

BEACON INVESTMENT MANAGEMENT

THE FRIDAY BRIEF

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Toll Free 888-621-5885

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Let's Not Get Ahead of Ourselves

New revelations about the weakness of America's banks have kept the pressure on stocks. The S&P 500 is down 5.2% at the moment but remains 14% above the market's low reached November 20, 2008. A major reason stocks are holding up in the face of relentless economic news is their yield. Dividends paid on S&P 500 stocks are roughly 3.5%, which compare very favorably to the 10-year Treasury yield of 2.4%. Stocks are also up on investors' high hopes for Obama's economic team and their ultimate stimulus package.

Ten-year Treasuries fell the most in almost two months this morning as stocks gained on confidence that government efforts to support banks will be successful. The \$138 billion bailout of Bank of America is just the latest evidence that the principal of 'too big to fail' will support the financial system until such support is no longer needed. The safe haven appeal of US Treasuries is declining somewhat as a result.

Meanwhile the banks are not making the government's job any easier. Citigroup posted an \$8.29 billion loss; twice as much as analysts estimated, and said it will split into two, selling control of its Smith Barney brokerage, CitiFinancial, and Primerica Financial Services. Bank of America, the largest US bank by assets, posted its first loss since 1991 and cut the dividend to a penny after receiving its emergency government funds to support the acquisition of Merrill Lynch & Co.

Bloomberg reports that there are new and more serious concerns about the viability of banks which are pushing regulators toward a new plan to remove toxic assets from bank balance sheets, in what may become the biggest effort yet to unfreeze lending. Harvard University Professor Kenneth Rogoff, Paul Volker, Timothy Geithner, Lawrence Summers, and others on the Council of Thirty along with Federal Reserve officials are focusing on the option of setting up a so-called bad bank that would acquire hundreds of billions of dollars of troubled securities now held by lenders. That may allow banks to reduce write-offs, free up capital and begin to increase lending. Paul Miller, a bank analyst at Friedman Billings Ramsey & Co. in Arlington, Virginia, estimates that financial institutions need as much as \$1.2 trillion in new aid.

While there is a huge tide of emotional support for the new President, his staff, and his advisors, one has to wonder if expectations are unreasonable. The money requests are going to have to come through a US Congress that has shown more than once a reluctance to act quickly or as expected in the face of overwhelming demands from the public and the Administration.

The Senate yesterday voted down a resolution that would have prevented the release of the second half of the \$700 billion Troubled Asset Relief Program (TARP). But at 52 to 42, it wasn't a resounding victory indicating future Congressional resistance to bailout and stimulus legislation.

The budget deficit has grown huge already. It may become difficult, without inflationary rates, for the US to finance the debt. Congressional Budget Office projects the deficit will grow to \$1.2 trillion this year even without new spending. Investors might conclude as many economists already have, that Obama's plans for an additional \$775 billion two-year stimulus program aren't enough to resuscitate the economy.

High expectations and presidential honeymoon aside, special interests and political agendas must be considered as remedies are shaped. As the crisis-mode recedes, so might the willingness among dug-in interest groups to compromise and to see the bigger picture. The new Administration will have to balance the demands of unions against the near critical need for corporate profitability and competitiveness. Tax cuts will almost certainly be required to stimulate private-sector job creation, yet getting them through an idealistic Democrat-controlled Congress may prove difficult at best. One has to wonder as well what impact a new round of regulations will have on the profitability and competitiveness of American banks.

We continue to believe that the economy will bottom and begin recovery later this year. But we fear that the stock market could be a bit ahead of itself. While dividend yields and long-term values are compelling, investors expecting better economic news, beyond stimulus measures, in the next few months will likely be disappointed. Equities markets will likely grind along for at least the first quarter of this year and perhaps longer.

While the monotonous grinding goes on, however, dividends and interest will continue and opportunities will appear here along the way. This bear market is not likely to end in the shape of a "V" but rather a flat and long-bottomed "U." It will recover and this bear market will end, but not as quickly as our instant culture demands. As we make the many adjustments required of a long and deep recession, we must add considerably larger doses of faith and patience. The considerable excesses and abuses that lead to this mess will take much longer than usual to wring out. Our nation has much to learn, and I believe we will.

On that note, persevere in faith and have a good weekend.