

BEACON INVESTMENT MANAGEMENT

THE FRIDAY BRIEF

Distributed to our clients and friends weekly

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Rocky Road

Those of us over 40 don't need reading glasses to know how bad the news is; headlines are full of it. And there is plenty to come in the weeks and months ahead. The economy is collapsing at an astonishing rate as we enter the self-perpetuating recessionary cycle. Banks aren't lending because they are afraid of the coming recession and the recession is growing deeper because banks aren't lending. Businesses are firing because demand is evaporating and demand is evaporating because businesses are firing. House prices are falling because no one is buying, and no one is buying because prices are falling. The worse the news gets, the more the consumer hunkers down.

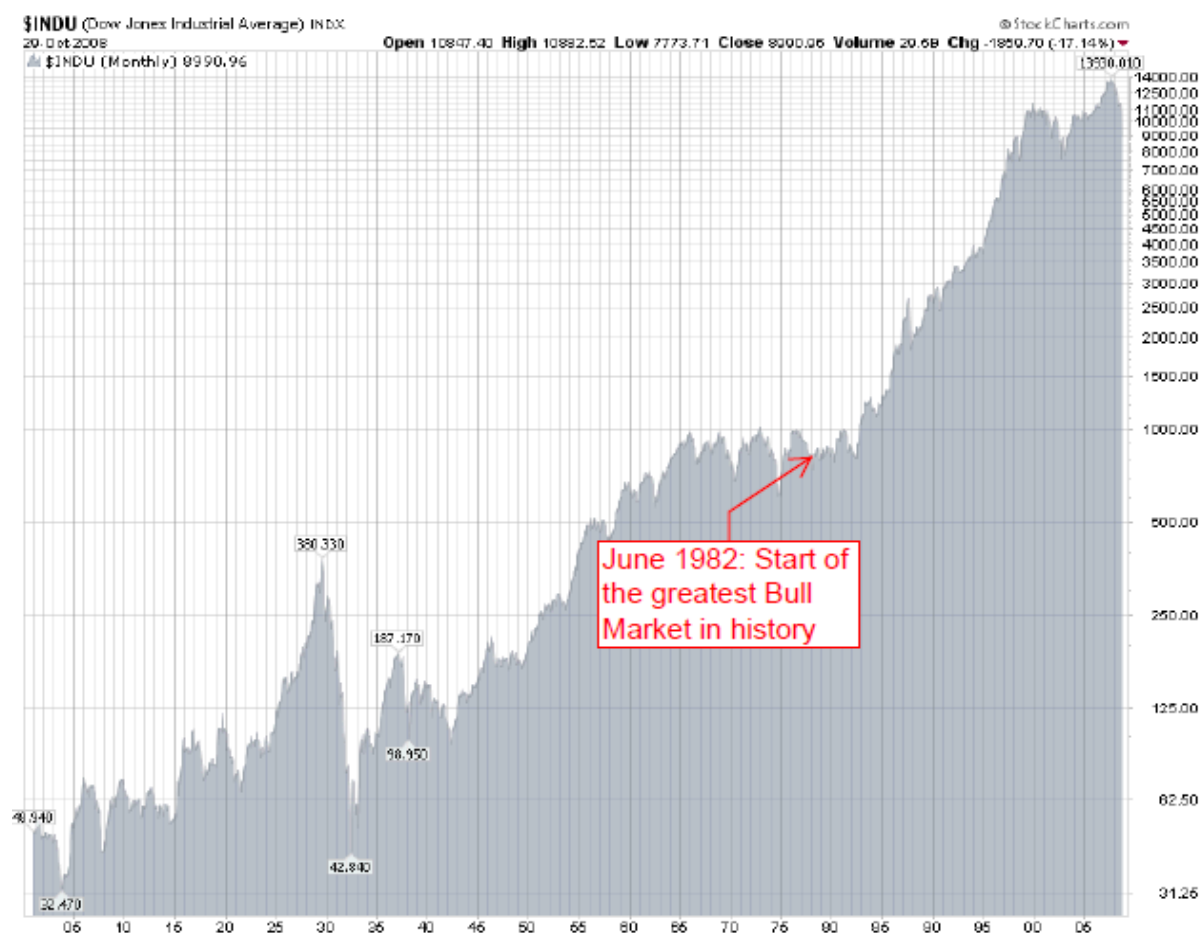
Libor fell to a four-year low of 2.29% after central banks around the world cut benchmark borrowing costs and kept the financial system flooded with cash to restore lending. In spite of unprecedented global efforts to restore confidence, bankers remain in their foxholes. They have virtually strangled businesses requiring a steady flow of credit to fund their short-term operations. Ford and General Motors are nearing the end of their capital. Mega-mergers of two years ago have all but ceased. Banks aren't even supplying the capital to do mid-market mergers; those in the \$50 million to \$1 billion range.

