

# BEACON INVESTMENT MANAGEMENT

## THE FRIDAY BRIEF

*Distributed to our clients and friends weekly*

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### Shifting Sand

As yet another bank fails and the stakes get higher, Congress and the White House continue to argue over the best plan for recovery. These are political institutions with some of the best politicians (best at being political) in the world, so it is difficult if not impossible to remove the political aspects of a public debate of this magnitude. And if you take your news and views from television it may be nearly impossible for you separate your emotions from the situation because these pols are so skilled at arousing the passions of those on their side. But if you can suspend your ire from the events of yesterday for a few moments a better understanding of the ideology behind what is going on might be possible.

The plan that is being railroaded through Congress by the Bush Administration, Democrat Chris Dodd, chair of the Senate Banking Committee, and Democrat Barney Frank, chair of the House Financial Services Committee, will be funded entirely by taxpayers. That's \$700 billion dollars or \$2400 that will come from each and every American taxpayer. Since announcement of the bailout, average Americans have been railing against the whole idea of rewarding with their tax dollars the very institutions that created this mess. Calls to congressional offices are "running 50 percent 'no,' and 50% 'hell, no,'" Democrat Paul Kanjorski told CNBC today. "Out of 100 calls, you are lucky if one of them is positive" toward the fast track plan.

Yesterday, a group of minority Republicans with some Democratic backing said they had a better plan and wanted it heard before the fast track plan was enacted into law. This plan was dramatically different from the taxpayer funded plan and it had growing support in the House. Instead of the government buying the distressed securities, the new plan would have banks, financial firms and other investors that hold such loans pay the Treasury to insure them. The Treasury would design a system to charge premiums to mortgage-backed security holders to finance the insurance. It removes regulatory and tax barriers that are currently blocking private capital formation. And it suggests that financial institutions should suspend dividends, along with other steps to address liquidity problems.

The differences are clear between the plans; the fast track one is simply a massive government transfer payment which could have significantly negative consequences on the dollar and the fiscal health of the US government. The minority sponsored plan places more burden on those who created the problem in the first place and minimizes the government's exposure. But its effectiveness is less certain because it takes longer to implement and Democrats likely would not support tax cuts.

I'm rarely in front of a TV these days, so I can only imagine the bluster of liberal Barney Frank angrily calling for passage of the same bill as conservative President George Bush. The articles I've read of the events of the past 24 hours take a decidedly negative view of the Republicans' plan and those who jammed it in at the last moment. But it is surprising to

me that, given the gravity of our situation, the very idea that there might be a better way could be so angrily and hastily dismissed in the noise of politics. If it is so easily believed that the minority Republicans were grandstanding at the 11<sup>th</sup> hour simply for political reasons, isn't there also room for the possibility that they had a better idea and were willing to risk much to have it vetted? Time will tell whether any of their proposals make it into the new plan. The idea of tax cuts and temporary reduction of regulations is contrary to the majority's ideology.

Last night we learned that JPMorgan bought most of the failed Washington Mutual yesterday and that is raised \$10 billion in stock sale today. The failure of WaMu is the largest bank failure in US history by far. The Seattle-based banks had about 2,300 branches at the end of June. Its \$310 billion of assets dwarf those of Continental Illinois National Bank and Trust, previously the largest failed bank, which had \$40 billion (\$83 billion in 2008 dollars) when it was taken over in 1984, according to Bloomberg News.

The U.S. economy expanded more slowly than previously estimated in the second quarter, showing consumer spending was weakening before the credit crisis intensified. The annual rate of 2.8% was down from a preliminary estimate of 3.3% issued last month according to the Commerce Department.

Today's gross domestic product report showed that the Fed's preferred measure of inflation, tied to consumer spending without food and energy costs, rose at a 2.2% annual rate which was higher than forecast and faster than the 2.1% previously estimated. Prices overall came in less than anticipated.

In his comments this week stumping for the bailout plan, Bernanke said the US faces "grave threats" to financial stability and warned the credit crisis is hurting business spending. He added that the outlook for consumer spending is "sluggish at best."

The economy has lost jobs every month this year, and the unemployment rate in August jumped to a five-year high of 6.1%, according to the Labor Department. Retail sales fell in August for a second consecutive month as the impact of the IRS stimulus checks diminished.

The trade gap widened to a \$381.3 billion annual pace and added 2.9% to growth, the biggest contribution since 1980, according to Bloomberg. Excluding trade, the economy would have contracted at a 0.1% pace after growing at a 0.1% rate in the first three months of the year. The boost from trade will likely wane this quarter as growth among some of the US's biggest trading partners slows. Europe and Japan both shrank last quarter. Ireland announced yesterday that they were officially in recession; the first European economy to declare. Dell Inc., the world's second-largest personal-computer maker, said that a U.S. slowdown in technology spending that started last quarter has spread to Western Europe and some Asian countries.

Whether or not a bailout plan comes today, Monday or later, we are firmly convinced that the recession we currently suffer will grow longer and deeper than earlier thought. Global credit is tight and risk-taking is at a virtual standstill. Even with a bailout in place, the length and severity of this crisis weighs too heavily on the hearts and minds of consumers, business leaders, and investors to be quickly dismissed. The trend remains negative in employment, spending, inflation, and it looks like exports will soon diminish.

We remain short term negative on stocks and will continue to be defensive for the time being. While we recognize that stock values are extremely attractive, markets tend to over-correct in both directions and we expect the bear to continue to drive prices down further. We will of course continue to seek positive signs of improvement and expect they will come. The bailout is not that far away and will have a positive effect. But confidence, which has been so badly shaken, will take considerably longer to return.