

BEACON INVESTMENT MANAGEMENT

THE FRIDAY BRIEF

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Toll Free 888-621-5885

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Markets Rally on Oil Prices and Bank Reports

On the 14th of this month, the collective global investor decided oil was entirely too expensive. It is down nearly 15% from its peak of \$147.27 per barrel. During the same period the Dow Jones Industrial average rallied 2.7%, the small cap Russell 2000 jumped 5.7%, and the tech-laden Nasdaq, 3%. Some better-than-expected news from leading banks added fuel to the rally.

The week brought plenty of continuing bad news, but investors seemed ready to buy stocks nonetheless. Whether the rally was driven by short-covering (removing bets that stocks will continue to fall in value) or bargain-hunting, the reasons for it seemed sound enough. Stocks rose on declining oil prices and stronger-than-expected earnings from banks, industrials, and select tech and telecom companies. Investors easily move beyond the huge losses posted by banks during the week as Wachovia took the prize with an \$8.7 billion whopper. Surprisingly, the fourth largest bank took another prize on Wednesday, a 40% stock rally. However, after more bad news from the housing sector and a few analyst downgrades, the stock has given back half of its' Wednesday rally.

Today, the government reported that orders for US durable goods unexpectedly increased by .8% in June, easing concern that companies would limit spending. Record exports, fueled by a weakening dollar and economic expansions abroad are helping US factories withstand the deepening housing slump and slowing demand at home. So far the manufacturing sector, which was slow to join the party during the last economic recovery, now remains our last strength in a slowing economy.

There was additional good news today as the government reported that June new-home sales decreased 0.6% to a 530,000 pace, from an upwardly revised 533,000 in May. Economists had forecast a 1.8% slide. The number of properties on the market dropped by the most in four decades, indicating builders are making some headway in clearing out inventories.

Consumer confidence also took a refreshing turn for the better. The Reuters/University of Michigan final index of consumer sentiment increased to 61.2 in July from 56.4 in June. The measure averaged 85.6 in 2007. Economists had forecast a reading of 56.4 in July.

Today's news is welcome relief in the midst of what seems to be an overwhelmingly negative trend. Does the market suggest that the worst is behind us for both credit and housing crises? Several experts like Bill Gross of PIMCO (world's largest bond fund manager) say the credit crisis has more to run. He suggests that losses could approach \$1 trillion, well beyond the \$300 billion already reported. US Treasury Secretary Henry Paulson hopes to prove him wrong as he bulldozes his bill to save Freddie Mac and

Fannie Mae through Congress and the White House. If the falling tide of home prices slows or reverses, Gross and others' scary forecasts might turn out to be pessimistic.

Crude oil has dropped remarkably in the last couple of weeks on rising levels of supply and falling demand. It is reported that refiners, who delayed buying at higher prices are now beginning to buy to fulfill their requirements. But the lows might prove unsustainable in the face of supply losses if Israel attacks Iran's nuclear facilities. Iran has warned it may blockade the Strait of Hormuz in that event. The strait is the export channel for a quarter of the world's crude. The country has the second-largest proven oil reserves and is the second-biggest producer in the Organization of Petroleum Exporting Countries.

Domestic increases in oil supply look unlikely as majorities in both the Senate and the House oppose offshore and refuge drilling. The majority also shuns nuclear expansion, so we are to look to renewables and hybrids for our long-term solutions. Unfortunately these are *very* long-term solutions for any significant improvement in cost.

To give you an idea of the viability of solar, I'll share a story. I am on a team studying the feasibility of adding solar power to our church building. Significant tax credits (some of which go away this year) help make the option possible from the standpoint of appearances, but there is little to no economic benefit. Without the upfront credits afforded to taxable entities, it appears that the energy generated by our system would be just enough to cover the cost of our solar plant. There would be nothing left to reduce our energy bills, other than perhaps a little added heat insulation on our roof. After 25 years of payments we would own our solar plant; just in time to replace it.

The US economy must adapt to stubbornly higher energy prices for the foreseeable future. It is a fact of developing global economy. Forced conservation and greater efficiency are good, but they come at a price and take time. Our economy will adapt, but there will be pain in the short run. We simply hope that geopolitical threats do not intervene before we are better able to cope with the next round of increases. Our economy may have just have sufficient momentum to rise from its slump if oil doesn't spike again in the coming months.

Have a good weekend.