

BEACON INVESTMENT MANAGEMENT

THE FRIDAY BRIEF

Distributed to our clients and friends weekly

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Illuminaiton

With each passing day more of the dark corners of uncertainty are illuminated. A few goblins lay in wait to surprise us in the coming weeks (like pension funds and corporate real estate), but most have reared their ugly heads by now. The world's financial system is slowly and systematically being purged of its ills, though recovery will be a long and painful process.

The world's central banks continue to cut rates and open up every liquidity pipe they can find to get banks lending again, but so far they refuse to take risks that just a couple of months ago were commonplace. Several are tying corporate loan rates to credit-default swaps (insurance against loan loss), which increase borrowing costs and expose companies and the entire credit system to the same unregulated derivatives accused of crippling the financial system. Presumably we will hear from the Fed and Treasury about reforms aimed at reigning in or regulating the market for credit swaps.

Credit-default swaps are derivative contracts designed to protect bondholders against default. They pay the buyer face value in exchange for the underlying securities or the cash equivalent should a company fail to adhere to its debt agreements. An increase in their price indicates deterioration in the perception of credit quality while a decline suggests the improvement.

Corporate earnings for the third quarter looked surprisingly good, as two thirds or 335 companies of the S&P 500 index have reported their third quarter results. For the group earnings are down 13.4%, but remove the 64 financial companies and the average earnings are actually 14% higher than the same period last year. Of the earnings reported so far, roughly 61% are better than analysts' estimates and 29% are worse. The remaining companies reported as analysts expected.

Virtually all global markets are down by record or near-record amounts in this credit debacle. Five days ago On Monday, the S&P 500 had declined by 45.8% from its 1,565 high on 10/9/2007. The NASDAQ fell 47.8% from its 10/31/2007 high of 2,861 to a low of 1,493 Friday last week. Commodities headed for their worst month since at least 1956 on fears the global recession will severely crimp demand. The Reuters/Jefferies CRB Index of 19 raw materials is down 23% this month, the steepest decline in at least a half-century. Crude oil has dropped 36% this month, surpassing a record 30% plunge in February 1986. Copper is in its biggest retreat in two decades and gold its worst performance in 25 years largely on a huge surge in the dollar, all according to Bloomberg.

Gross domestic product contracted in the third quarter at the fastest annual pace since 2001, according to the U.S. Commerce Department yesterday. The US likely entered a recession some months ago, though it has not yet been officially called. Several countries in Europe are officially in recession. Japan is probably in recession now as indicated by slowing inflation and deteriorating employment prospects.

Central banks continue to pull out all the stops. Money-market rates are declining albeit, surprisingly slowly in comparison to the plummets of equities and commodities. The London interbank offered rate, or Libor, dropped more than 16 basis points to 3.03%, its 15th straight decline, according to the British Bankers' Association. But so far, banks are not taking the bait.

Prices for credit-default swaps (corporate loan insurance) are reaching record highs on the Markit iTraxx Crossover Index of 50 companies with mostly high-risk, high-yield credit ratings.

While short-term credit remains exceedingly expensive, if available at all, long-term credit is also dangerously high. Investors are demanding the highest yields relative to government debt in a decade to buy corporate bonds. The Fed's rate cut on Wednesday is having some positive impact on corporate bonds and should slowly bring rates more in line with historical level. Unfortunately the abruptness and duration are already showing up in the numbers.

The Institute for Supply Management in Chicago said today its business index decreased to 37.8 this month, the lowest level since the 2001 recession. The drop from 56.7 in September represents the biggest since the index started in 1968. Anything below 50 represents contraction. Businesses react quickly to slowing business cycles by shelving investment plans and cutting production. But economists were well behind the curve as they expected the reading to come in at 48, a full 10 points off. From there, the cycle perpetuates itself.

How do we find the foundation of our economy - the intrepid, indefatigable, and resolute consumer? Well, not surprisingly, scared, tired, listless, and downright stunned. While consumer confidence numbers failed to predict consumer behavior for every major shock this decade, this time they will likely get it right. Spending in September by US consumers dropped .3% for the month; more than forecast for the weakest quarter in three decades. High food and fuel prices, falling property values, tight credit, and outright fear dazed the consumer last quarter. The results for October will likely be worse than any so far. What's more the seizure in credit will have a considerable impact on the duration of the slide.

However, improving oil, gasoline, and fuel prices will help to alleviate some pressure on the household budget. While not enough to motivate spending, it will likely dampen to some degree the rate personal bankruptcies. The decline in home prices may be slowing as well. Record-breaking declines do not go on indefinitely and we have already seen bumps in both new and existing home sales, suggesting some buyers are stepping up. The Fed's rate reductions also improve the likelihood that mortgage rates will soon decline.

Next week's election carries more economic weight than any in recent memory. Solutions for the economy, Social Security, healthcare, and energy, as well as geopolitical threats are in stark contrast between the two candidates. With Mr. Obama, government is the answer. If elected, he will lead perhaps the most powerful, passionate, motivated, and unimpeded democratically controlled Washington in the history of this country. What's more, recent capitalistic and free market abuses will have played directly into their hands to justify the largest government and union power grab since the Great Depression. A unified Washington (either party) is NEVER good for the market.

On the other hand, if Mr. McCain wins, he will likely have little support from the largely democratically controlled Senate and House for his legislative initiatives. Under Mr. McCain we likely face at least two years of gridlock at a time when significant problems need to be addressed quickly.

On Tuesday, another dark corner will be illuminated. What lurks in the shadows?