

BEACON INVESTMENT MANAGEMENT

THE FRIDAY BRIEF

Distributed to our clients and friends weekly

<http://www.beaconinvest.com>

Toll Free 888-621-5885

Friday, June 12, 2009

Of Interest

Markets largely tracked sideways this week as investors weighed improving economic signs against concerns of rising interest rates, inflation, and a falling dollar. The Treasury successfully completed a record offering of debt including the reintroduction of the 30-year bond. Earlier this week Treasury announced that they would allow nine banks to repay their TARP money. The move reveals improved internal and regulator confidence in their stability. The money is also freed for other uses. Jobless claims, retail sales, and other economic reports continued trending more positive.

The single most important concern bond and stock investors face is looming inflation. Record government spending, if not reigned in, threatens to send interest rates higher slowing growth and worsening the US and global recessions. The answer does not lie in uninformed tax increases or ill-advised spending cuts by the government. What markets are hoping for is a plan for the return to fiscal responsibility. Rates are not too high yet. There is still time for the President, the Treasury, and the Fed to demonstrate how they expect to get back to fiscal health.

In a speech at Georgetown University on April 14th titled "The House Upon a Rock" (a scriptural reference from Psalm 27:5) President Obama, while recognizing the problem, failed to impress bond investors then that he would significantly reign in spending, in fact he suggested the opposite.

"I absolutely agree that our long-term deficit is a major problem that we have to fix. But the fact is that this recovery plan represents only a tiny fraction of that long-term deficit. As I'll discuss in a moment, the key to dealing with our long-term deficit and our national debt is to get a handle on out-of-control health care costs – [entitlement talk] not to stand idly by as the economy goes into free fall." . . . he went on to say that "in tackling the deficit issue, we simply cannot sacrifice the long-term investments that we so desperately need to generate long-term prosperity."

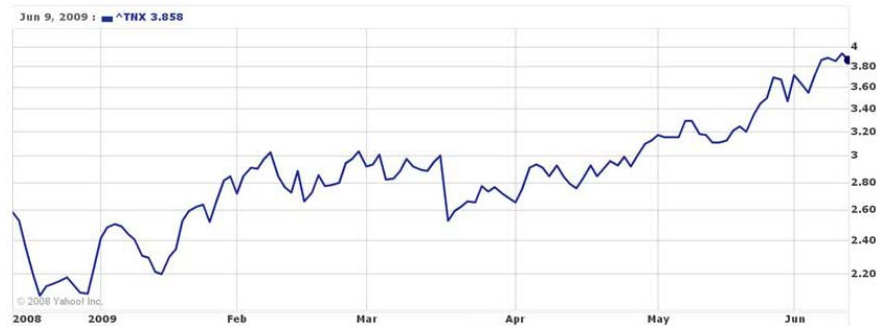
He made the following analogy: "Look, just as a cash-strapped family may cut back on all kinds of luxuries, but will still insist on spending money to get their children through college, will refuse to have their kids drop out of college and go to work in some fast-food place, even though that might bring in some income in the short-term, because they're thinking about the long term--so we as a country have to make current choices with an eye for the future." [Link](#) to speech.

On Tuesday, the President delivered a more fiscally conservative message without overtly discussing spending plans. He suggested strong support for bringing back 'PAYGO' couched in the usual disclaimers of responsibility and bashing of the former administration:

"The 'pay as you go' rule is very simple. Congress can only spend a dollar if it saves a dollar elsewhere. And this principle guides responsible families managing a budget. And it is no coincidence that this rule was in place when we moved from record deficits to record surpluses in the 1990s--and that when this rule was abandoned, we returned to record deficits that doubled the national debt.

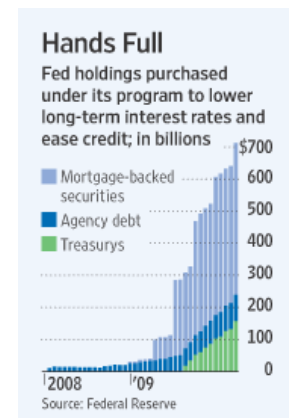
Entitlement increases and tax cuts need to be paid for. They're not free, and borrowing to finance them is not a sustainable long-term policy." [Link](#) to speech.

