

BEACON INVESTMENT MANAGEMENT

THE FRIDAY BRIEF

Distributed to our clients and friends weekly

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Clouds Clearing

This was a good week from both the perspective of strong new monetary remedies as well as economic indicators that the economy may be turning. On Monday, Mr. Geithner knocked one out of the park (market-wise) when he announced his plan to buy as much as \$1 trillion of bad assets from banks and avoid nationalization. Bond fund giants Pimco and Blackrock and others say they will participate in the plan. Economic reports on housing and durable goods also added to the prospect that the fourth quarter's slide of 6.3% might have been its worst.

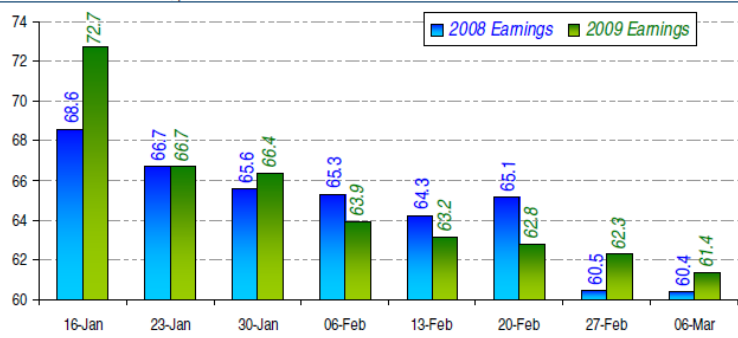
On Monday the National Association of Realtors reported that existing home sales increased 5.1% from January. The report also showed that prices firmed up .4% to a median \$165,400. On Wednesday the National Association of Homebuilders reported that new home sales gained a sizeable 4.7% in February which followed a 10.2% drop in January. Supply on the market fell to 12.2 months from 12.9 months, still quite large, but an improvement nonetheless.

Wednesday's positive reports also included surprise news that Durable Goods Orders rose 3.4% in February. The report which gauges the demand for machinery, computers and defense equipment showed the largest increase in a year and follows a 7.3% decrease in January.

March has seen the best monthly rally since 1974 with the S&P 500 index rising nearly 24% since March 9th. The characteristics of the rally suggest investors sense economic recovery. Financials are up a whopping 26% in the last 12 days. The other cyclical sectors of the economy, including consumer discretionary, technology, industrials, and energy are all up suggesting that investors see earnings prospects improving. At the same time, the more defensive sectors, which are less or non-cyclical in nature and include consumer staples, health care, and utilities have all declined during this rally. Money managers are positioning their portfolios for a recovery in earnings.

However, earnings improvement may be slow and uneven. Earlier this week JP Morgan cut its earnings estimates for S&P 500 companies to \$57 this year compared with a previous forecast of \$65. The Credit Suisse chart below shows how steadily, and perhaps stubbornly analysts have reduced their full-year earnings projections for S&P 500 companies. JP Morgan's latest estimate takes the average still lower than \$61.40 estimate on the chart.

Exhibit 3: Year 2008 and 2009 Index Level EPS consensus estimates for the S&P 500
Index Level EPS is measured as \$ per index share



Source: Credit Suisse Quantitative Research

First quarter '09 earnings announcements begin next month. They will provide the first evidence of how well companies were able to downsize in the face of a rapidly declining economy. The prevailing market-think is that they did so very well as inventories were not high and layoffs were so dramatic. There may in fact be some positive surprises signaling that the decline in corporate earnings may have bottomed.

Much of the market's confidence in recovery comes from monetary measures taken by the Federal Reserve and the Treasury, not from fiscal measures of the Congress or Administration. The \$750 stimulus package and the President's ambitious budget have not received high marks. They continue to be criticized as the wrong approach to fixing the economy because they do not offer significant near-term remedies to recession pressures and they are hugely inflationary. As he pushes his budget along with the yawning deficits it will create, Mr. Obama is considering ways to shave those deficits.

The President announced Wednesday that he plans to form a task force headed by former Fed Chair Paul Volker to review and overhaul the US tax code. The goal is to "find ways to simplify the tax code, protect progressivity in the revenue base, close tax loopholes and find ways to reduce tax evasion and that reduce corporate welfare." The names mentioned so far to fill the panel indicate a diverse range of opinion and political backgrounds; even if the stated goal implies a political leaning as well as a stated objective that no one below \$250,000 would see more taxes.

Obama wants recommendations on his desk by December 4th. That will be a challenge. If trimming the nearly 70,000 page code is not a momentous enough task then getting something meaningful through this Congress will be; a Congress that crafted a 90% tax specifically targeted at the AIG bonuses. That hasty legislation has similar roots to an evil cousin – the Alternative Minimum Tax. A Cato Institute article by Chris Edwards back in 2003 reminds us of the ugly history of the AMT. It began in 1969 when Congress was *shocked* to learn that **155** wealthy individuals were not paying tax because they used too many of the deductions that Congress had provided them. Thanks to the *patriotic diligence* of that 1969 Congress, the progressive parallel tax we lovingly call the AMT now increases the taxes of more than 23 million Americans. Mr. Bush couldn't get rid of it when he had a Republican majority in Congress. We wish you our best Mr. Volker; we and our economy need a better system.

We face significant challenges as investors in the coming several years. One, history suggests that a sizeable rally in stocks lies ahead. But just when things start feeling good, at least two threats await; inflation and rising taxes. These evils are not necessarily market killers like the perils of recession or deflationary spirals which are hopefully behind us. Nevertheless, they present a huge drain on the economy. It is also likely that energy costs may once again skyrocket as the global economy reignites. Only time will tell if the US economy will recover sufficiently to withstand these looming threats.

We believe that diversification, low costs, tax efficiency and adroit asset allocation are more critical to the success of your investment program than perhaps any time in history. Superior investment portfolios combined with a thorough knowledge of when you need to access your investments; you will be as well equipped to face tomorrow's challenges as possible. We close with our quote from Mark Mobius of Templeton earlier in the week, "you have to be careful not to miss the opportunity . . . there is a tendency to hold back." If you are an investor with a time horizon beyond a couple of years, now is the time to invest, but wisely. "*Steady plodding brings prosperity, hasty speculation brings poverty.*" Proverbs 21:5