

BEACON INVESTMENT MANAGEMENT

THE FRIDAY BRIEF

Distributed to our clients and friends weekly

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A Good Week

This afternoon we find the S&P 500 advancing for the fourth day, up nearly 12% for the week. News on Tuesday that Citigroup CEO Vikram Pandit's remarks in an internal memo saying the bank is having its best quarter since 2007 and comments from regulators in Washington suggesting they may reinstate rules that limit short selling sparked the rally. By Wednesday it looked like it would run out of steam when Thursday's Retail Sales report demonstrated there was still life in the consumer. The possibility that consumer, the largest part of the US economy combined with the picture Bernie Madoff swiftly and justly being escorted off to jail in handcuffs gave the market it's second powerful boost upward. This week's move dramatically demonstrates how fast markets can move on relatively little information.

The stock market was clearly oversold given a nearly 30% drop since the first of the year. Short-selling bears were clearly in control of the market's spiral as they blew through two very modest price rallies in late January and early February. But on Tuesday Mr. Pandit gave them the fright of their trading lives and they rushed to cover their positions. Many were thinking that further downside in stocks was limited given the swift and significant declines already.

According to data compiled by Bloomberg, at the end of February \$19 billion in 4,887 companies' stock was shorted; just under 4% of all stocks. The largest short positions by far were in automobile companies, followed by consumer durables, then the banks. While the data will not be available for another week or so, it is safe to say that the short position in bank stocks was reduced substantially over the past couple of days given their run-up. The S&P Financial Index is up over 33% for the week.

It is said that the stock market climbs a wall of worry. This rally has been a refreshing reminder that stocks can rise and quickly, even in adversity. But there are simply too many cracks in the foundation to expect sustainability. Comments from leading banks including Citigroup, Bank of America, and JP Morgan are very positive indeed, but significant questions remain about the quality of their assets as housing values continue to decline and mark-to-market accounting and credit rating agencies can surprise at any time with downgrades.

Economic recovery will not gain significant momentum until confidence returns to the banking industry and to consumers. The best gauge of bank confidence is the London interbank offered rate (Libor), the rate that banks say they charge each other for three-month loans. The rate rests at 1.33% today, near the highest level since Jan. 8 and up from this year's low of 1.08% on Jan. 14th. The rate suggests that banks are still hoarding cash as they do not trust each other.

Consumers don't have much on which to rest their confidence either. Today's Reuter's/University of Michigan's Consumer sentiment index for February came in at 56.3, compared to a 61.2 reading in January. The latest number was barely above the record low of 51.7. Falling home prices, and employment, as well as tight credit all encourage the consumer to be a saver. The bright spot in the sentiment report was that its leading component did rise 2-1/2 points to 53.0, indicating that pessimism isn't getting worse and perhaps hinting that it may now be receding.

The stock market will anticipate a recovery months before actual numbers on employment, consumer spending, or even corporate earnings turn positive. This market's decline from peak to trough reached 56.4% on Monday which ranks it second only to the 86% drop from 1929 to 1932. The year following that great decline stock investors reaped returns of 121%. The average return of markets following other significant drops is 43%. In fact, if one considers only those declines of a magnitude similar to this one, the average one-year return jumps to 56.4%. That is something to look forward to.

Have a nice weekend.