

# BEACON INVESTMENT MANAGEMENT

## THE FRIDAY BRIEF

*Distributed to our clients and friends weekly*

<http://www.beaconinvest.com>

Toll Free 888-621-5885

Friday, January 23, 2009

### Back to Reality

Good news on the economic front is rarer these days than moments of grace from our new Vice President. The lofty and idealistic words of President Obama, so well spoken seem a distant whisper among the barrage of history-making declines in housing, employment, prices, and confidence. Republicans and Democrats are already at loggerheads over the stimulus package. Corporate earnings are more dismal than expected and equities markets have given up almost two-thirds of their gains from lows reached in November.

Earnings drive stock values, and nobody really knows what earnings will be. As demand dries up for goods and services, corporate earnings fall, and so do their stocks. We know that the fourth quarter of last year was horrible for earnings as consumers and corporate customers alike froze in their tracks while major banks teetered and lending came to a halt. Stock investors expected the quarter to be a terrible earnings period and they factored that into stock prices. The S&P 500 declined almost 36% in October and November.

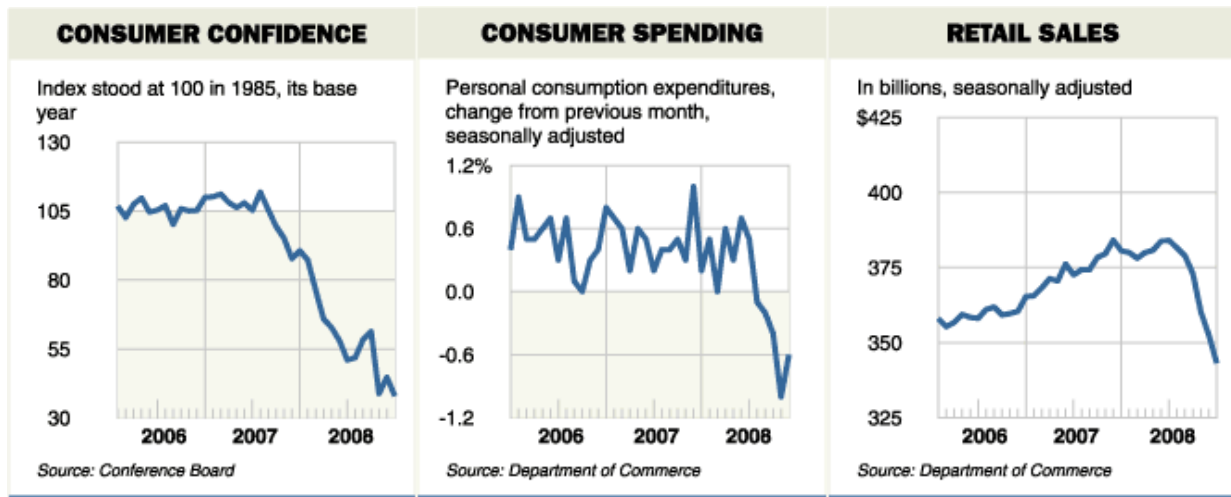
Hopes for a 'silver bullet' of a stimulus package boosted the averages in late November and December by 24%, but as the reality of intractable special interests dominate the news and corporations share their dismal fourth quarter results, the gains are steadily eroding.

Profits have dropped by 60% for the 69 S&P 500 companies that have released fourth-quarter results so far. Analysts now estimate a 28% drop in profits for the entire index, which would mark the fifth straight quarter earnings slumped. In March 2008, analysts projected that income would rise as much as 55%, according to Bloomberg data. The market is now in a phase of 'washing out' excessively optimistic analyst projections.

Additionally, as companies report losses, they are reducing their dividends at rates not seen since WWII. According to Bloomberg, companies in the S&P 500 cut \$40.6 billion in payouts last year after a five-quarter profit slump lowered cash reserves. The reduction in dividend yields puts further downward pressure on stock prices.

But stocks still have not fallen off a ledge as recent earnings reports, taken in a vacuum, might suggest. State Street's global investor confidence index, reported on Monday, jumped 12.1 points in January to 60.3, led by gains among North American investors. While a good sign, it is just one dot on the chart. State Street said that it remains to be seen whether the reallocation to riskier assets represents a change in long-term conviction.

For two decades our economy, and indeed the world economy were propelled by the indefatigable American consumer. What the tech bubble, 9/11, two major wars, and corporate scandals could not do to dampen his enthusiasm, the unprecedented events of 2008 finally did. Take a look at the charts below to better understand just how dramatic the drops in confidence, spending and sales have been.



With the continued decline in home prices (the consumer's major asset) and the difficulty or impossibility of getting credit, it is difficult to imagine that US consumers will soon again be the global economic force they once were. Our recovery and indeed the world's recovery will likely have to look to other drivers to propel their recoveries. Countries will have to be much more effective in increasing their own domestic demand, rather than to simply rely on SU demand.

A case in point is the world's third largest economy – China. The country announced yesterday that its economy expanded at 6.8%, the slowest pace in seven years, as the global recession dragged down exports. The dramatic fall follows a 9% gain for the previous three months. China's government will face increasing pressures to stimulate growth internally. There will be further pressure on US stocks if China is unable to turn their economy soon.

Here at home, President Barack Obama is pressing congressional leaders to reach a consensus on an \$825 billion stimulus plan, warning the country may be facing an "unprecedented" economic crisis. He says that while there are "some differences" between his administration and lawmakers on the details, the legislation is "on target" for passage by mid-February. This may be optimistic given what legislators call significant differences.

Republicans are seeking deeper tax cuts and expressing doubts that \$550 billion in new federal spending for such items as roads and bridges can be pumped into the economy quickly enough to do any good. Some Democrats also are pressing to speed up infrastructure spending.

While all legislators express their understanding of the need to pass legislation quickly, deep differences still exist. It is not at all unlikely that opposition could be much stronger this time than it was for TARP given the mounting Federal deficit. We are with them 100% if the stimulus package does not contain the potency necessary to get this economy going. Why saddle the next generation with debt that cannot be repaid by a flagging economy?

In essence, the stimulus package must get banks lending, create jobs – private sector jobs, and reverse home prices. Political gimmicks at the individual level like tax bonuses, mortgage assistance, or aged-based tax breaks will not get the job done.

What will get it done is incentives aimed at the most innovative and productive elements of our economy to get them taking risks again. Examples include tax incentives to small businesses (where two-thirds of new jobs are created), infrastructure re-builds targeted at modernizing our aging power and communications grids, practical and cooperative research investments in alternative energy implementation, and strategic energy independence. We must also eliminate the bad assets on banks' balance sheets which are at the root of their current weakness. The package must assist the Fed in stimulating mortgage lending to new and used home buyers to arrest the free-fall in home prices. These are a few of the things on our wish list. Have a nice weekend.