

## Boenning Morning Comment

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

August 4, 2010

Stocks finished modestly lower in a rather quiet session. Most of yesterday's data were on the disappointing side and earnings from Procter & Gamble and Dow disappointed. However, the news wasn't universally poor. Auto sales rebounded in July to an 11.9 million annual rate from an 11.2 million pace in June. However, that is still at recessionary levels especially if you consider that more than 14 million vehicles are scrapped annually.

Let me lead off with a few numbers. Disposable income, according to latest GDP data, is growing in excess of 4% per year. Nominal GDP is growing a little less, perhaps in the 3-4% range. Consumer spending is growing just under 2% per year while the savings rate has risen from near zero before the recession began to over 6% currently. It may rise a bit further. Money supply is barely growing and monetary velocity is flat or even shrinking a bit.

These numbers are all consistent with each other. None suggest the notion of a double dip recession but all suggest below average growth going forward because Americans are borrowing less, spending at a slower pace and rebuilding savings. That all makes sense. In the 1990s, rising stock market values reduced the need to put away cash for the future. Early in this decade, rising home values led to the same behavior. But now that stock values have flatlined for a decade and savings yield a near zero return, Americans are forced to take a piece of their disposable income and put it away for future needs.

The end result is an economy that is destined to grow at a substandard rate until the savings rate flattens out and a new normal is reached. We can all guess when and at what level that will occur but it is only a guess. However, since it took us about 5 decades to build up debt, it is going to take some amount of time to restore balance sheets to a new normal.

All of us, myself included, fuss a lot about Washington's behavior. It does matter and I will discuss it again in context in just a moment. But the overriding reality is that Americans now don't want to be in debt and they want to rebuild their nest eggs and safety nets. Until they are comfortable again, that need is going to govern their behavior. They have demonstrated over the past year their determination. Low interest rates are a temptation but not a deterrent to the new normal. We all have to resign ourselves to the facts. Population growth plus productivity gains generate a core domestic growth rate in the 3-4% range that will be reduced as consumption is diverted to savings yielding a growth rate somewhere in the vicinity of 2%. At times it might be a little less. At other times it might be a little more.

2% isn't very exciting. It isn't very appealing. It won't absorb a lot of excess capacity very quickly. It won't bring the unemployment rate down very fast. This morning's ADP forecast of July employment growth is consistent with what we have seen for months, a steady but frustratingly slow growth in job creation. But that is the reality today and there isn't a lot that government can do to move the needle a whole lot

So what should the government do, if anything?

Let's start with fiscal policy. Clarity would be a good start. The sooner Americans know the tax rates for 2010 and beyond, the more likely they will act on plans. *Never in my memory has tax policy been so uncertain.*

It can spend. But simply spending for spending's sake accomplishes little. Spending what you don't have simply increases borrowing, something that clearly isn't needed. Most in the private sector would like to see less government intervention. If you ask homebuilding CEOs if they want to see yet another tax credit for home buyers they will answer a very loud no. It is time for market forces to take over.

But there are places for government to spend, where the needs really exist. Corporations are flush with cash. You hear a lot of talk of how they aren't spending because the Obama administration is so anti-business. That is simply a red herring. CEOs don't make spending choices based on whether Obama calls them fat cats or not, they make choices based on the numbers. With gobs of excess capacity, no car manufacturer is about to build a new plant and no steel company is about to build a new mill. The economic growth driver is productivity. Higher productivity means higher growth. That is a basic law of economics.

How then can the government help to increase productivity? Targeted tax credits help. Improved education, especially in the math and sciences, helps. Today, venture capital almost doesn't exist. It no longer exists not only because returns in recent years have been bad but because there is no exit strategy today. There is a backlog of fine partially funded small businesses that will die because they will run out of capital. Drug companies are merging to drive down costs. That includes R&D. So pipelines shrink while the FDA lengthens the time and cost to review new medicines and new devices. Medical device makers are taking new products overseas for development because the time and cost of getting through the FDA are too great. The incubator for new environmental technology is now China, not the U.S. China is spending more money on the development of alternative energies than we are. Thus, instead of giving cash for buyers of new appliances, the government should help to seed the development of appliances that consume significantly less energy. The Obama administration wants our car fleet to move to alternative fuel sources like electricity but is taking only baby steps to help develop the infrastructure to support the needs of recharging electric vehicles. If the infrastructure isn't ready when electric cars go on sale, no one will buy them.

As for the Federal Reserve, much is being made about the need for further stimulus. If I were a Fed Governor, I would like to see a policy consistent with the economic reality I described earlier. That means a monetary policy that supports growth in the monetary base of about 3-4% per year. Consumption is destined to grow closer to 2% while savings should stabilize in the mid-high single digits. There is little or no need to force or keep rates unrealistically low. There is little need to try and push Americans to borrow, the obvious purpose of low rates. Americans aren't going to borrow and corporations are flush with cash. Corporations today are selling new debt, thanks to the Fed's current monetary policy, and simply adding the cash to their bankrolls to be used either for acquisitions, to refinance existing debt or for stock repurchases neither of which are supportive of GDP growth. The two headline borrowers over the past week were McDonald's and IBM. Both are prodigious generators of free cash flow and certainly don't have to borrow a dime to support internal growth. Fed policy today is designed for an economic system that wants to add debt, not one that wants to reduce debt. More money and more stimuli are exactly the wrong recipe. It won't create more spending. It simply robs savers or any return on investment.

A lot of market observers look at current low market rates and worry that markets are signaling recession or deflation. Let me offer a third alternative. \$10 trillion sits on the sidelines including \$2 trillion in corporate hands. Corporations were burned in 2007-2008 by greed chasing what Wall Street called enhanced cash returns available through SIVs and auction rate preferreds. Chastened, they now invest in Treasuries. Banks borrow for near zero and

buy Treasuries. Individuals have so much money in Treasury money market funds that many are closed to new investors. You do the math. U.S. Government debt held by the public is less than \$10 trillion. Demand exceeds supply. When that happens prices go up and rates go down and down and down. As more cash is accumulated, rates go lower. It isn't fear of deflation or recession. It's too much cash sitting on the sidelines looking for a better place to invest. Printing more money is only going to press rates lower. It's really that simple.

If, however, there were a catalyst to invest some of that sideline cash productively, here is what would happen:

1. Investment, already strong, would increase further.
2. Job creation would rise.
3. Productivity might increase and that would spur GDP to increase as well
4. Stocks would go up.
5. Interest rates would go up.
6. Savers would earn a return on investment.
7. Borrowings would continue to decline (investment isn't going to change basic behavior patterns).
8. Incomes would rise further enabling more money to be saved.

*So government's real goal should be to develop incentives to get that excess cash working again.* History shows it can happen. The Marshall Plan, the Interstate Highway System, the Space Race, seeding development of the Internet, finding a cure for polio or AIDS, these are just a few examples that come to mind. They don't require massive debt and they don't all have to be funded by the government. All the excess cash sits outside of government hands. True investment for a better tomorrow works. History proves it. Until then, the new normal is 2% growth and 6% savings. That isn't so terrible. Accept it.

Futures suggest a slightly positive opening.

Today Jeff Gordon is 39. President Obama turns 49.

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