

BEACON INVESTMENT MANAGEMENT

THE FRIDAY BRIEF

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A Tale of Two Bears

It can be argued that since September of 2008 the stock market has experienced two distinct bear markets; one starting in September 2008 and one starting February 10th 2009. It could also be argued that three-month 40% rally we now enjoy eliminates the second bear market leaving only the first to battle.

The second bear market began forcefully with a 400-point drop in the Dow and a 4.6% drop in the S&P 500 on a February 10th speech by a new and uninitiated Treasury Secretary Timothy Geithner. It was quickly apparent to both the Congress and Wall Street that his plan was short on details of how he proposed to stem the decline in global financial markets. President Obama, had for days been painting a bleak picture. On the night before Mr. Geithner's speech to Congress Mr. Obama in a prime time news conference warned of a "lost decade" and said the US faced a "profound economic emergency," as he made the case for his stimulus plan.

The following weeks were filled with doubts as to whether the major banks would be solvent enough to make it. Congress and the Administration began a series of hearings on the pay structure of banks receiving aid from the government. Bernanke worried that the declining economy and the financial crisis were feeding on each other. Bankruptcy by the automakers was an ongoing possibility. Talk of stress tests and nationalization sent bank share prices into the single digits. The government reported that GDP fell 6.2% in the fourth quarter of 2008 and unemployment rose to a new high of 8.1%.

Then on March 9th the bear was stopped dead in its tracks. That day markets posted their first major rally of 2009 as the Dow Jones Industrial rose 379 points, and the S&P 500 rose 5.9% for their biggest gains since Nov. 21st. The rally was spurred by comments in a memo to Citigroup employees from CEO Vikram Pandit which said that the company was profitable in January and February putting them on track to break a streak of five straight quarterly losses totaling more than \$37 billion. Citigroup was up 38% that day and other financial institutions showed huge gains as well. Strangely fitting was how news that Bernie Madoff would plead guilty to 11 felonies coincided exactly with the most significant jump in the averages that day.

The S&P 500 is now 8.5% above where it stood before it's the 'second bear' retreat on February 10th. If we look at it in isolation, we can say that most of the questions precipitating the 'second bear' are now answered and it is behind us. For instance, the stress tests are concluded and the path to solvency set. GM has declared its bankruptcy and the market met the news with a 200 point rally in the Dow. Imagine what the market reaction might have been if GM had announced in November of 2008 or March of 2009?

So if the mini-bear or 'second bear' of 2009 is behind us, can we now largely discount the 40% rally as an erasure of a 20% decline in March that largely might not have happened were it not for some ill-timed PR missteps by a new and unseasoned Administration? Granted there were bad economic reports and frightening corporate disclosures, but arguably, the market was well prepared for them. What seemed to be the biggest surprise was the fact that banks could

actually make money again. That realization brought hope back that at least the financial crisis could be abating.

The possibility of a continuing market rally is more plausible if we accept that the last three months just got us back to neutral. Investors can now focus on the longer-term thornier issues, such as the housing recovery, unemployment, looming federal deficits, increasing regulations, falling dollar, not to mention brewing geo-political issues. Nevertheless, many of these issues will improve and as they do, there can be significant market recovery in the meantime. It seems to be what investors both at home and abroad are thinking as markets continue to rise.

Economic news this week was largely positive towards the trend. On Monday, along with GM's announcement of bankruptcy, the government reported that construction spending unexpectedly surged .8% in April. The bounce follows a .4% gain in March. The gain was led by a 1.8% increase in private nonresidential outlays with private residential construction spending rebounding 0.7% which did not include new homes. New one-family and new multifamily construction outlays fell 6.7% and 8.9%, respectively.

Personal income in April unexpectedly rebounded .5% as spending slipped further. The spike in personal income was led by an 8.6% surge in unemployment insurance benefits, largely reflecting provisions of the American Recovery and Reinvestment Act of 2009. Also, rental income rebounded 3.1% after several months of decline.

Motor vehicle sales came in very strong in May compared to April, at a total domestic and import annual rate of 9.9 million units vs. April's 9.3 million. Interestingly truck sales rose despite a 20% jump in gasoline prices during the month.

Tuesday brought good news as the Pending Existing-Home Sales index jumped a much sharper-than-expected 6.7%. The year-on-year rate is also improving, at +3.2% vs. +1.1% in March. For comparison, the year-on-year rate for existing home sales was -3.5% in April. The National Association of Realtors said that the \$8,000 government credit, which extends through November, points to further gains in the months ahead.

The Mortgage Bankers' Association purchase index posted a 4.3% gain in the May 29 week to 267.7. The index has been flat all year and needs to keep moving up weekly before signaling stronger demand for housing. However, the average 30-year mortgage rate soared 44 basis points in the week to 5.25%, undermining policy maker efforts that had pulled mortgage rates to record lows of 4.78% earlier this spring.

Perhaps the last segment of economic recovery will be employment. But this week's reports were positive there too. Jobless claims, released yesterday showed improvement. Initial claims in the May 30 week fell 4,000 to 621,000 (prior week revised 2,000 higher to 625,000). The unemployment rate for insured workers, which has been ticking consistently higher, held unchanged at 5.0%. Were it not for pending layoffs in the auto sector, today's report would have raised talk that labor contraction had reached its peak. Today the government said that payroll employment in May was unexpectedly and significantly less negative than in recent months.

The general feeling around here and in most of the research we read is that the recovery is real. With the extreme uncertainties largely behind, investors now have historical precedents on which to base their recovery projections. There is only 65% remaining to get back to the market's last high of November 2007. The S&P 500 average recently crossed its 200-day moving average following the longest period below it since the 1930's. Is the Big Bear finished? Many are voting yes with their money.