dividends supplemented by true growth companies and companies with large exposures to growth areas of the world. Nothing has changed there. Having some extra cash to take advantage of bargains should stocks fall further over the near term in reaction to weak economic news certainly isn't a bad idea.

The combination of deteriorating economic news without a recovery game plan in place is potentially toxic. But stock prices are forward looking and crisis forces resolution. While the resolution may not be visible at the moment, markets will force one quickly. Look at Europe. A debt crisis forced action last spring and almost all major economies are improving as a result. Many are shocked. Most thought austerity would lead to another recession. But the right plan inspires confidence and confidence may be the biggest driver of economic activity. At the moment we in the United States face confusion driving the market behavior we are seeing. When confusion morphs into an acceptable vision, stocks will turn around, probably in a major way. Again, think back to the fall of 2009. We went from utter chaos and the brink of collapse to a workable game plan in a matter of weeks. We are nowhere near that precipice today. The solution today is much simpler and the problems are much easier to solve. Be patient. Market forces will mandate that solution sooner rather than later.

Futures at the moment point to a higher open based on the GDP numbers but that could change either way when Bernanke talks.

Today Paul Reubens, alias Pee-wee Herman is 58. Barbara Bach is 63.

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