

BEACON INVESTMENT MANAGEMENT

THE FRIDAY BRIEF

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Oil vs. Global Growth

The broad US economy continues to find ways to grow despite mounting hurdles. Government reports this week of increases in GDP, exports, personal incomes, and new houses sold all defied economists' estimates. Gains in some cases were significant, while others were increases on a declining scale.

There were some other significant increases this week too, most notably in energy costs. Oil prices surged above \$130 per barrel as gasoline followed, topping the \$4.00 mark in numerous cities across the US. Last year and early this year consumers ignored rising fuel prices, but they and investors are now paying closer attention. Oil is up 33% this year alone. Distinct trading patterns have developed between oil and the dollar in global markets and oil and the stock market here at home.

Oil has become a store of value for buyers in currencies other than the dollar. When the dollar drops they move to oil. However, the notion that the US may avoid recession is causing the dollar to appreciate relative to the euro as it heads toward its second monthly advance relative to that currency. In the US rising oil prices sent the stock market on a five-day rout of over 5% as oil spiked above \$133 per barrel. Energy consumption in the US has dropped almost 4% from a January peak. Experts expect the trend to repeat globally bringing prices down.

In its revised report of growth in the US economy, the government said first quarter GDP rose .9%, better than expected. Fourth quarter growth was .6%. The report showed that the trade deficit shrank to an annual pace of \$480.2 billion, the smallest since the third quarter of 2002. Trade's contribution to growth jumped to 0.8%, four times more than previously estimated.

Consumer spending grew in April by 0.2% following a 0.4% increase in March according to the Commerce Department. Spending rose at 1% during the first quarter which represents the slowest growth since the 2001 recession. Tax incentive checks have begun hitting mailboxes, but economists at Credit Suisse Holdings in New York point out recent increases in energy expenditures will consume about 80% of the more than \$110 billion in rebate checks being sent.

Retailers are reporting mixed results in the difficult environment of rising oil prices and falling home values. Retailers who understand their customer and the issues he faces are doing pretty well. Costco and Target are gaining share against their competitors Sears and Wal-Mart as they offer cheaper prices with larger and better merchandised selections. Even the more affluent retail customers are not spending at the pace they have. Tiffany & Co., the world's second-largest luxury-jewelry retailer expects full-year earnings ahead of analysts' estimates. The gains are expected not from domestic growth but from a surge in jewelry sales abroad and foreign-tourist spending in the US.

Other companies, while seeing no indication of a rebound in spending, are also not seeing any further deterioration.

Personal income grew 0.2% in April, twice economists' average projections. But the increases are weak and getting weaker. March income grew at .4%. Jobs are engine for income growth and the economy is not creating new ones at present. In fact, first-time claims for unemployment insurance rose to 372,000 last week, higher than economists had forecast, from 368,000 the previous period. Benefits jumped to 3.104 million in the week ended May 17, the highest level since February 2004.

The news from employers is pretty good on balance. The National Association of Purchasing Management-Chicago said today its business index rose to 49.1 this month, higher than forecast, from 48.3 in April. While figures lower than 50 signal contraction the last two quarters have shown improvement. Manufacturing has slowed more gradually than in the 2001 recession likely because exports are supporting demand.

Another government report today supported the export thesis as orders for durable goods excluding automobiles and planes also unexpectedly rose in April. The report indicates growth in Europe and emerging markets along with a cheap dollar are sustaining demand for American made goods even as US consumers slow their spending.

The housing market continues its worst recession since the Great Depression, but there were at least a couple of positive signs this week. Bloomberg reported that housing demand in California, where one out of every eight US residents lives, is reviving as bargain hunters buy foreclosed properties, reversing a two-year decline in home sales. The government reported that new home sales in the US unexpectedly rose 3.3% in April to an annual pace of 526,000 from 509,000, still, the lowest in 17 years. And the pace of decline may be slowing. Residential construction decreased at a 25.5% pace in April, less than previously estimated. However the drop was still the biggest since 1981. Builders began work in April on the fewest single-family houses in 17 years, according to Bloomberg.

Now that housing and the credit crisis that followed are waning in market influence, oil has become the major driver, the major risk factor, the major unknown. One gets the feeling that we have neared a line in the sand where global growth is in peril. Is it \$133, is it \$150 or \$200 as Goldman Sachs and others suggest? What seems clear is that the portion of the price that is supported by speculation could quickly disappear at the first real signs of slowdown in the more vibrant economies of the developing world. If oil prices are ahead of demand and continue to bubble proportions we could see a dramatic fall as in other recent bubble collapses. Alternatively, if the dollar continues its rise relative to the euro and the yen we might see a more orderly decline in the price of oil as it loses its 'store of value' quality for non-dollar investors.

It's way too early to look for recovery, but it may be equally off base to suggest that things get significantly worse from here. The signs suggest continued gradual slowing in the US and Europe. If the developing economies prove as resilient as they have of late, and if oil doesn't spike too high, maybe we can pull out of this malaise, sooner rather than later. We will keep watching.

Have a good weekend.