

BEACON INVESTMENT MANAGEMENT

THE FRIDAY BRIEF

Distributed to our clients and friends weekly

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The Good, The Bad, and The Ugly

Since the exaggerated stock market lows of early March, investors have been overjoyed by recent *Good* news that the trends in earnings, housing, jobs, and the economy may be slowing in their descent. They are glimmers of light in an otherwise dark reality. But this is a *Bad* Recession, the worst since the Great Depression, and it is unique in numerous ways. Finding remedies that don't make matters worse poses hugely daunting challenges for government officials. And the *Ugly* truth is they have bent and even broken good faith promises, contracts, and even the Constitution in the name of remedy. The effects of these broken trusts, the exponential explosion of federal debt, and unprecedented spending on social programs that will not end after recovery will have major and unintended consequences on our future economy.

The Good

This week we saw a continuation of the trend of slowing declines in some major economic indicators. Almost three quarters of S&P 500 companies have reported their first quarter earnings. Actual results are 9.5% above analysts' projections, the best reading ever. Managers suggest the better performance is the result of their aggressive cost cutting in the last quarter of last year as it became obvious that the economy would not avoid a serious recession in the wake of Lehman's and AIG's failures.

Other economic reports bear out the premise that the economy's decline is slowing. Construction spending in March rebounded unexpectedly by .3% following a 1% decline the month before. It was the first increase in six months. Also on Monday, the National Association of Realtors announced that their pending homes sales index rose 3.2% to 84.6 in March, suggesting improvement in existing home sales for April and May.

The Redbook report showed that store sales rose 0.3% in the May 2 week, indicating strength. Redbook, as reported by Bloomberg, estimates that full-month April sales rose 1.5% compared to March suggesting strength for the non-auto non-gas category of the monthly retail sales report. Redbook sees momentum continuing, targeting a 0.5% month-to-month rise for May.

The ISM's non-manufacturing index, like Friday's ISM manufacturing report, indicates that rates of economic contraction are slowing. The ISM's non-manufacturing composite index rose nearly 3 points in April to 43.7. New orders are especially strong, jumping more than 8 points to 47.0 and roughly matching the same reading on the manufacturing side. Employment also improved, up nearly 5 points to 37.0 to point to lower levels of job losses in Friday's employment report.

Mr. Bernanke in his testimony to the joint finance committee in Washington said that both the economy and employment would likely be slow to recover. But government reports did show some improvement, again in terms of slowing descent. Initial claims for unemployment fell a sizable 34,000 in the May 2 week to 601,000 for the lowest rate since late January. But the good news here is minute compared to the problems. The unemployment rate for insured workers rose another tenth to 4.8% and workers are staying unemployed much longer.

The Bad

The bond market is often credited as being smarter than the stock market, particularly on the thorny issue of inflation. You might recall the several deliberate and targeted announcements by Mr. Bernanke and his Fed aimed at driving down interest rates through TARP, TALF, and direct Fed purchases of mortgage and Treasury debt. This recession differs from its predecessors in so many ways, but a major difference is that the Fed has had to resort to quantitative easing because short interest rates are effectively zero. Quantitative easing in short is a flooding of the economy with dollars. The Fed does this by buying massive quantities of bonds for cash, thereby pumping over a trillion in new dollars into the economy.

The problem is, and we hinted at this a couple of weeks ago, the bond market is not taking the bait. The 10-year Treasury's yield has jumped .7% since March 18th, the day it plunged .51% from 3.02% to 2.51% when the Fed announced its aggressive program to buy bonds. This morning the yield is 3.28%, well above both the high and the low on March 18th. Bond investors do not believe the Fed can keep yields down; a vital component in their efforts to keep mortgage rates down at levels that will continue to boost refinancing activity as well as purchases of homes. Bond investors are also clearly concerned about the long-term inflationary threat of projected \$10 trillion deficits over the next 10 years and the potential that the Fed will have to monetize that debt; in essence "buy the debt," flooding the economy with even more money and driving prices ever higher as the recession ends.

