BEACON INVESTMENT MANAGEMENT
THE FRIDAY BRIEF

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Is this the Bottom?

Everyone is wondering if there is a bottom? Markets around the world tumbled yesterday on the same fears driving our markets down. How badly will a global recession hurt corporate profits? As investors sell on earnings fears, they exacerbate the fragile stability of the credit markets – a self-perpetuating spiral. Every drop in stock prices reduces further the assets of banks and corporations, suggesting that an increasing number of them will have trouble paying their debts.

Fears are growing around the world that that there could be a serious, widespread recession. Hedge funds and large investors are responding by deleveraging, or paying down their debts. Deleveraging involves selling stocks, commodities, and other assets. These funds are so huge that the selling volumes can overcome markets, causing stock and commodity values to plummet further than their fundamentals would imply.

Yesterday's and today's market tumbles remind us that the potential for panic remains our unwanted companion. It is important to note that as the markets headed down today neither the Dow nor the S&P 500 reached the intra-day lows of October 10th , the latest market lows. The Nasdaq Composite and Nasdaq 100 did reach new lows today, but they are bouncing pretty strongly off those lows currently.

Housing is what got us into this mess, and maybe housing will lead us out. Today's news on home resales was welcome indeed. The National Association of Realtors today reported that sales of existing homes rose to a 5.18 million annual rate in September; a 5.5% increase from August's unrevised 4.91 million annual pace. Falling prices no doubt provided the stimulus. It was also reported that the median home price was $191,600 in September, down 9.0% from $210,500 one year ago. That $191,600 median price is the lowest since April 2004. The median price in August this year was $203,100.

Falling mortgage rates help too. The average 30-year mortgage rate fell to 6.04% in September from 6.48% in August, according to Freddie Mac. Bankrate.com quotes the following national mortgage averages.

	CURRENT	1 MONTH PRIOR	3 MONTH PRIOR	6 MONTH PRIOR	1 YEAR PRIOR
30-Year Fixed	5.96	5.98	6.51	5.8	5.94
15-Year Fixed	5.59	5.66	6.04	5.4	5.56
5/1-Year ARM	6.01	5.87	5.97	5.54	5.65
1-Year ARM	5.76	6.18	6.3	5.77	5.71
30-Year Fixed Jumbo	7.38	7.23	7.64	7.17	6.54
15-Year Fixed Jumbo	6.68	6.73	7	6.51	6.37

5/1-Year ARM Jumbo	6.23	6.27	6.35	6.39	6.1

The rates at which banks lend to each are falling still. The London Interbank Offered Rate, or Libor, on three-month loans in dollars dipped to 3.52% from 3.54 percent on Thursday. While the trend in rates is good, the desired effects are not yet materializing. Banks continue to hoarding cash. The Federal Reserve reported late Thursday that banks' excess reserves more than doubled in the two weeks ended Wednesday to $282 billion from $136 billion in the two-week period ended Oct. 8.

One large bank so far is using the Fed's money to buy another. PNC Financial, Pennsylvania's largest bank, announced plans to buy National City Corp. for about $5.2 billion in stock. PNC will pay $2.23 a share, 19% less than National City's closing price yesterday, to create the fifth-largest U.S. bank by deposits, the Pittsburgh-based lender said today in a statement. The $7.7 billion of Treasury funding "put this transaction on a very solid footing," said PNC. A bank buyout beats a government takeover anytime and is a good move toward recovery in the credit markets.

Rates for corporate borrowers have not yet joined other rates in retreat as investors worry about their ability to repay. The cost of insuring against investment-grade corporate bond defaults surged to a record level today, according to Markit CDX North America Investment Grade Index. But the thing about historic peaks in indicators is that they are usually followed by rapid moves the other way.

Speaking of rapid moves the other way; oil is now down 56% from its peak of $147.27 per barrel in July. Unusually powerful moves in one direction are generally followed by equally powerful moves in the other direction (reversion to the mean). Oil options contracts to sell crude at $50 by December almost tripled today after OPEC's decision to slash production failed stem falling prices. If one wants to jump-start an economy, oil at $50 per barrel sure doesn't hurt.

The bottom line for stock markets is corporate earnings. We are in the midst of the third quarter earnings reporting season. Earnings at S&P 500 companies that have reported third quarter results so far dropped by an average of 23%, trailing analysts' projections by 1.6%, according to data compiled by Bloomberg. S&P 500 profits declined from the year-earlier period in each of the past four quarters. For the fourth-quarter, analysts estimate a 19.2% increase. For fiscal 2009, they project growth of 15.2%. These targets will rally markets if they hold.

We remain of the opinion that we are at or near the bottom in this stock market collapse. But the potential for further hedge-fund and bank deleveraging (forced large-scale selling) will make markets edgy for weeks to come. Our portfolios are over weighted in 'defensive' companies such as healthcare and consumer staples (food, beverages, and toothpaste). Additionally we have added a hedge position representing 10% of our equity allocations to help preserve portfolio values in the event of further unforeseen drops.

The odds favor sideways movements in the markets for the next two or three months, until earnings are behind us and the effectiveness of the credit market remedies are evaluated. At some point during that period, the market will likely begin anticipating some degree of recovery and it will rise. But until then, stay buckled up as volatility will remain high, perhaps moving as much as 5-10% above or below current levels.