

# BEACON INVESTMENT MANAGEMENT

## THE FRIDAY BRIEF

*Distributed to our clients and friends weekly*

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### The 'Grate' Grind

As of this writing, we find the S&P 500 down 8.6% for the week and the month of December, so far. Yet it remains 10% above its intra-day low reached Friday two weeks ago. The economic news has been as bad as expected and government counter-moves have been about as good as could be expected, with lame-duck limbo in full swing. Both Democrats and Republicans are warning Paulson that he may not get the additional \$350 billion TARP funds.

This economy is in a tailspin and the only way to pull it out will be to stop the losses in housing and employment. Until problems are fixed in housing, "we're going to have at best slow growth," said Robert Eisenbeis, a former Atlanta Fed research director. Bernanke is "trying to truncate what he fears will be a downward spiral" he continued.

Bloomberg reports that yesterday, Fed Chair Ben Bernanke urged using more taxpayer funds for new efforts to prevent home foreclosures, saying the private sector is incapable of coping with the crisis alone. He outlined options, including buying delinquent mortgages and providing bigger incentives for refinancing loans. He called for addressing the "apparent market failure" where lenders aren't modifying mortgages even in cases where it's in their own economic interest to do so.

"More needs to be done," Bernanke said in a speech to a Fed research conference on housing and mortgage markets in Washington yesterday. "Policy initiatives to reduce the number of preventable foreclosures should be high on the agenda." The government could buy "delinquent or at-risk mortgages in bulk," then refinance them through the federal Hope for Homeowners program, Bernanke said. Congress could also help reduce loan rates and lender insurance premiums, he said.

Foreclosures may begin on 2.25 million homes this year, more than double the pace before the financial crisis, according to Bernanke. Estimates show that as many as 20% of borrowers may now be "under water," where their mortgages are higher than the prices of their homes.

No wonder response to the Hope for Homeowners program, run by the Federal Housing Administration, is being shunned by banks since it started in October. Under the program, banks are required to write-off large portions of the loan and pay high fees. Bernanke's proposed changes would go beyond those of the current program. The agency will lower the amount of the loan a lender must forgive, allow banks to extend mortgage terms to 40 years from 30 years and give subordinate holders immediate payment for releasing their liens. Congress could make the program even more attractive by reducing the up-front insurance premium paid by the lender, which is now 3% of principal, and the borrower's 1.5% annual premium, Bernanke said.

The news is just as bad on the jobs front. Today the Labor Department reported that unemployment has reached 6.7%. The trend of jobs lost is accelerating and now exceeds 100,000 per month. November jobs lost totaled 533,000 (the highest level since 1993), 403,000 in October, and 320,000 in September. November's drop exceeded all 73 forecasts in a Bloomberg News survey.

Unemployment and foreclosure numbers as well as Fed officials' warnings of the past few days suggest that we are headed for the longest and the deepest recession since WWII. The two longest recessions of 11/73-3/75 and 7/81-11/82 were 16 months each. The average recession (11 of them not counting this one) since WWII lasted ten months. We are already in this one 12 months.

The deepest recession since WWII occurred during the years 1974 and 1975 when the economy contracted three quarters in a row; 3Q74 (3.8%), 4Q74 (1.6%), and 1Q75(4.7%), according to Us Dept. of Commerce. Economists polled by Reuters think the current downturn probably won't be as deep as even the recession in 1990/91, bottoming at a minus 1.3% in the current fourth quarter. But they say it will probably be 2010 before growth gets back to normal trends.

The median forecast calls for three consecutive quarters of contraction and the most pessimistic views show the possibility of no growth for 18 months, something that has never happened in U.S. economic data going back to 1947. But there is plenty of fuel to keep these worst fears burning. Today's unemployment rate is already higher than it was in July of 1990 when that recession began. Unemployment could approach double digits next year. Unemployment reached 9.7% during the 1982 recession.

AS the news continues to frighten and to set new records, it is reassuring to see that the markets remain relatively stable. At present it appears that the market has sufficiently discounted today's surprisingly bad numbers. The recession, officially announced earlier this week by the NBEA also delivered a resounding blow to the market, but failed to knock it out. Arguably, much of the adjustment to a steep recession outlook has occurred.

The S&P 500 is down 44% in 2008 and is headed for its worst year since 1931. Perhaps the buoy holding the market for now is the speculation that the Federal Reserve will cut interest rates at their next meeting and Congress will soon (after inauguration) pass another economic stimulus.

Your November statements will bring further bad news with declines ranging from .5% to 10%, depending upon your allocation to stocks. Clearly it has been a long ugly way down and the market may have some more to go before the economy finds a bottom. But remember what you bought into. You invested into the stock market because you knew that history shows that it offers a better long-term return than other asset choices. You are familiar with charts that reflect its long and steady upward path over the years. You also knew and accepted long ago that up close, the upward sloping mountain was marked with jagged peaks and crags, sometimes big ones. Yet you saw that long steadily upwardly sloping mountain and you wanted in.

Investing is all about balancing risk against an expected return on our money. Today's perception of risks is magnified and amplified to extreme levels for reasons which need no explanation. But we must be careful to properly assign risks in our investment discipline. With the 20/20 hindsight of the 'retrospectometer' we know that the stock market carried huge risks in October of 2007. But now that it is down 44% or the worst since 1931, how much more downside risk could there be? Another 5%? 10%? 15%? We have seen the market jump this much in a day or two. We know that every government in the world economy is doing all it can to promote growth, from lowering interest rates, to removing restrictive business measures, to tax cuts, to pumping trillions of new cash into the system. No time in world history has witnesses this degree of cooperation focused on a common goal – economic growth.

If you are invested in the stock market, the larger risk is not staying in the market, but getting out of it. Remember the revealing study that showed that behavioral mistakes significantly diminish investors' returns. It showed that from 1984 through 2002 individuals earned only 2.6% compared to the S&P's 12.9%. Undisciplined investors bought in late, near the peaks and they cashed out when things got scary, near the bottoms. History suggests that the market will eventually return to its 8-10% long-term annual trend line. Simple math tells us that huge gains will be required to return the averages to their 8-10% long-term trend line. Behavioral investor studies tell us that the best way to ensure getting those returns is to remain invested in the market, not to time it.

HOLD FAST