

# BEACON INVESTMENT MANAGEMENT

## THE FRIDAY BRIEF

*Distributed to our clients and friends weekly*

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### Who's in Charge?

*"If you like laws and sausages, you should never watch either one being made."*  
German Chancellor Otto von Bismarck, 1870s

As the nation tumbles more deeply into recession, perhaps worse, Americans are wondering if "change" in Washington is really possible. In the House's version of the stimulus bill we saw enough pork to unify all of the House Republicans and 11 Democrats against it, a hugely popular President, and an American public eager for a shot of confidence. A week later we see in similar proportions of Republicans and Democrats entrenched resistance to a Senate's bill. There are signs that Mr. Obama, on the defensive, is growing increasingly frustrated as his rhetoric toughens.

In one short week the President has changed his tactic from courting Republicans to deriding their ideas for the stimulus. He said yesterday that Republican proposals are "rooted in the idea that tax cuts alone can solve all our problems, that government doesn't have a role to play, that half measures and tinkering are somehow enough, that we can afford to ignore our most fundamental economic challenges. Those ideas have been tested, and they have failed." He's right; tax cuts without commensurate spending cuts are as bad as unbridled spending.

In the give and take of the past two weeks, Republicans have managed to retake some high ground. Peggy Noonan captured the thought so well in today's Wall Street Journal.

"[Mr. Obama's] serious and consequential policy mistake is that he put his prestige behind not a new way of breaking through but an old way of staying put. This marked a dreadful misreading of the moment. And now he's digging in. His political mistake, which in retrospect we will see as huge, is that he remoralized the Republicans. He let them back in the game.

Mr. Obama has a talent for reviving his enemies. He did it with Hillary Clinton, who almost beat him after his early wins, and who was given the State Department. He has now done it with Republicans on the Hill. This is very nice of him, but not in his interests. Mr. Obama should have written the stimulus bill side by side with Republicans, picked them off, co-opted their views. Did he not understand their weakness? They had no real position from which to oppose high and wasteful spending, having backed eight years of it with nary a peep. They started the struggle over the stimulus bill at a real disadvantage. Then four things: Nancy Pelosi served up old-style pork, Mr. Obama swallowed it, Republicans shocked themselves by being serious, and then they startled themselves by being unified. But it was their seriousness that was most important: They didn't know they were! They hadn't been in years!"

Why are politics so important in an investment brief? The answer quite simply is CONFIDENCE. Confidence and capital are the bedrocks of our modern economy. We are awash in capital thanks to a bevy of government actions. But confidence is evaporating as Americans search for leadership. Employers are our most immediate leaders. But as we daily hear of thousands of layoffs at the big companies, as we hear of friends and neighbors

losing their jobs, and as state and national unemployment percentages approach double digits, our trust in our employers wanes.

We look to Washington for some sign that our elected leaders are going to do the right thing and get this economy going again. While we know that no fiscal stimulus bill will provide all the answers or cure our ills quickly we hope that in this moment of national crisis our leaders will put aside their partisan divisions to craft a bill that will revive confidence in employment, in housing, and in our banking system. Instead we find Congressional division as strong as it has been in recent memory and a hugely popular President playing defense.

In response Mr. Obama is now taking his popularity and this case directly to the American people in hopes of breaking the Republican united front which stands against the stimulus package in its current form as too expensive and ill-targeted for efficient and effective economic stimulus. Seeking to regain momentum on his economic policy, Mr. Obama today named an advisory board drawn from business, labor groups and former government officials to provide an outside perspective on plans to revive the economy. The Economic Recovery Advisory Board, headed by former Federal Reserve Chairman Paul Volcker will include former Securities and Exchange Commission Chairman William Donaldson, former Fed Vice Chairman Roger Ferguson, UBS Americas Chairman and Chief Executive Officer Robert Wolf, General Electric Co. CEO Jeffrey Immelt, and Service Employees International Union Secretary-Treasurer Anna Burger. The President said "the board will bring a diverse set of perspectives and voices from different parts of the country and different sectors of the economy to bear in the formulation and evaluation of economic policy."

