

BEACON INVESTMENT MANAGEMENT

THE FRIDAY BRIEF

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Markets Decline on Record Oil and Continued Credit Woes

Equity markets in the US continued the longest stretch of weekly losses for the S&P 500 Index in four years. Despite good news of a smaller trade deficit and better-than-expected jobs data, investors continued to worry about oil, credit, inflation, and consumer spending.

Investor fear propelled selling of both Fannie Mae and Freddie Mac, the huge, government-created buyers of US mortgages. These institutions provide the essential function of adding liquidity to the home loan market by buying mortgages from lenders such as banks and S&L's then selling them to the public as bonds with the implicit guarantee of the US government. The near free-fall of these two giants has continued to drag down the major banks, including Bank of America Corp., Washington Mutual Inc. and Wachovia Corp. to ten and fifteen-year lows.

The major indices, including the S&P 500, the Dow Jones, the Nasdaq Composite, and the MSCI World Index are at their lowest levels in two years. Each is down more than 20%, taking them beyond the threshold of a bear market. The S&P's 12% rally in March, spurred by the government rescue of Bear Stearns was wiped out by the end of June.

Oil is breaking out to new highs on worries that Israel will attack Iran and an end to the rebel cease fire in Nigeria. Hurricane Bertha, an innocuous whirling dervish south of Bermuda reminds us that the season for US supply disturbance is again upon us. Of course, as global demand declines, the demand for oil will certainly follow. But the question remains, will the decline be enough to offset the potential for significant geopolitical and environmental supply disruptions.

While pundits have consistently underestimated the spending power of the American consumer time and again, this one might just be different. Household budgets are dramatically impacted by rising gasoline and food prices and confidence is eroding amidst rising unemployment, interest rates, and sinking home values. Bastions of consumerism Wal-Mart, Best Buy, and theme-park operator, Disney are all watching their stocks drop as investors bet that the consumer will take a pause. Starbucks is closing 600 stores as its sales decline. Apple Computer is down 2% on the day millions of people lined up around the world to buy its new iPhone. Could it be that appetites for the latest and greatest toys, eating out every night, and rewarding ourselves with trips every few months are taking a back seat to frugality?

We believe that our economy has considerable excesses to work off that could take several months, even more than a year. The credit crisis has devolved into a confidence issue now. Auction markets, mergers, and acquisitions, and risk-taking, all cornerstones of

Wall Street are in a deep sleep, if not broken. It may take years for financial stocks to regain their valuations.

Almost eight years after the tech bust, technology stocks trade at a fraction of their previous levels. The Nasdaq Composite Index (a proxy of the technology sector) now stands 57% below its all-time bubble high reached in March of 2000. During the Bear Stearns rally it managed to close the gap to a 44% decline. The point is bubbles cause ripples for many years after the inflection point of losses, particularly among the guilty economic sectors; in this case housing and financials. The ill effects on the broader market do, however, diminish faster than those inflicted upon the culprits.

According to Bloomberg, the S&P 500's drop has lasted 275 calendar days and wiped out a fifth of its value. In the 11 previous bear markets, the index has dropped an average of 30.4% over 386 days. If the index were to decline another 10% it would send the average to 1,119, a level last seen August 2004.

We believe that markets have further to go on the downside. Over the past several months we have added portfolio insurance (diversification and hedges) such as gold which does well during inflationary periods, dividend paying stocks for pure growth, and short ETF's on the Russell 2000 (small cap index) and the S&P 500. Short positions rise in value when their respective indices decline. While we want to avoid timing markets, as active managers it is incumbent upon us to recognize risk trends and act appropriately to counter them. We believe the models have an appropriate balance of dividend and interest generation as well as downside risk protection. We think we can achieve some modest appreciation over the coming months if oil prices stabilize or fall modestly and if housing finds a bottom soon. If not, we will continue to add risk measures.