

BEACON INVESTMENT MANAGEMENT

THE FRIDAY BRIEF

Distributed to our clients and friends weekly

<http://www.beaconinvest.com>

Toll Free 888-621-5885

Friday, August 08, 2008

Bear or Bull?

Oil is dropping like a rock. It stands at \$117.42 a barrel in New York, 20% below its record high of \$147.27 reached July 11th. Copper heads for its biggest weekly drop since March and down 12% since June. The dollar is climbing to a five-month high against the Euro putting further pressure on oil and other commodities. And gold fell to an eight-week low in London on speculation that dollar gains will spur gold sales by investors who bought the metal as a hedge against a sinking dollar.

The principals of supply and demand are finally taking hold. As the global economy slows, investors are betting that demand for commodities across the board will drop as well. The decline in commodities prices is good news for central bankers as they can shift their focus from inflation concerns to those of economic growth. The trend is also good for the US dollar. If major central banks are no longer raising rates and indeed may lower them, the dollar will continue its rise relative to other major currencies. A stronger dollar means lower oil and commodities prices. It takes pressure off of the US Treasury as it finances a growing budget deficit and it reduces inflationary pressure of imports into the US.

Another encouraging piece of news on the inflation front was released by the Labor Department this morning. Worker productivity grew in the second quarter by 2.2%, while labor costs climbed only 1.3%. Employers eliminated 165,000 jobs from April through June to shore up profits, and still managed to get more output with fewer workers. David Greenlaw chief US fixed-income economist at Morgan Stanley notes that productivity growth "historically tends to suffer during energy-price shocks. The current year-over-year growth rate of just a shade under 3% demonstrates an impressive degree of resilience [in the economy]."

Fed Chairman Alan Greenspan recognized in the mid-90's that productivity was accelerating because of the increased use of computers and the Internet. He postulated that the improvement would diminish inflation pressures even as the economy gained strength and unemployment fell. When a rapidly growing economy can produce sufficient goods to stay ahead of demand as well as contain the pressures of rising wages (caused by a shrinking workforce), then inflation may not necessarily result. The realization allowed the Fed to keep interest rates little changed from 1996 to 1999.

Today the Fed continues to bank on rising productivity as it leaves the benchmark rate unchanged at 2%. We face an unpleasant combination of slowing growth and rising inflation. The official statement earlier this week summed up the Fed's concerns. "Although downside risks to growth remain, the upside risks to inflation are also of significant concern. The committee expects inflation to moderate later this year and next year, but the inflation outlook remains highly uncertain." They hope that weaker consumer demand in a slowing economy combined with rising productivity will help keep a lid on inflation.

Nearly 75% of companies in the S&P 500 have reported their earnings. Positive surprises lead disappointments by a 2.5:1 ratio, which is only slightly below recent historical norms according to Zacks. The median surprise is also in line with recent history at 3.33%. The median EPS growth rate of 10.60% is great news for the market.

Based on actual returns, the technology sector is winning with median earnings growth of 25.0%. These returns are based on the results of 52 companies reporting, or 73.2% of the total Tech firms in the S&P 500 index. Energy is a close second. Health Care's median eps growth rate is 17.4% and Industrials averaged growth of 15.6% so far. Their actual earnings have bested analysts expectations by 7.5 and 7.8 times, respectively.

As you might suspect, Financials have been the weakest sector by far, with the median earnings per share dropping by 18.2% from a year ago. The sector is responsible for over one third of all the earnings disappointments to this point. It is the only sector where disappointments have exceeded positive surprises in number. Consumer Discretionary is the only other sector to show negative year over year growth on a median eps basis -1.8%.

In summary, we continue to observe a relatively resilient economy outside of housing and finance. As we discussed last week, housing may be nearing a bottom. A bottom in real estate prices would be the proverbial light-at-the-end-of-the-tunnel for financial firms. Experts worry that banks risk greater losses as long as housing prices continue their declines. And estimates for the bottom range from six months to sometime in 2010.

Because real estate performance varies so much from one location to another, the national averages can be misleading. Home prices have stabilized in markets that did not experience speculative bubbles like Dallas, Denver, Atlanta, and Charlotte. However, prices continue to fall in the speculative epicenters like Las Vegas, Miami, and Modesto, California. When the national averages finally turn, some regions may be months ahead.

We believe we are closer to the end of the pain than the beginning. We also believe that the broad economy will skirt a deeper recession given the favorable trends in commodities, inflation, productivity, and earnings, mentioned above. We also believe that the most recent stock market rally is not a 'bear market rally' eventually resuming a declining trend, but it actually marks the beginning of the end of the bear market.

Have a good weekend.