

BEACON INVESTMENT MANAGEMENT

THE FRIDAY BRIEF

Distributed to our clients and friends weekly

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As Goes January?

There's an old market axiom that says as goes January, so goes the market. As this one draws to a close we find the S&P 500 down 7.5% as the economy's descent continues. According to Commerce this morning, the economy contracted at a 3.8% annualized rate in the fourth quarter. If the inventory buildup which occurred in the fourth quarter is excluded, the economy actually contracted 5.1%, the worst in 28 years. As reported, it is the worst since 1982. The economy shrank at a 0.5% annual rate from July through September. The back-to-back contraction is the first since 1991. For all of 2008, the economy expanded 1.3% helped by exports and government tax rebates in the first half of the year. The GDP report is the first for the quarter and will be revised in February and March as more information becomes available.

In response to the dramatic contraction of the economy, companies are cutting jobs at an increasing rate. Employers cut 524,000 workers in December, bringing total job cuts for last year to almost 2.6 million. Many more are on the way as companies have announced thousands this month. Continuing claims for jobless benefits rose to 4.776 million in the week ended Jan. 17, the highest since record-keeping started in 1967, according to the Labor Department.

Businesses are not only cutting jobs. Investment in plants, equipment, and technology dropped at a 19% pace in the fourth quarter, the most since 1975. Purchases of equipment and software dropped at a 28% pace, the most in a half century. Business investment's decline subtracted 2.3 percentage points from GDP, representing the largest drop since 1980.

Orders for durable goods fell in December for a fifth consecutive month, signaling the slump in business spending will deepen and prolong the now 13-month recession. The 2.6% drop, followed a 3.7% decrease the prior month. Today, the Institute for Supply Management said its business barometer decreased to 33.3, from 35.1 the prior month. Readings below 50 signal a contraction. The January decline represents the fourth consecutive month of declines suggesting the downturn in manufacturing may worsen this year.

The slump in home construction accelerated, contracting at a 24% pace last quarter after a 16% drop in the previous three months. Small wonder why: Home prices fell in 24 of 25 US metropolitan areas in November from a year earlier as the recession spurred record foreclosures. The number of "motivated sales," (houses sold at significant discounts) such as foreclosure auctions, helped increase November transactions in 13 metropolitan areas of the 25 Radar Logic tracks. Four metropolitan areas had their largest monthly price declines since the beginning of Radar Logic's records, which date to 2000. They were: Charlotte, Denver, San Jose, and Tampa.

An earlier report on January 15th showed that purchases of existing homes rose 6.5% to an annual rate of 4.74 million in December from 4.45 million in November, according to RealtyTrac Inc. The median price dropped 15 percent from the previous year to \$175,400, the biggest decline since records began in 1968. Foreclosure filings jumped 41% in December from a year earlier to 303,410.

Consumer spending, which accounts for more than two-thirds of the US economy, dropped at a 3.5% annual rate last quarter following a 3.8% drop the previous three months. It's the first time purchases declined by more than 3% in consecutive quarters since records began in 1947. Holiday sales for 2008 were the worst in 40 years

However, cheap gasoline and high hopes for Mr. Obama's stimulus plans boosted consumers' confidence this month. The Reuters/University of Michigan final index of consumer sentiment rose to 61.2, the second consecutive monthly gain, from 60.1 in December.

So, where do we stand on the vaulted stimulus package? Zero for one so far. The House of Representatives under the shameful leadership of Nancy Pelosi managed a strikeout on its first at bat. As pointed out in today's Wall Street Journal Opinion page, Mr. Obama had better use his 70% approval ratings to get a *meaningful* stimulus package enacted rather than turning it over to political demagogues like Nancy Pelosi, Henry Waxman, and Pete Stark. Every Republican and 11 Democrats voted against the bill, not to insult the new President (dangerous too when he carries a 70% approval rating), but because it is a pork-fest, rife with billions of useless spending. Too, Republicans block voted against it because none of it is their own. They got only lip service from the Democratic leadership when they asked for input into its crafting. Mr. Obama needs the Republicans in the Senate more than for just bipartisan appearances as in the House, so it is expected that the next measure will be closer to something still expensive, but more useful.

As to fixing the banking system with a bank that will buy up all the bad loans, it looks like more patience and study are required. Yesterday, Vice President Joe Biden said the Obama administration will wait to see if the second \$350 billion installment of the federal rescue money "unclogs" credit markets before taking more actions. "Once we do that and see whether or not we can get this system kick-started, the credit system flowing more, that's when we'll make the judgment whether anything else is necessary." Not missing an opportunity to get his digs in, Biden said the second \$350 billion in the Troubled Asset Relief Program needs to be spent "more wisely" than the first half. Perhaps in the VP (with a better memory than our Chief Justice) has 'forgotten' that banks were falling into insolvency by the hour as the first \$350 billion was spent.

If Mr. Obama cannot reign in the arrogance of Joe Biden and Nancy Pelosi's House, bipartisanship may be dead on arrival, and along with it hopes of a stimulus package with any real meat in it. It must have significant tax cuts and credits aimed at creating jobs, incenting business investment, halting the slide in home prices and foreclosures, reducing mortgage rates and improving their availability, and in building confidence overall. As a commentator put it on CNBC this morning, it should be designed to improve the confidence of healthy businesses (and consumers) more than totally focused on the weak and ill-managed businesses (and consumers). Aim it at the productive elements of our economy and get results.

We still believe that economic recovery is possible by the end of this year, but it will likely be anemic and uneven. Large segments of the economy may lag significantly as a few show signs of life. Housing may be an early leader. It dragged us into this recession and may just bring us out. Housing is elemental to a number of the woes facing us now. Home values determine the quality of collateral at many of the nation's banks and thrifts and their values improve or deplete the confidence and financial well-being of their owners.

Federal tax cuts at the consumer level will not prompt spending if people are afraid of losing their homes and businesses are not be motivated to invest in new resources or jobs if consumers aren't spending. Government stimulus must address the core of the problems which face us. Boiled down to its essence the problem is home prices. Reverse them and bank collateral improves. Their confidence to lend improves, further perpetuating the improving cycle of housing. As consumers see their home values rising, their confidence improves and they begin to loosen up their purse strings. Businesses take note and prepare for growth – they invest and they hire, further perpetuating the improving cycle.

Eventually this economy will turn. Government has done much to help turn it so far. To improve those odds further, we hope that Mr. Obama can shepherd a far better stimulus through the Senate and House in rounds two and three. If so, our old axiom might well be proven very wrong this year.