BEACON INVESTMENT MANAGEMENT
THE FRIDAY BRIEF

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Recession - Recovery

Falling oil prices, an improving credit picture, and a few stronger-than-expected corporate earnings put a floor under equity markets that began a free-fall in June. The S&P 500 is down only 1% compared to a decline of 9% in June. The Nasdaq is up 1.5% for July following its 9% decline in June. Global equity markets demonstrated a similar pattern.

The US economy has likely been in recession since last year as we have been saying for months. Yesterday, the Commerce Department's Bureau of Economic Analysis announced revised estimates for GDP in the fourth quarter of 2007 saying the economy contracted by .2%. They previously estimated that it grew by .6%. The last contraction was in the third quarter of 2001, during the last recession, when it shrank by 1.4%. The figures also showed the housing slide that began in 2006 was worse than previously thought. Residential investment fell 32% in the two years ended in December 2007, compared with a prior estimate of 29%.

For seven straight months the US has lost jobs, another sign of recession. The Unemployment rate increased to 5.7%, the highest level since March 2004. According to Bloomberg, the last time the unemployment rate climbed so much in four months was during the last recession in 2001.

A separate report from Radar Logic showed that home prices fell in 23 of 25 U.S. metropolitan areas in May from a year earlier as foreclosure sales pushed down values. Sacramento had the biggest price drop, falling 31% from May 2007. Las Vegas declined 29.5%, San Diego 27.2%, St. Louis 26.9% and Phoenix 25.8%.

The report went on the say that sales rose in 22 areas in May from April, driven by "motivated" sellers including banks. Bloomberg reported that price declines are occurring in areas where subprime lending was heavily concentrated, and a large percentage of sales are foreclosure sales. Those sales are always significantly lower than transactions that are not forced. US foreclosure filings more than doubled in the second quarter from a year earlier as almost 740,000 properties, or one in every 171 households, was foreclosed on. Another report, the S&P/Case-Shiller home-price index of 20 metropolitan areas, dropped 15.8% in May, the most since at least 2001.

Oil prices are down over 16% from their peaks as global demand has fallen faster than supply. Prices might stay down too if it not for continuing worries from Israel and Iran. Israeli Deputy Prime Minister Shaul Mofaz told a Washington audience today that Iran is on a path toward a "major breakthrough" in its nuclear program that is "unacceptable" to Israel. Mofaz accused the Iranian government of "buying time" in its resistance to international pressure to suspend uranium enrichment. He supports diplomacy saying "we don't want war, we want peace. But we will not let the second Holocaust take place."

Crude oil for September delivery rose $4.10, or 3.4%, to $128.26 a barrel at 10:22 a.m. on the New York Mercantile Exchange. It had dropped after the Labor Department said payrolls fell by 51,000 and the jobless rate rose to 5.7%. Fuel consumption in the past 12 months was the lowest since 2004-2005, according to the Energy Department.

Despite all of the negative news just highlighted, the market is demonstrating a reluctance to decline further. Since July 16th, the Dow has had twice as many up days as down and volume on those days has been higher. The Nasdaq rally began a day earlier, but with the same characteristics as the Dow. The Russell 2000 rally started on July 8th and has been the most convincing rising 8% from its low.

While depleted substantially, there remains a huge amount of capital still sloshing around the global economy. Eventually these major asset classes, such as housing, banks, or stocks in general will bottom. Their value will be apparent. When this happens there could be a huge influx of buyers going entering the market at the same time and prices could rise quickly. While impossible to predict the precise set of circumstances or market asset class that might bottom first, it is useful to look at various potential outcomes with an eye on the biggest winners. We do this regularly as a part of our ongoing investment discipline. Here is an example.

Asset prices generally fall the fastest just before reaching a bottom during a period known as capitulation. A panic to get out of the falling asset engenders a reaction to 'sell at any price.' Add regulatory requirements to offload sinking assets such as those banks have with foreclosed houses, and prices can be leveraged down even further. Another psychological factor prolonging price declines is one experienced by potential buyers who are lulled to the sidelines by rapid or steady price declines. They don't want to 'catch a falling knife' as they fear buying too early. In other words, falling prices look more like a long-term trend with no signs of reversing.

Let's consider housing in this scenario. Prices have fallen steadily for three years. However, the rate of price declines is now increasing. Nationally, home prices fell at the fastest pace of the year in May, dropping 4.8% from a year earlier. The Case Shiller index dropped 15.8% in May, the most since the last recession in 2001. The large drops are likely the result of increased foreclosures which are leading to increased sales at dramatically lower prices. Yet the trend of foreclosures may reverse soon as a result of recent housing legislation signed by the President.

There will come a point in every local market when the prices of houses reaches that certain point where buyers are compelled to act (assuming they can). Given the length and steepness of the decline in home prices the reversal could be significant. There could be a stampede back into houses as buyers exchange their concerns over falling prices for fear that they might just miss these great prices. One of my strongest memories of the 1987 crash is the speed with which the blue chip stocks came roaring back when people began to realize the world was not ending after Black Monday.

Now that the recession is a near or in fact a reality, we can expect the next talk to be of recovery. Modern recessions last about a year. If this one started in December and is typical, we are closer to the end than the beginning.

Have a good weekend.