The market is up today and yesterday on this news and on the bet that the awful unemployment numbers released today will motivate Congress to enact a stimulus bill sooner than later. Unemployment reached 7.6% in January, the highest level since 1992 as payrolls tumbled by 598,000, the biggest monthly decline since December 1974. Economists say that we may see 2 million to 3 million more job losses before this is over adding to the 3.57 million lost so far.

Republican Senator Charles Grassley of Iowa said Congress is on track to get an economic stimulus bill to President Barack Obama by next week. Grassley, the ranking member of the Senate Finance Committee, said figures released today by the Labor Department showing unemployment rose to 7.6% last month have put more pressure on lawmakers to pass a bill quickly. "A week from now we're going to be gone," Grassley said on Bloomberg "we ought to deliver a stimulus package" to Obama, Grassley said. "I just hope it's the right one." We do too Senator.

On Tuesday we got a bit of fresh air in housing. A report from the National Association of Realtors said that the number of Americans signing contracts to buy previously owned homes unexpectedly rose 6.3% in December, signaling that foreclosure-driven declines in prices are boosting demand. It was the first increase since August. Other reports showed a record number of houses for sale stood vacant last quarter and property values sank by more than \$3 trillion last year. The Obama administration, in seeking to stem record foreclosures, is considering offering government guarantees to mortgage lenders that modify loan terms. Still, restrictive lending rules and further price declines mean most buyers will keep away from the market, extending the real-estate recession.

More help for the banking industry will be announced on February 9<sup>th</sup> by US Treasury Secretary Timothy Geithner. He will probably emphasize guarantees of toxic assets over

proposals to create a 'bad' or aggregator bank that would remove the bad loans from balance sheets. The government guarantees, which might be modeled on those already given to Citigroup Inc. and Bank of America Corp., may be coupled with the purchase of preferred shares in the banks that would be later convertible into common stock. The 'bad bank' has lost favor because of the complexity of pricing the assets and because of the potential costs involved.

US banks have already racked up \$745 billion in credit losses and have warned of more to come. Shares of Bank of America, the country's largest bank, touched a 24-year low yesterday amid concern it would be nationalized. The stock recovered to end the day 3% higher at \$4.84. Nouriel Roubini, a professor at New York University, has predicted that US banking losses may ultimately reach \$3.6 trillion. Many feel the government's measures will fall short of getting credit flowing again, especially in light of the difficulty the Administration is having getting its \$800-900 billion stimulus plan passed.

Banks are also pressing for the plan to include a temporary easing of the 'mark-to-market' rules that require them to reduce the value of assets they hold as markets decline. They argue that at least some of the assets are not as impaired as prices might indicate, arguing that investors are being too pessimistic about their ultimate value.

The public's stake in the nation's banking system continues to grow as efforts from both Mr. Bush's and Mr. Obama's administrations continue to manage the crisis. TARP, which is part of the more than \$9 trillion the government has pledged to rescue the financial system, has guaranteed \$350 billion to banks so far, with another \$350 billion set for use in coming months. A report just out shows that US taxpayers have been shortchanged by about \$78 billion through the Treasury Department's bank bailout so far, according to the panel overseeing the program. The Treasury has received bank assets worth about \$176 billion in exchange for capital purchases of \$254 billion.

But remember, the crisis was in full swing in the early days of TARP. Accurate valuations were virtually impossible. The early capital injections of TARP were more about keeping the patient alive than excising the disease. That surgical duty falls to Mr. Geithner.

The stock market has made up about a third of its January losses. Last week, while the House argued the stimulus bill, the S&P 500 gave up 6%. It has gained 4.7 this week as the Senate wrestles with the bill and as the Obama Administration fleshes out their policy initiatives. On the fundamentals, earnings and dividends are still in freefall. Profits for the 306 companies of the S&P 500 that have reported so far have decreased 36% on average. This quarter is projected to be the sixth straight of decreasing profits, the longest streak on record. Dividends for companies in the S&P 500 index will fall 13.3% this year, the steepest annual decline since 1942, S&P forecast in a report today.

Despite the continuing bad news, stocks are holding their own. It appears that the bad news is factored into the market. Barring a major new crisis, failure of the Congress to pass a stimulus bill or the Administration to move aggressively on banking crisis, stocks may have seen their lows. New remedies are being shaped and only time will show how effective they will be.