

BEACON INVESTMENT MANAGEMENT

THE FRIDAY BRIEF

Distributed to our clients and friends weekly

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Capitulation?

The oil bulls stampeded last night and the herd is growing. Crude rose more than \$8 per barrel on a Morgan Stanley report that Asia is taking an unprecedented share of Middle Eastern exports. The report said that oil could reach \$150 per barrel within the month. Almost on cue, Nigerian workers threaten to strike if Chevron fails to meet its demands.

Analysts say that the latest move in oil is purely demand driven with Asia in the driver's seat. China and other large users may begin stockpiling just as the US halts strategic oil reserves buildup. But, US demand will remain at peak for the summer as vacation driving season is upon us and high temperatures place greater demands on utilities. Throw in the speculative worries of looming hurricanes and it's pretty easy to see that oil is going higher – possibly way higher.

Recent positive signs that the economy is holding its own are now withering in the fire of inflation rhetoric from the likes of European Central Bank President Jean-Claude Trichet and our own Ben Bernanke. Trichet hinted at a rate hike next month and Ben suggests that the Fed is finished lowering rates. Battle lines are being drawn for the coming fight against inflation while the risk of collateral damage seems secondary. In other words, controlling inflation is now more important than keeping the economy out of recession; at least for the Fed and for the EU Central Bank. It is likely that either presidential candidate would open the public spigots early next year, but probably too late to forestall recession, should the current measures fall short.

Yesterday's report of jobless claims surprised to the upside, but it proved only a mirage. Today, the government said that the US lost jobs in May for a fifth month and the unemployment rate rose by the most in more than twenty years. Payrolls fell by 49,000 after a 28,000 drop in April. The jobless rate increased by half a point to 5.5%, higher than every forecast in a Bloomberg News survey. Payrolls shrank by 324,000 workers in the first five months of this year. Last year, the economy generated 91,000 new jobs a month on average.

Banks continue to struggle in the sub-prime morass. Bond insurers MBIA and AMBAC seem resigned to Moody's and S&P's coming downgrades of their credit ratings. If their ratings are reduced, bonds insured by those companies will no doubt lose more market value, reducing banks' already pummeled assets. Lehman Brothers is set to report what may be its first quarterly loss since going public in 1994. The brokerage firm is in talks to raise as much as \$5 billion by early next week.

On June 2nd S&P downgraded the credit quality of Lehman Brothers, Merrill Lynch and Morgan Stanley because of the potential for more credit write-downs. With nearly \$400 billion lost so far, global banks face near-unprecedented difficulties raising capital to

replace their losses. The cost of capital is rising for them and for every other business that borrows money.

Housing woes continue without any real sign of a bottoming except for limited rallies in areas such as California, where buyers are snapping up bargain basement foreclosure sales. With jobs now showing significant declines and oil pointing higher, the chances for bottoming or recovery are waning. To make matters worse, Business Week reports that the next wave of foreclosures is just around the corner. By April of 2009 around a million borrowers with option adjustable rate mortgages will see their monthly payments reset to dramatically higher levels than their initial 'come-on' rates. About 13% of option ARMs issued in 2006 were two months delinquent by the time they were 18 months old, according to Credit Suisse.

Congress is proposing a rescue that would save as many as two million borrowers by insuring \$300 billion in refinanced mortgages. However, a real threat is that the severity of the problem may be both prolonged and worsened. Bloomberg quotes expert Dan Castro of Merrill Lynch who says that declining home prices will force nearly a third of the insured borrowers into a second default. Oh yes, the lenders take their hits now, especially second-lien lenders who stand to lose nearly all of their investments under the 'rescue' plan. And what about the value of the contracts when they become worth no more than the paper they consume? We come full circle back to securitized mortgages. Those investors will once again wonder how much they are at risk.

Sorry for the doom and gloom this very hot Friday afternoon. You will recall that we said that oil and jobs were the indicators to watch for some near-term direction of the US and global economies. Both reported loudly today, in the wrong direction. The US economic recovery will likely look more like a 'W' than a 'V.' Put another way, signs hinting at recovery over the last few weeks are now yielding to stronger downward forces. But, as oil eventually declines with global demand, it makes it possible for a second attempt at recovery. Perhaps that recovery might just coincide with the coming 2009 first year presidential cycle.

We are taking all necessary and appropriate tactical (intermediate-term) measures in our model portfolios to avoid excessive risk, particularly in the financial industry. We expect to hold more cash as well as to increase our exposure to oil which for some time to come appears likely to remain in its long-term super-bull cycle. We continue to believe that the technology sector shows promise even in a slowdown as developing countries continue to demand their products, businesses in developed countries continue to boost productivity, and they do not need to borrow money to fund operations.

Have a good weekend.