

# BEACON INVESTMENT MANAGEMENT

## THE FRIDAY BRIEF

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Friday, April 03, 2009

### Monetary Policy is Working

There are two categories of policy available to the government to influence an economy; monetary and fiscal. Fiscal policy employs government spending and taxation. Monetary policy, primarily overseen by the Federal Reserve and the Treasury is used to control and manipulate the supply and the cost (interest) of money in order to regulate the growth in the economy and the stability of prices. Of the nearly \$12 trillion lent, promised and spent so far, Fed Chair Ben Bernanke's program to drive down mortgage rates is delivering on its promise. Fixed 30-year mortgage rates are now down to 4.78% according to Freddie Mac. They are down for the second week in a row.

On November 18<sup>th</sup> Mr. Bernanke announced his plan to the Financial Services Committee. A week later he began executing his program to buy up home-loan securities which has now grown to \$1.25 trillion. Since then he has also announced a program to buy up long term US Treasuries driving their rates below what would be palatable to bond buyers, thereby forcing them to other safe instruments, such as mortgage securities.

Banks and mortgage lenders are reporting record refinancing rates. It is hoped that the cash gained from refinancing will boost consumer spending and that lower rates will reignite home sales. Retail sales data show recent improvement in consumer spending and February homes data showed an unexpected increase.

Other rates are dropping as well. The London interbank offered rate, or Libor, for three-month dollar loans dropped to 1.17% yesterday, down from 1.43% at the start of the year, showing banks have become more willing to lend. The TED spread, or the gap between what banks and the Treasury pay to borrow money for three months, shrank to 96 basis points from 1.35% points on Dec. 31. It touched a yearly low of 91 basis points on Feb. 2 according to Bloomberg. The gauge reached a high of 4.64 percentage points in October, up from 1.35 percentage points on Sept. 12, the last trading day before Lehman Brothers Holdings Inc. filed for bankruptcy, according to Bloomberg data.

The Treasury and the Fed's efforts to rid the banks of bad assets are progressing more slowly and less elegantly than the mortgage program. Regulators may have to force those banks they deem near failure to write-down as much as twice what they have already recorded based on FDIC auction data compiled by Bloomberg. Treasury Secretary Timothy Geithner's plan to buy between \$500 billion and \$1 trillion in bad assets may falter if banks refuse to sell at distressed prices. FDIC data indicate that prices of bad loans could be as low as 32 cents on the dollar, less than half of the 84 cents on the dollar the Treasury initially said might be possible. Lower valuations will lead to more write-downs and new capital injections.

Mr. Geithner's program is set up to purchase loans which will be overseen by the FDIC, which also guarantees the debt. The Treasury will invest capital alongside private investors

to fund the purchases. The problem is a plan like this one has never been tried before so no one can accurately predict its outcome.

Treasury spokesman Isaac Baker told Bloomberg that “past auctions cannot reliably predict asset prices in the Public Private Investment Program, as we are creating a new market that has not previously existed to help value these assets, and offering financing to help investors purchase them.” The program is voluntary and the government expects banks will want to sell assets to clean their balance sheets and make it easier to raise capital from investors, he said. The clear risk to the program however, is that prices will be too low to induce banks to sell.

The program is being described as a secret way to reorganize a failed or near-failed bank. As Joshua Rosner of Graham Fisher & Co. says, “it is a way to functionally wind down a bank as big as Citi without the world realizing that they’re essentially in resolution. The real value of this is a tool to resolve a too-big-to-fail institution.”

Write-downs of these assets would total \$1 trillion if the program buys \$500 billion in loans at 32 cents on the dollar, the average for non-performing commercial loans in the FDIC sales. Geithner said March 29<sup>th</sup> that some firms will need “large amounts of assistance” while he tries to avoid bank nationalizations. Getting much of the funding from the private sector makes the program more palatable to taxpayers and provides a clearly different path than the one taken by Japanese authorities. Their failure to rid their banks of bad loans led to a decade of economic stagnation.

