

## Boenning Morning Comment

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

September 1, 2010

Stocks meandered about yesterday ending with little change in front of three days of data that will help to draw a fairly complete picture of where our economy stands today. Expectations are low. Consensus today suggests that not only is our economy slowing down but anecdotal evidence suggests the slowdown may be accelerating a bit. Today we will see some manufacturing data from both China and the United States for August. The Chinese numbers, released overnight, were encouraging. Growth there is moderating but still strong. We will also digest ADP's forecast for private sector employment growth for August. Its forecast shows a modest decline of 10,000 jobs, the first decline in many months. Over the next two days we will get a lot of data on retail sales from auto manufacturers and chain stores. Finally, on Friday comes the important employment report for August.

The set up has stocks trading near the low end of the trading range established in May. That range pretty well discounts a slow growth economy. If we are on the cusp of tipping back into recession, still a minority viewpoint, then stocks probably have another leg down. If the economy is simply in what many describe as a "soft patch" and is set to recover later this year into next year, then stocks will eventually break out to new recovery highs. As always, it is toughest to judge right at the cusp of change. Good cases can be made for all three scenarios.

But whatever the outcome, clearly frustration and uncertainty have escalated over the past several years. Part has to do with the August information vacuum I have alluded to in the past. Without a lot of hard data, investors are nervous and fester over bad news. Part has to do with the deteriorating outlook expressed by many Federal Reserve Governors over the past two months. Apparently they were caught a bit by surprise. When the leaders of your central bank are thrown a bit off course, that clearly has to be disconcerting. A lot has been made in the press of the shrinking size of the tool kit at the Fed's disposal but that is a vast overstatement. Although the Fed cannot lower short term interest rates any further, it can print all the money it wants to and it can put heavy downward pressure on long term rates as well through concentrated asset purchases. One can argue the pluses or minuses or using those devices but clearly it has the ammunition to make a difference if it chooses to, especially in the short run.

However, the Fed is quick to point out, as Chairman Bernanke did last Friday, that effective growth policies must go beyond the Fed. If you look around the world, most nations underwent some sort of economic trauma in 2007-2009. The economies of most developed nations have stabilized or begun to recover. Only the U.S. and Japan seem to be decelerating at the moment despite austerity measures taken by many European nations to improve support for their debt.

I think it is worthwhile asking ourselves, why we seem to be going in a different direction. First, we chose a different route. Most nations have tried to spend less; our government continues to expand at a very aggressive rate. In the last year and a half, the Federal government has added over 150,000 new positions as it vastly expands government infrastructure and oversight. Second, most countries have an economic roadmap for at least the next year or so. Tax structure is in place and so are regulations. Banks everywhere face uncertainty associated with pending Basel 3 requirements, but the U.S. banks also have to adjust to new levels of oversight and capital constraint associated with the Dodd-Franks legislation. Almost all of those regulations have yet to be written.

But in the U.S., the biggest uncertainty now is taxes. Congress returns next week and taxes will be discussed. The Republicans would like to see the entire Bush tax cuts extended for 1-2 years (they would like them made permanent but that is not going to happen!). President Obama has proposed a partial extension for families making less than \$250,000 but tax increases for those making more. Therein lies the problem. With polls now favoring Republicans by a near record gap, there is no way they are about to acquiesce to Mr. Obama's plan which results in a large tax increase. The Democrats will blame the Republicans for forcing a tax increase on everyone, but the Republicans will counter that any increase right now is crazy with the economy as weak as it is. They already are getting several noted Democrats to agree. The President doesn't take losing real well (who does in politics?) and has an instinctive hatred for anything starting with the word Bush (as in tax cuts). But if he can't pass what he wants in this Congress this fall, what are his chances next year with one that will clearly be more conservative?

Putting aside which way the stock market might go as this battle plays out, it is logical to expect businessmen to postpone decisions as long as possible until the rulebook is written. One thing is clear. In a fragile economy, Congress and the President are going to have to find common ground. Finding common ground when both chambers of Congress and the White House are controlled by the same party seems a lot easier than waiting for next year. Clearly, the decision lies in the White House. If election polls don't improve for the Democrats soon, it is almost certain that members of Congress will try to separate themselves from the White House and push for some tax relief sooner rather than later. Voting for lower taxes 60 days before elections isn't a hard call for a candidate from either party.

