

# BEACON INVESTMENT MANAGEMENT

## THE FRIDAY BRIEF

*Distributed to our clients and friends weekly*

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### The Lazy Hazy Days of Summer?

The summer of '08 has been anything but a typical lazy, quiet break from an otherwise frenetic calendar. Global equity markets dropped like October meteors in July; oil and gasoline prices exploded past record highs as the summer driving vacation season approached; record levels of rainfall in the mid-west sent the mighty Mississippi River pouring over thousands of acres of rich farmland, destroying much of the nation's bread basket; thousands of Americans have lost or are near losing their homes to foreclosure; China puts its best national face on for the rest of the world as they host the 2008 Summer Olympics – a time for peace and international friendship, and two Russian and Georgian women hug during their medal ceremony as their countrymen kill one another.

Markets of every kind have been anything but quiet or sleepy this summer. Commodities, after huge run-ups driven by demand initially, later by hedges against a plummeting dollar, are now themselves dropping like rocks. Gold is now well below \$800 an ounce, platinum posted the biggest drop in almost seven years along with corn, copper and oil. Major commodities are down in excess of 20% across the board. Experts are predicting that oil will likely fall below \$100 per barrel in the coming months. All this chaos as the dollar rips its way to 5 ½-month highs against the Euro, 7-month highs relative to the Japanese yen, and 22-month highs against the British Pound.

The strength of the dollar's rally likely suggests a major turning point for the currency which has been in a bear market for over seven years. Since its turn in the last month the dollar has rallied over 5%. For the past several months Ben Bernanke and his Federal Open Market Committee have been well ahead of the inflation curve compared to other central banks. As a result of their boldness earlier, they have positioned the US economy far better than others for growth. At a 2% Fed Funds rate the US economy is in far better position to pick itself up compared to Europe's 5.25% and England's 5%. Foreign bankers have been far more worried about inflation than of their economies. They face the real prospects of deeper recessions. They will almost certainly be obliged to cut rates soon. As they do, the dollar will only go higher (and oil and commodities – lower).

We are not out of the woods yet as far as inflation goes, but the Fed believes that the recent spikes will reverse as the economy slows and as oil and commodities fall globally. Yesterday, the government announced that the consumer price index jumped .8% to a 17-year high in July. The cost of living was up 5.6% in the year ended in July, the biggest rise since January 1991. The core prices, which strip out the volatility of food and energy prices also advanced a more-than-projected .3%. But, keep in mind these numbers reflect the past. Commodity and energy prices have fallen remarkably in the past couple of weeks which will reflect positively on inflation. Also, the contributors to inflation - wages and housing costs are not a problem. The Fed has it right, we believe. Gold investors – traditionally the best indicators of inflation, concur. Gold has fallen by that hauntingly recurring 20% since reaching its peak of \$989.60 in mid July.

While credit, housing, and consumer spending problems continue to drag on, the manufacturing side of the economy shows remarkable strength, particularly in exports. Today the government announced that industrial production unexpectedly increased in July by .2%. Earlier in the week the government announced the biggest jump in exports in more than four years overwhelmed record

imports of oil to shrink the trade gap y 4.1%. Shipments were strong to Europe and Latin America, but sales may wane later this year as those economies slow.

Historically, recessions last about 8-10 months. If the US recession started sometime at the end of last year as we suspect, we are nearing the end of a typical recession. However there are many caveats to make this one different. The collapse of oil prices certainly helps the prospect for our economy, but housing remains a major hurdle.

Yesterday we learned that existing US home sales fell to a 10-year low in the second quarter and the median price for a single-family house dropped 7.6%. The median price of a home tumbled to \$206,500 from \$223,500 a year earlier. Sales of single-family houses and condominiums fell 16% to a 4.913 million annualized pace. Prices declined in 115 of the 150 metropolitan areas surveyed as foreclosures and "short sales," in which lenders agree to take a loss on a property, accounted for a third of all sales in the quarter. Bank repossessions of property almost tripled in July from a year earlier, according to RealtyTrac. The tracking firm also noted that bank seizures of properties in default rose 184% to 77,295 in July. More than 272,000 properties, or one in 464 US households, got a default notice. Credit Suisse predicts that foreclosures could put 8.4% of total homeowners, or 12.7% of homeowners with mortgages, out of their homes.

There will have to be a dramatic improvement in these statistics for the economy to rally with significance. The congressional bill designed to help 400,000 homeowners refinance their mortgages will provide some relief. Yesterday's announcement that a relaxation of Freddie Mac's and Fannie Mae's debt limits to allow them to buy more mortgages will help too. But there needs to be more. Banks have virtually stopped lending in this market. Something will have to happen to bring risk-taking back into the housing market and we feel that it is coming sooner rather than later. It could be as simple as buyers realizing that prices are simply too good to miss. Given the significance of price drops reported recently, it could be that that moment is not far off.

But most people need a mortgage to buy a house. So a critical piece of the puzzle will be a willingness on the part of banks and mortgage firms to begin lending again. We believe they will. The first ones will be those with strong balance sheets and capital positions and there are more than a few. They will get further government assurances for the marketing of their mortgages as well. We believe the turning point in the real estate recession is closer than the gloomy statistics suggest.

Finally, stock markets, particularly in the US, have shown remarkable strength coincident with the rise of the dollar. The Nasdaq 100, which hosts a large number of technology companies, is up almost 12% since mid July. The broader S&P 500 is up 6.75% during the same period. The Dow Jones Regional Bank index is up a whopping 36% since mid July. Most of the leading banks in this index reported second quarter results which were ahead of analysts' projections, signaling that the average bank in America may be significantly stronger than the top headline-grabbing money center banks. Investors are buying the argument anyway.

No, it's not a typical summer, but fall and October are just around the corner. Fall is a traditionally difficult time for stocks as corporations come clean with their earnings reports for the year. It might just be that most of the dirty laundry is out of the basket. Maybe just maybe, fall will be just as atypical as summer has been and the good news will outweigh the bad. Perhaps stock prices will do anything but 'fall.' Just a thought.

Have a nice weekend.