Beacon Investment Management

The Friday Brief

Distributed to our clients and friends weekly

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Friday, September 12, 2008

Faint Signs of Improvement

Headlines continue to scream that things are getting worse, but there are whispers that a bottom is nearing. The S&P 500 index reached a low of 1,215 on July 15th. It is said that market bottoms require a double test before investors feel confident enough to begin buying again. Yesterday's market swoon took the average below the July low before rallying 3.1% from those lows. Wharton's Professor of Finance, Jeremy Siegel points out that investor sentiment, a good contrary indicator, is at an 18-yaer low on bullishness - lower than October 2002, which followed a 50% decline in the market. Another good sign is that despite the latest bad news from Lehman Brothers and Washington Mutual, many bank stocks are higher than their July 15th lows which show that investors are now beginning to discriminate to find value. Finally, the dollar has formed a strong bottom and the commodity price spiral has come to a dramatic end.

The latest news on inflation is good as the government reported today that prices paid to US producers fell .9% in August for the first time in a year, due primarily to lower energy costs. Removing fuel costs, prices rose .2%. In the last couple of weeks oil has fallen to near $100 per barrel with the prospects good that it will remain there or fall a bit further. With the retreat in commodity prices it looks like inflation will not be a problem for the Fed going forward.

The spoiler, at least in the short run may be gasoline prices. They are expected to spike as Hurricane Ike forces the closures of roughly 19% of US refining capacity. Experts expect the damage to be primarily flooding and the loss of electrical power for an extended period of time. According to Bloomberg, the Houston area's eight refineries (where Ike appears headed) have a processing capacity of 2.22 million barrels a day, which represents 13% of the US total.

Foreclosure filings of US homes rose to a record in August as falling home prices made it harder to sell or refinance homes to pay off the mortgage, according to RealtyTrac. August filings of 303,879 were 11% higher than the previous record of 273,001 set in May. It represents the slowest gain since February 2007, indicating the federal program to help borrowers avoid foreclosure may be having some impact.

But the headwinds are strong. Home prices in 20 U.S. metropolitan areas declined 15.9% in June from a year earlier, according to the S&P/Case- Shiller index. Prices may fall another 10% through the end of 2009, according to analysts at Lehman Brothers Holdings Inc. Defaults rose 10% and auctions rose 7% from August 2007, said RealtyTrac. There are 3.9 million unsold existing single-family homes, the most since at least 1982, according to the Chicago-based National Association of Realtors. There is an 11.1 month supply of existing unsold homes at the current sales pace, up from 4.6 months in September 2005, the

Realtors said. Financing is difficult to obtain, and borrowers must put down 20% to 30% of the purchase price.

Today brought mixed signals from the US consumer as confidence unexpectedly increased, but spending dropped faster than expected. A .3% drop in August sales follows a .5% drop in July according to the Commerce Department. Surprisingly, consumer confidence jumped to 73.1 from 63 in August, according to the Reuters/University of Michigan index. The group credits falling gasoline prices as the primary driver. If the spike in gasoline prices from Ike is short, confidence may continue its recovery, even as spending slows. We expect either presidential candidate to offer additional spending incentives early in his new tenure in office.

If we are now in recession and it started, as we believe, in November or December then we have reached the average life expectancy of a modern recession; eight or nine months. The number of months the US economy spends in recession has steadily declined over the last two decades due to what has arguably been better monetary policy and the inflation-killing secular forces of globalization and information technology according to the economists at Stretegas. Their research shows that recessions lasted an average of 28 months in the 70's 21 months in the 80's and 8-9 months during the last 20 years. While the headlines show few signs of the recession abating, we believe the stock market is sending signals that recovery could begin in the coming months. Markets anticipate economic turns by as much as two quarters.

During the month's gyrations only a handful of indices performed well. Interestingly, they are the S&P Homebuilders up12%, S&P Retail up 6%, and the Lehman 20+ Year US Treasury Index up 2.75%. These suggest that investors may believe the bottom is coming soon for the housing crunch and that inflation is abating. During the last week, transportation and healthcare showed strength. And investors are buying oil and gas stocks on their dips to 8-month lows.

We expect the markets to continue their ups and downs as investors and economist try to understand the severity and duration of this global recession. We believe the continued strength of the dollar suggests that global investors maintain a certain degree of confidence that recovery is not too far off. We are lighter in our foreign exposure as we believe the 8-year slide in the dollar is over and US assets, particularly stocks and bonds will be in greater demand. To say that timing the markets turns is an exact science is a gross understatement, but confidence is rising that we are at a point where long-term investors will be rewarded handsomely by holding and investing at today's prices.

Have a nice weekend.