Banks which comprise the country’s most important lenders are now undergoing stress tests that are aimed at evaluating their viability under extraordinarily difficult circumstances. The tests are expected to be concluded by April 30<sup>th</sup>. Banks hold nearly \$4.7 trillion in loans that are not packaged into bonds and the vast majority of these loans are carried at face value because they have not defaulted. But the stress tests will likely reduce their value requiring substantially more capital to offset ‘potential’ losses. Details of the stress tests will not be published, but the world will effectively know when banks announce how much capital they will be required to raise. Regulators will then give them six months to obtain funds from investors or taxpayers as a last resort.

A measure of fiscal stimulus that is clearly not working to promote economic recovery is the administration’s mortgage re-work program. Regulators reported today that mortgages modified in the third quarter of last year failed at a faster pace than those revised in the first, and the delinquency rate on the least risky loans doubled.

Loans modified in the first quarter to help borrowers keep their homes fell delinquent 41% of the time after eight months, and second-quarter loans had a 46% default rate. Third-quarter trends “are worsening,” the agencies said. “For the year and this quarter, we saw the same trend that we saw last time: quite high re-default rates, no matter how we measured them,” John Dugan, the U.S. Comptroller of the Currency, said in a conference call with reporters. The Obama administration is acting to help as many as 9 million struggling homeowners by using taxpayer funds to pay lenders such as bond investors, mortgage servicers for reworking the mortgages. Many of these borrowers reportedly fall into the category of those given a mortgage because they met only one criterion; “they could fog a mirror.” The proof of that claim is in the numbers.

The government reported today that the US unemployment rate climbed in March to 8.5%, the highest level since 1983, but in line with economists' projections. During the month the economy lost 663,000 jobs. Since the recession began 5.1 million Americans have lost their jobs. Today's results clearly demonstrate how difficult it will be for Mr. Obama's fiscal stimulus plan to create an additional 3.5 million jobs, especially given that they include higher taxes and a massive re-structuring of the healthcare industry.

While it is expected that employment will likely be the last component to show improvement as the economy recovers, today's ISM report of non-manufacturing businesses, which comprise 90% of the economy, fell to 40.8 in March, down from 41.6 in February. This report is a setback for those in the economic recovery camp, though it is not a stopper. Retail sales excluding cars and trucks showed strength in February, and consumer purchases have increased for a second straight month.

The stock market is an excellent leading indicator so it pays to watch for signs it may be giving us regarding a turn. From a fundamental perspective the right things are happening. The hands-down winner is financials which are up 27% during the period. Investors are showing confidence that the banking crisis is diminishing. With only one exception (energy which recovers later in a cycle), sector performance indicates that investors expect recovery in the coming months. Cyclical industries such as consumer discretionary, technology, industrials, and materials are up an average of 7%.

Investors generally hold non-cyclical companies such as consumer staples, healthcare companies, and utilities when they worry about the economy. These companies make products or provide services which generally sell well regardless of economic health. During the rally we saw non-cyclicals decline as investors sold them in favor of better-performing cyclicals.

Unfortunately, from a technical perspective, the rally is somewhat fragile and may be premature. Volume during the run-up has been declining which suggests that it was a corrective rally, a simple reaction to over-selling. As investors remove short positions they must buy stocks. If the move is forceful and quick, prices can rise quickly creating a situation known as a 'short squeeze.' There are other technical indicators as well which urge caution in assuming the bottom is in place, but we'll not bore you with them here.

In conclusion, signs are mounting that point to improvement in the economy, real and dependable signs. Massive sums of taxpayer money are being spent through both monetary and fiscal efforts to ensure the recovery continues. It is clear that the government will accept nothing less than a speedy recovery.

As investors we are obviously challenged by current market conditions as we anticipate an eventual recovery. Unfortunately the very medicine used for a cure can seriously harm us later. The huge outlays of government spending will be inflationary if not removed expeditiously. We know that the Fed is aware of its part in this challenge and we believe they are up to the task. The fiscal medicine poses a far greater challenge.