

# BEACON INVESTMENT MANAGEMENT

## THE FRIDAY BRIEF

*Distributed to our clients and friends weekly*

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Friday, May 29, 2009

### The “New Normal”

As the world recession eases there is much talk of a “new normal,” in the global economy, characterized by heightened government regulation, slower growth, and a shrinking role for the US. Anyone familiar with the history of booms and busts hardly disagrees with the premise, especially given the extensive damage wrought on the worlds’ credit infrastructure, the breakdown of fundamental investor trusts by regulators who increasingly blur the lines between public and private rights, and a consumer who is too tapped-out, over-leveraged, and over-taxed to consume us out of this one.

Pimco’s CEO Mohamed A. El-Erian sees a protracted period of leverage, credit, and entitlement “exhaustion” in the US with real GDP growing 2% rather than 3% and the unemployment rate falling to 6% over the next three to five years. Dr. Ed Yardeni poses an Old World vs. New World investment thesis. In his model the Old World includes the US, the UK, the Eurozone, and Japan. He says “the billion people in these nations enjoyed rapidly increasing prosperity following the end of World War II. Their standard of living may stagnate for a while as a result of the lingering repercussions of the financial crisis of the past couple of years.”

Yardeni goes on to say that “investors should find plenty of growth to invest in around the world. In the New World, there are three billion people who are striving to achieve greater prosperity. They’ve had more opportunities to do so since the end of the Cold War in 1989 and since China joined the World Trade Organization in 2001.” The extraordinary performance of emerging market stocks and commodity prices bear out this thesis.

### **What happens to Old World stock markets?**

Yardeni suggests that US and other Old World markets will underperform for a time, but that the S&P 500, the FTSE (UK), the DAX (Germany), and Nikkei (Japan) “will increasingly decouple from the Old World economies and couple with the ones of the New World. During Japan's lost decade of the 1990s, Japanese companies expanded overseas to grow their businesses. American and European companies have been doing the same, and will do so at an increasing pace in the New World.”

Industry analysts and investors probably do not fully grasp the rate of global expansion by Old World companies and therefore likely underestimate their future profits, according to Yardeni. S&P 500 companies already derive more than half their profits from overseas. That percentage should move higher quickly if domestic corporate profits rebound more slowly than profits from abroad, as seems very likely. Many US companies are reporting that their overseas sales and profits continue to grow despite the global recession, particularly in China. The MSCI World Index is now enjoying its longest monthly winning streak since the credit-market seizure began, after economic reports that Japan’s industrial output increased the most since 1953 Japan, India’s economy grew more than analysts estimated last quarter and Poland’s economy expanded in the first quarter.

## The Week's Economic Reports

Data continues to be mostly negative, but with some good news sprinkled in. The government reported today that the US economy shrank at a 5.7% annual pace in the first quarter of this year. Combined with the fourth quarter '08 decline of 6.3%, the last six months represent the worst economic contraction since WWII.

"As goes General Motors . . ." – we hope not. The huge auto manufacturer reported yesterday that they would file for bankruptcy on June 1<sup>st</sup>. The failure of regulators to force bondholders to give up their contractual rights and the excessive concessions made to labor by the government forced management to seek the protection of the courts.

The Institute for Supply Management-Chicago reported today that US business activity contracted this month to a level of 34.9, faster than forecast. Readings below 50 signal contraction. Private economists have scaled back forecasts for economic growth in the second half of the year.

On the positive side though, confidence among US consumers rose this month to the highest level since September. The Reuters/University of Michigan final index of consumer sentiment increased to 68.7, more than forecast, from 65.1 in April. Rising confidence indicates that the consumer will continue to provide some support for the US and the global economy. Still, the weight of unemployment at 25-year highs, tight credit, falling home prices, and looming taxes on essentially keep a lid on hopes for a strong consumer-led recovery.

Signs of recovery in the housing market retreated some this week. On Tuesday the Case-Shiller composite-10 index for March fell the same 2.1 percent it did in February, while the composite-20 shows back-to-back 2.2 percent declines. Year-on-year rates continue to show little to no improvement, holding in the high negative teens. The text of the report highlighted the weakness, saying there's "no evidence" that home-price recovery is here. The best news is that the data is for March, keeping up hope that home prices in April and even perhaps May will show improvement.

Existing home sales, reported on Wednesday, provided a little better news suggesting a bottom may be forming. They were up 2.9% in April to a 4.680 million annual rate. The year-on-year rate is nearly flat, at a -3.5% rate. Prices held steady, up 0.2% to a median \$170,200 for still very deep year-on-year contraction of 15.4%. Unfortunately supply of new homes increased to 10.2 months at the current sales rate versus 9.6 months in March.

Unfortunately, Mr. Bernanke's efforts to keep bond/mortgage rates down are under siege by bond vigilantes who rightfully demand higher yields to hedge against the hyper-inflation they expect is surely coming as a result of looming massive Federal deficits. Oil prices are running in parallel. Crude prices rose for their largest monthly gain since March 1999 and now rest at \$66.00 per barrel. Unchecked, these increases threaten recovery or at a minimum put the brakes on it.

Bill Gross, co-chief of Pimco, said yesterday that "everything in this 'new normal' world should be questioned in terms of the returns going forward." We take it a step further to suggest that **every aspect** of your investment program should be re-examined in light of this "new normal" world of lower returns and greater risk. Are you taking more risk than is required? Are you **confident** that you will successfully meet all of your life's financial objectives in this "new normal" world? We have the tools to help you answer these important questions.