The unemployment rate in the US increased from 6.1% to 6.5% in October, the highest level since 1994. Employers fired 240,000 workers in the past month in addition to the 284,000 in September. Productivity or worker efficiency took a nosedive from 3.5% in the second quarter to 1.1% in the third. Labor costs climbed at a 3.6% pace, more than anticipated while business demand dropped like a rock. Businesses are having a tough time cutting expenses to offset the rapid declines in their revenues.

Goldman Sachs Group predicts the economy will shrink by 3.5% in the fourth quarter and by 2% in the first quarter of next year. According to Bloomberg, the forecast represents the largest back-to-back quarterly contraction since the start of the second year of Ronald Reagan's presidency. Back then, Paul Volker, then Fed chairman, (and current advisor to President Elect Obama) drove the overnight interbank rate to as high as 20% to strangle inflation. The economy contracted 4.9% in Q4 1981 and 6.4% in Q1 1982. Mr. Volker's iron fist of rate increases strangled the economy much like the banks are doing today. But he beat inflation and recent data show it is going away today.

The steep, Fed-driven recession of 1981-82 began to bottom in the third quarter of 1982. But by early 1983 it began firing on all cylinders to start a near decade-long run of phenomenal economic growth. But what does this have to do with today? Please take a look at the chart on the next page of the Dow Jones Industrial Index. Remember the economy in our example didn't improve until the end of 1982, yet the stock market began a strong rebound in the middle of 1982, almost six months before the economic news improved.

Even more remarkable, that turn in the market represented the beginning of the greatest bull market in US history. The result of Mr. Volker's painful remedy was a stronger more vital economy that was ready to run as fast as it possibly could – and run it did. There were several quarters in 1983 and 1984 that reached nearly double-digit GDP growth, rivaling the emerging market rates of growth we witnessed just a few months ago.



The Dow was at 776 back in June 1982 and peaked at 13,930 in October of last year. That mountainous climb represents a 1,693% gain in 25 years. If you question the apparent dip in 1994, it is due to the use of a logarithmic scale which flattens the actual results so the graph can fit on a single page. The Dow was actually 40% higher in June of 1994 than it was in June of 1982.

The point of all this is to demonstrate both the micro and the macro effects of recessions. In the micro, the short-term (where we live) there is pain – economic and investment. Markets decline in fear of economic contraction. We have likely experienced the largest portion of decline in the stock market so much of that pain is behind us. Yet we will likely continue to experience declines in the economy for one or more quarters. Economists expect the economy to bottom in the second quarter next year. If that view holds, the market will, by historical indications, begin to anticipate the recovery in the first quarter next year with significant rallies.

The macro lesson shines in the very mountain in front of us. In the here and now, we must deal with the rough trail and deep crevices along the way, but the peak is inspiring indeed. Stock market investing has always had its pitfalls, and it is not for everyone. But for those who can withstand the elements, stay on the trail, and avoid the temptation to settle in the valleys, they will indeed reach the peak.