

BEACON INVESTMENT MANAGEMENT

THE FRIDAY BRIEF

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Is the Market Telling Us Something?

The drumbeat of worsening economic news on jobs, corporate profits, bank downgrades, auto makers, and housing continued this week, yet the market is higher by 1.6%. It was a week of new records as inflation fell 1.7% in November, faster than at any time since records began in 1947. Construction of single-family homes dropped 16.9 percent to a record-low 441,000. Oil by the barrel has fallen 75% from its record high of \$147.27 reached only five months ago on July 11th. But the most remarkable records were made in US Treasuries. Yesterday, the yields on two, five, 10, and 30-year US government debt reached the lowest levels since the Treasury began regular sales of the securities. The Fed dropped the target on their main rate from to near zero on Wednesday. We saw the yield on three-month Treasury bill actually drop to a negative return.

So why would anyone knowingly buy a bond that would cost them interest rather than paying them interest? In simple terms, the answer is fear, or uncertainty which in investing parlance means the same thing. Billions, even trillions of dollars are, in essence, being buried under the mattress, in this case under the safe cushion of the US government. Banks, money markets, brokerage houses are not deemed safe enough to hold the big money. The money that came out of the stock market, the billions of government aid, and banks' cash, it's mostly going into Treasuries as they are deemed the safest place for the time being.

Interestingly, gold a traditional safe haven for fearful investors has fallen right along with other commodities. The manufacturing uses of the metal (jewelry and technology) seem to be driving its fundamentals more than its store of value. Just a few months ago, oil was a favorite hedge against a falling dollar, yet as the dollar slides on lower interest rates, oil continues to fall despite announced cuts in production by OPEC.

A concern of policy makers and economists is that conditions are ripe for a deflationary spiral; a persistent decrease in the general price level of goods and services, or a negative inflation rate. When the prices of goods consistently fall, consumers have an incentive to delay purchases and consumption until prices fall further, reducing overall economic activity - contributing to a deflationary spiral. A notable example occurred in the car industry when manufacturers offered a steady stream of lower prices and zero percent financing to encourage sales of their products after 9/11 in 2001. What they found was that after the initial surge, sales slowed dramatically as consumers ceased buying in anticipation of yet lower prices.

But remember, stocks are rising, they are not falling as one would expect in the face of a deflationary period. So far, investors are hopeful that measures taken by the Federal Reserve, the US Treasury, the President with the auto bailout announced today and by Obama's planned massive public works package that all this money being pumped into the system will at some point gain traction in reversing the downward spiral in the economy.

The largest problem today is that banks are not lending. All of the money being thrown their way by government agencies is going into their vaults or into US Treasuries. But as rates approach zero banks will run out of options to make money. They can buy longer term bonds to pocket the spread, but that spread is falling. The difference between the ten-year bond and their cost of funds is about 2%. Demand for longer term bonds will only drive their yields down further, diminishing the

viability of this option. Eventually they will have to begin lending money to generate revenues to keep their doors open.

A primary tool for reversing the slide in housing prices is getting mortgage rates so low that payments will be affordable for most homeowners. While rates are low by historical standards, they must be significantly lower in the current environment to make a difference. House prices and incomes have fallen sufficiently to make it difficult for potential homebuyers or struggling homeowners to buy or to meet their current mortgages respectively.

While the average rate on a fixed 30-year mortgage fell to 5.18% last week from 6.47 percent in October, according to Mortgage Bankers Association data, the historical relationship between home loans and mortgage bonds shows rates should be at least half a percentage point lower. Though the U.S. is paying nothing to borrow in some cases, homebuyers are paying about \$730 more a year than they would otherwise on a \$200,000 mortgage according to Bloomberg.

The difference between the average rate on a typical fixed-rate loan and Fannie-guaranteed securities widened to more than one percentage point last month for the first time in at least a decade, and to more than 1.4% yesterday according to Bankrate.com and Bloomberg data. The average over the past five years is 0.14 percentage point.

Now think for a moment, has the desire for profit evaporated completely from the US economy? Has fear become so ingrained that investors have given up? That's not what the stock market is telling us. Remember, just a moment ago we were discussing the narrowing spread (difference between the bond income and what they have to pay on the money to buy them) on long-term Treasury bonds was declining. Yet, in the mortgage market, spreads are widening to historic levels. The Treasury market is about \$5.7 trillion and is nearing saturation where prices are so high and yields so low, that they no longer offer economic benefit. Money always goes where it's treated best. We believe that cash will soon begin flowing from banks into the \$6.7 trillion US home-mortgage bond market where spreads are considerably higher and repayment is guaranteed by the US government. As that happens, mortgage creation will rise and rates will fall further.

In June 2003, mortgage rates fell to 4.99%, the lowest since at least the John F. Kennedy Administration according to Mortgage Bankers Association. Freddie Mac's weekly survey released today showed rates falling to 5.19%, the lowest in its 37- year history and down from 6.46% on Oct. 30. Indications are that they will go lower.

Lower rates will help those who have good credit as well as job prospects, but for far too many, home loans will not be made at all until the job picture improves. Economists project unemployment to peak at 8-9% next year. Obama's infrastructure package will help some, but tax cuts will facilitate a more broadly based recovery as most jobs in this country are created by small business, not large.

Market action tends to suggest that improvement in the US economy will begin in the mid to third quarter of next year. Economists largely agree. If these forward indicators are correct and if you are one of those who stuffed some money under a mattress, our best recommendation to you is to grab it and rejoin the free enterprise system, a.k.a. the stock market. Just as nature abhors a vacuum, investors seek extreme values. The stock market is extremely cheap and will not remain so indefinitely. Bull markets always follow bear markets. They run longer and go higher. Don't be left out.

We at Beacon wish you and yours a very Merry Christmas!