Getting policy right and selling it to the American people and to investors boils down to leadership. Leadership at the White House and leadership at the Federal Reserve. Business people hate uncertainty. Ideally, they want to see a game plan established and then executed. Right now we don't have much of a game plan. To the Fed's credit, at least Mr. Bernanke clearly spelled out his range of possibilities. In the ideal, it would like to see 2% core inflation and 3%+ growth in order to provide an environment that will create new jobs. But no matter how much quantitative easing it undertakes, it will need some help elsewhere. The President can try to limit the Bush tax cut extension to just those making less than \$250K but Congressional leadership should be able to tell him in short order (as in days) whether that can be accomplished or not. If it cannot, he only has two choices. Extending the cuts in total for a specific period of time or let them expire completely, at least until the next Congress convenes. The relative state of the economy and financial markets will determine how quickly legislation passes. Unfortunately, one constant remains. Congress almost always reacts after crisis, not before. Crisis could be economic (falling stock prices) or political (worse poll numbers for the Democrats).

In the meantime, stocks are holding near strong support and bonds continue to race to new highs. Money continues to pour from stocks and money market funds to bonds chasing yield. As bond yields decline, dividend paying stocks look more attractive. Normally bonds yield more than stocks since equity returns are a combination of dividend yield and appreciation whereas bond return is all yield. At some point it would seem the gap will become overly compelling and reverse. It is already at historically high levels but that doesn't mean it can't widen further.

In the meantime, it is proper to ask what can drive stocks up or down. In theory negative economic news and lower earnings expectations should drive stocks lower. But too much weakening accelerates the timing of quantitative easing by the Fed. If the Fed truly decides to go that route it will pour \$1 trillion or more into the economy over a relatively short period of time. They will do it via the purchase of government bonds but, for illustrative purposes, you can imagine a series of helicopters dropping one trillion dollar bills from the sky. Everyone will scramble for his or her fair share. Some will spend it leading to temporary acceleration of economic growth. Some will stash it away in the mattress, bank or money market funds. And some will invest it, maybe even in the stock market. In other

words, a rising tide lifts all boats. The massive stock market rally that began last March started shortly after the Fed began to expand its balance sheet drastically. Thus, bad news may not be as bad as you think.

On the other hand, there is a reasonable possibility that the gloom overhanging Wall Street is excessive. The economy is still growing despite relatively flat employment. Maybe the consumer took a break in August enjoying vacation rather than shopping. Maybe the relative value of stocks versus bonds is getting too compelling. We will learn a lot more this week.

I said the bottom line earlier. The narrow but volatile trading range stocks have been in since May fairly accurately discounts a very slow growing economy. The upper end of the range discounts growth of 2% or better; the bottom end closer to 1%. If we slip back into recession, the bar may have to be reset lower. Conversely, if we get through the soft patch we are in at the moment and resume a modest but sustainable recovery, stocks can move higher. Americans are sitting on almost \$10 trillion in cash and corporations are flush with cash as well anxious to invest. What is lacking is a playbook and leadership. The playbook will become much more clear in the months ahead. Basel 3, new Dodd-Frank and health insurance reform regulations, and tax structure will all be set within the next several months if not sooner. A more conservative Congress will slow the rapid expansion of government and the Federal Reserve will invoke quantitative easing if necessary. Thus, even if leadership is lacking, the roadmap will become more clear. But the next few weeks could be quite volatile. The wild swings in the bond market, the likelihood that earnings estimates for 2011 will have to be reduced and chaos in front of elections could generate wild swings in stock prices. Disciplined buyers will make some great purchases. In difficult economic times, well managed companies with high free cash flow and excellent management should excel. Blue chip stocks haven't been this cheap relative to other asset classes in decades. I can't predict what will happen over the next few weeks but long term investments in companies with solid growing dividends and good economic outlooks should do very well.

Futures are up this morning. The ADP number seems to indicate that markets have already discounted a lousy labor report on Friday. If the ISM manufacturing data is simply positive for August (we will know at 10AM) and auto sales are within the range of estimates, we could see a modest rally within the recent trading range.

Today Gloria Estefan is 53. Dr. Phil McGraw is 60. Lily Tomlin turns 71.

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Additional information is available upon request.

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