Mortgage data has not joined other indicators in their deceleration of declines. Almost 21.8% of all American homeowners with mortgages were underwater as of March 31, according to Zillow.com. At the end of the fourth quarter, 17.6% of owners owed more than their original mortgage, while 14.3% had negative equity three months earlier. Yesterday, the Senate passed a bill 91-5 aimed at addressing foreclosures. Passage was facilitated by stripping it of an amendment allowing bankruptcy judges to modify terms. The financial services industry fiercely opposed the amendment saying it would raise costs and rates.

The federal government projected that 19 of the nation's biggest banks could suffer losses of up to \$599 billion through the end of next year if the economy performs worse than expected and it ordered 10 of them to raise a combined \$74.6 billion in capital to cushion themselves. In Washington on Tuesday, Fed Chairman Ben Bernanke said, "The purpose of the bank stress test exercise is to ensure that banks will have a sufficient capital buffer to remain strongly capitalized and able to lend to creditworthy borrowers even if economic conditions are worse than expected. Following the announcement of the results, bank holding companies will be required to develop comprehensive capital plans for establishing the required buffers. They will then have six months to execute those plans, with the assurance that equity capital from the Treasury under the Capital Assistance Program will be available as needed."

The Ugly

This recession is profoundly different from others in ways that bode ill for the long-term. Typically, as our economy recovers from recession, tax revenues increase quickly to reduce federal deficits that resulted from the slowdown and from fiscal stimulus employed to hasten recovery. Rising productivity, the natural result of a smaller workforce equipped with improved technology working harder and smarter to produce more goods, served to keep a lid on inflation. We do not find ourselves so aptly poised this time.

Today, most of the projected federal deficits over the next 10 years are the result of rapidly expanding social welfare spending that will not be removed as the economy improves. What's more and possibly worse, there is a shattered trust between the public and the private sector. Regulators will be much more restrictive than in decades past as evidenced by the stress tests. Investors may not for a long time trust government promises. Consider, as Ed Yardini points out, what happened to investors in Fannie Mae and Freddie Mac who had invested billions in preferred shares with government encouragement in May only to be wiped out in September when they were placed into conservatorship. The move also erased about \$30 billion in capital at banks holding their preferreds.

Yardini lists other breaks in confidence, trust, contract, and even the Constitution.

- Some conservatives claim that TARP is an unconstitutional delegation of power by Congress to the Executive branch, giving the White House a \$700bn carte blanche.
- On October 13, Hank Paulson forced nine major banks to take some of the TARP money by selling the Treasury preferred shares, even though most of them didn't need it or want it at the time. They were assured that the shares would not be converted into voting common shares. That's what is likely to happen soon for banks that fail the government's stress test.
- On January 12, Larry Summers sent a letter to the Congressional leadership assuring them that banks that had received TARP dollars would be prohibited from paying more than de minimis dividends. That message amounted to de facto nationalization of such banks, which is why their stock prices cratered earlier this year.
- On March 30, the government fired the CEO of GM, a distressed, but still publicly traded company.
- The government is pushing Chrysler's secured lenders to take a much bigger hit than the UAW in violation of due process under bankruptcy law and fairness. The administration is pushing to give GM creditors the short end of the stick as well.

Whether through giant steps as in Mr. Obama's complete overhaul of the healthcare system, or the de facto nationalization of banks, or through smaller steps such as the government's micro management of public companies like GM and Chrysler, our government is undeniably bent toward socialism, in the name of rescue. One need only look across the pond at Europe's economy to project our future as an economic power should these trends continue.

All indications are that China specifically and Asia generally will lead the world out of this recession, not the US. The strength and speed of our recovery has everything to do with how much burden it must carry from our government's attempts to revive it. We hope our leaders wise up or 'idealize' less and recognize that it is the private sector that energizes an economy not the government.