

BEACON INVESTMENT MANAGEMENT

THE FRIDAY BRIEF

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So Far, Equity Investors Believe

There remains at least one strong horse in the US economy - exports. As the dollar falls in value relative to other currencies, American produced goods and services become more competitive in the global marketplace. Our trade deficits with creditor nations are shrinking dramatically. As a whole, our trade deficit is now 5% of GDP, down from a 7% peak. According to Credit Suisse it is only 3% when oil is excluded.

Today the government reported that the US trade deficit narrowed faster than expected in March to \$58.2 billion from a revised \$61.7 billion in February. Adjusting for inflation in the calculation of GDP, the trade deficit shrank to \$47.2 billion, the lowest since November 2003.

Improvement is coming on both sides of the ledger as Americans buy fewer imported goods and US businesses sell more goods and services abroad. Reduced consumption comes as the result of an economy growing at the slowest pace since 2001. Exports, on the other hand are setting records, but last month's pace of growth did slow modestly, perhaps indicating the global economy may be slowing some. But if it is slowing, it's primarily in the developed economies, not the emerging. Brazil's economy grew 6.2% in the fourth quarter from a year earlier, India grew 8.4% and China expanded 10.6% in the year ended in March.

Expansion of emerging economies continues to pressure prices of commodities such as oil, which is steadily hitting new highs. Emerging country economies are proving more resilient to the drag of slowdowns in developed nations. Most of their exports go to each other and an increasing amount of commercial activity is focused internally on the building their own infrastructures. What's more, their consumers are becoming a larger part of their economies.

Still, the effects of continued credit woes among the world's largest financial concerns, record energy prices, and food prices will eventually exert their full drag on global growth. Many experts have said the worst of the credit crisis is behind and they are probably right. Still the sizes of the losses that continue to be reported are staggering. The world's largest insurer AIG yesterday reported a first-quarter net loss of \$7.81 billion and disclosed more than \$15 billion in pretax write-downs.

Commodity prices, including food and oil are rising for a number of reasons. But speculation has often been cited as the culprit as they have been made available to a much larger investing market than before through ETF's and other forms. But a recent Wall Street Journal survey of global economists shows, in their view, that higher prices are driven primarily by supply and demand factors with China and India as prime movers. I believe the fundamentals are a large part of the story, but remain convinced that speculation still plays a major role in oil prices.

According to the survey, economists expect the price of crude to fall to about \$105 by the end of next month and to about \$93 by the end of the year. On the buy side of the oil market is Goldman Sachs. That broker's oil analysts said earlier this week that they expect oil prices to climb as high as \$200 in the next two years on tightening supply. Clearly the market is broadly mixed on the future of oil prices.

Earlier this week oil prices spiked on news that US worker productivity accelerated in the first quarter by 2.2% compared to a 1.8% in the fourth quarter. Rising productivity generally acts as a retardant for inflation as more goods can be produced by an economy keeping supplies ahead of demand. In the case of oil it is feared that if the US economy is emerging from its slowdown, demand for energy will rise and prices will also. However, the trends suggest the reverse. The latest government reports show that Americans are reducing their gasoline purchases. The high prices are having a measurable impact on its consumption.

The economic data released lately indicates that this economic slowdown/recession is less severe than the one in 2001 at the same stage of development. Whether we are in recovery or decline remains to be seen. The size of the declines in housing and jobs numbers are declining. Consumer demand has not dropped off the cliff and credit markets are gaining in confidence. Through it all, equity markets here and abroad are demonstrating remarkable confidence. The S&P Global 100 Index is 10.6% higher than its mid-March lows. Market volatility has dropped significantly as measured by the VIX. That indicator is down 45% from its peaks reached in mid-January and mid-March and is down to lows not seen since July and October of last year.

On the corporate earnings front things are shaping up pretty well too. With 80% reporting as of Monday, 73 of companies either met or beat analysts' projections. The growth rate now stands at -15.3% with the S&P 500 headed for three consecutive quarters of negative growth, the first since 2001, according to S&P. Excluding financials though, the growth rate is 4%. The sectors with the best earnings performance reported so far for the first quarter include energy (28.8%) consumer staples (13.5%) and information technology (10.2%).

The bulls continue to vote with their money that recovery is coming and many of the signs agree. We'll stay focused on the obstacles and the opportunities.

Have a good weekend