

BEACON INVESTMENT MANAGEMENT

THE FRIDAY BRIEF

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Back in the US of 'AAA'

Mounting concerns over unemployment, country-debt quality, and housing helped send the S&P 500 down 2.4% from Monday's close, but the index remains .7% above last Friday's close and more than 31% ahead of its low reached March 9th. A bit of cooling is inevitable as investors are perhaps a bit too far in front of the economic data; data which largely expresses 'less bad' news than truly good news on the recovery.

Among the most notable pieces of 'good news' is the liquidity of the credit markets, a major concern for the health of the global economy. The cost of borrowing in dollars between banks for three months is poised for the biggest weekly decline this year amid speculation the worst of the global recession is passing. The London interbank offered rate, or Libor, for such loans was at 0.65% at 7:08 a.m. in London today according to Bloomberg. The TED spread, the difference between what banks and the US Treasury pay to borrow for three months, was 49 basis points yesterday, the lowest level since August 2007, when the credit crisis began. It was at 50 basis points today. US Treasury Secretary Geithner told lawmakers this week that the recently concluded stress tests have gone a long way to boost confidence in the financial system.

But not all is good. The market briefly fell this morning on news that the FDIC seized and quickly sold the assets of BankUnited of Florida to equity firms in New York. It represents the largest bank to fail since IndyMac last year and the 34th failure this year.

The VIX which represents market volatility grabbed some headlines this past Wednesday as it fell significantly. The benchmark index for US stock options slipped below 30 for the first time in eight months, as traders paid less for insurance against declines in the S&P 500. The last close below yesterday's VIX level was 25.66 on Sept. 12, the session before Lehman Brothers Holdings Inc. filed for bankruptcy. The VIX dropped 6.9% to 26.82 Wednesday.

Among the less-bad news was last night's announcement by Bank of Japan Governor Masaaki Shirakawa that the world's second-largest economy is emerging from "freefall." It was the central bank's first positive outlook issued in almost three years. "Economic conditions have been deteriorating, but exports and production are beginning to level out," the bank said today. Previously it said the world's second-largest economy had "deteriorated significantly."

Earlier in the week, housing start headlines sent stocks down, but a closer look revealed that the drop was the result of weaker multifamily activity, not single-family starts which actually increased nearly 2.8% during the month. Former GE CEO Jack Welch pointed out that slower housing starts, in his view weren't a negative for now. It means that fewer new houses are being added to already swollen inventories.

News from across the pond last night reminded investors of a clear and present danger. Britain on Thursday became the first big economy to be warned that it might lose its AAA credit rating. It raised fears of possible downgrades for other large industrialized nations, including the US. Bond expert Bill Gross says the downgrade is inevitable because of 10% GDP deficits promised

by our Administration and Congress as far as the eye can see. Though debt is only 60% of GDP now, it can't help but approach 100% in the foreseeable future.

The quantitative easing policies of the Fed and Treasury further complicate the picture. Huge purchases of mortgages, money markets, corporate, and US Treasury debt have shaken the confidence of bond buyers all over the world and put increasing pressure on the dollar. Economists see no way around the tidal wave inflation that is coming in the next few years. Inflation is feared by investors because it discounts the present value of cash flows of stocks and bonds. Bondholders are hyper sensitive to it because their interest payments are fixed for the life of the bond. As investors demand higher yields to keep up with rising prices, the value of existing bonds falls accordingly. Similarly, as yields rise on bonds, they begin to look more attractive than the dividend yields on stocks. However, once an inflationary environment sets in, companies can raise prices to increase their earnings and their dividends. Equity shareholders are better hedged against inflation than are bondholders.

Whether we are in a new bull market or a bear-trap, or housing is near a bottom or banks have purged their worst news all requires more time and patience. There are however, certain inescapable risks that will impact investors for years to come. The points are those of Mohamed El-Erian of Pimco (the nation's largest bond fund manager) as written in a recent blog in the Wall Street Journal.

- “Over the next few months, political feasibility (rather than economic desirability) will dictate most economic policy responses.” There are few if any checks and balances in our current political governance allowing the liberal party almost full control of policy. Little regard to long-term fiscal viability has been demonstrated.
- “The healthy functioning of markets (and societies at large) depends on a set of implicit contracts - what our MBAs labeled social contracts. As is often the case in emergency situations, these contracts are being subjected to major shocks.” Investors buy with a trust and security that long-held rules and even understandings will continue. In the name of crisis management and for ideological reasons, these tenets are being re-written.
- “The management of public debt in industrial countries will be a delicate process.” The UK and the US may experience significant penalties for fiscal irresponsibility.
- “Any further erosion in the autonomy and mission of key economic institutions, including the Federal Reserve and to a lesser extent the FDIC, would be terrible news.”
- “Even our muted projections for global growth [1-2% rather than historical 3-4%] assume some important handoffs that are inherently difficult and face large time-inconsistency challenges. Remember, we are postulating that continued robust growth by some major emerging countries (particularly Brazil, China and India) will serve to partially offset the lower growth in the G-3 and the U.K. We are also postulating that growth in these countries will be driven by a significant pickup in the consumption of an expanding middle class.” These are uncharted waters.

These risks are real and they add significant drag to and economic recovery that is just as real. The indicators of recovery strongly suggest that bottoms are forming in housing and banking. What is at stake now is the strength and speed of the recovery. In essence the US recovery will be anemic by historical standards. The risks stated above represent burdens that that the US economy hasn't faced since the Great Depression with some greater than ever faced. The President's 2010 budget estimates that total debt relative to GDP will rise to 97% by 2010 and stabilize at approximately 100% thereafter. Goodbye AAA.