The so called Bond Vigilantes (coined by Edward Yardeni in 1984 to describe bond market investors who protest monetary or fiscal policies they consider inflationary by selling bonds, thus increasing yields) continue to express disgust over the lack of a plan to rein in spending, both monetary and fiscal. As evidenced by chart on the right 10-year Treasury yields have risen steadily in the new year as government spending continues without signs of abating in the distant future. We hope that as Mr. Obama says, something dramatic has to be done about the federal deficits, that the something or things will indeed be constructive. The Bond Vigilantes are watching.



This week, ten-year note yields fell the most in two weeks after touching 4% for the first time since October. The good news for rates is that the spread between long-term Treasury yields and the federal funds rate (the rate at which banks borrow money) is at record levels boosting the net interest income for banks. The bad news is that mortgage rates, tied to the bonds are also rising.

With the Bond Vigilantes driving Treasury rates higher, there's not much the Fed can do to buy them down further. The spread between the 30-year mortgage yield and the 10-year Treasury peaked at 2.96% during the week of December 26, 2008. The mortgage rate was 5.14% at the time. It plunged to a recent low of 4.78% during the week of May 1st. By last week, their yields were up to 5.29%. The spread however, has narrowed to a more typical 1.5%. Ed Yardeni notes there's little more the Fed can do to reduce the spread to bring mortgages down further. Their \$300 billion buy-down is due to end in about 10 weeks, or late August.



Banks are growing stronger as evidenced this week's announcement by the Fed that it will allow nine majors to repay their TARP money. This is a clear signal that the government is not intent on nationalizing the banking system and that managers and regulators alike deem them sufficiently recovered pay back those reserves.

Another concern highlighted this week was the continuing weakness in the dollar. The greenback's plight was not helped by muscle-flexing by Brazil, Russia, India and China, the so-called BRICs that they planned to shift some of their foreign reserves into International Monetary Fund bonds. However, as the Treasury auction proved later in the week, demand remains strong for US assets, particularly debt. Bloomberg reported that the higher yields attracted a surprisingly strong list of indirect bidders, a class of investors that includes foreign central banks. In a speech yesterday, former Fed Chairman Paul Volker said there was no viable alternative to the US Dollar as a world currency.

Jobs are largely believed to be the last leg of the economy to recover, and there are few signs that recovery is near. The unemployment rate jumped from 7.6% to 9.4% over the past four months through May. However, part of the increase was due to a 2.895 million increase in the number of people seeking work. The fact that so many have rejoined the prospective workforce pool is a sign that confidence in hire may be rising. Though, some of that number were formally retired workers returning to the workforce to replace retirement assets eroded by financial meltdown.

The consumer is also facing severe headwinds and is not expected to be the primary driver of recovery as in recessions past. Yesterday, Bloomberg reported that the government said that US household wealth fell in the first quarter by \$1.3 trillion, extending the biggest slump on record, as home and stock prices dropped. Net worth for households and non-profit groups decreased to \$50.4 trillion, the lowest level since 2004, from \$51.7 trillion in the fourth quarter, according to the Federal Reserve's Flow of Funds report.

As a result of the financial carnage Americans have reduced debt and increased savings. The jump in savings rate to 5.7% in April was helped by an increase in incomes linked to the fiscal stimulus plan, but some economists are forecasting that savings will continue to rise as consumers hold back on spending.

Real-estate-related household assets decreased by \$551.1 billion in the first quarter, following a \$974.5 billion decrease in the fourth quarter. Net worth related to corporate equities fell by \$347.8 billion the first three months of this year. We expect that number will show an almost complete reversal for the second quarter.

Some are saying it's too early to say the economy is in recovery. Others such as Paul Volker say the global economic slump is easing "most clearly" in the US and the UK. The stock market continues to register the temperature of the recovery and we would have to agree with Mr. Volker. However, bond investors, out of necessity, measure the direction of the recovery and they are not pleased. While still relatively patient, they will not wait forever to hear a viable plan for removing the massive stimulus and debt burden from the economy. Mr. Obama, Mr. Geithner, and Mr. Bernanke proved up to the task of flooding the economy with liquidity. Their challenge now is how to drain it, not too fast and not too slowly. Perhaps the best plan we can suggest to our government is the one Ron Blue recommends to anyone who asks his advice on managing household finances.

1. Think long-term with goals and investing
2. Spend less than you earn
3. Maintain liquidity
4. Minimize the use of debt