

BEACON INVESTMENT MANAGEMENT

THE FRIDAY BRIEF

Distributed to our clients and friends weekly

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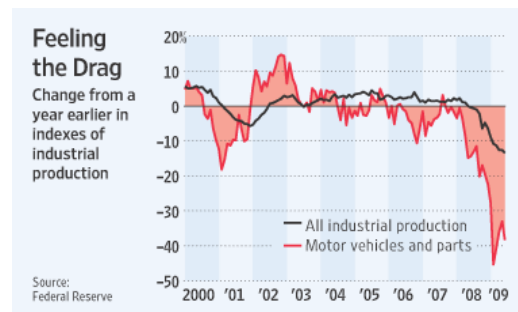
Bouncing Along the Bottom

After trading in a narrow range from the beginning of June, stocks took a 3.7% dive on Monday and Tuesday as investors focused more on the disappointing economic news than on positive. However, the down days were on relatively light volume and there was little selling conviction evident.

The first economic report came from the NY Fed as the Empire State's general business conditions index deepened in June to -9.41 vs. -4.55 in May largely on declining shipments. The good news in the report was that future shipments didn't show greater declines. Looking further ahead, the six-month outlook for general business conditions was up 4 points to 47.81. Businesses reporting also see employment rising, with a reading of 10.34 vs. 9.09.

Also on Monday the National Association of Home Builders reported that confidence among U.S. home builders fell in June disrupting a two-month rising trend. A prime concern was the rise in mortgage rates following a recent selloff in U.S. Treasuries. The NAHB says credit remains tight and buyers who want to move are having a hard time selling their existing homes.

Tuesday brought more bad news to those hoping for a quicker-than-expected recovery. The government reported that manufacturing fell significantly further in May and declines were widespread. Industrial production for the month dropped 1.1%, following a 0.7% fall in April. Not surprisingly, the largest source of weakness was motor vehicles & parts which plunged 7.9% after slipping 1.2% in April. On a year-on-year basis, industrial production in May worsened to down 13.4% from down 12.7% the prior month according to Bloomberg. Capacity utilization in May fell to 68.3% from a level of 69% in April setting a new historical low in a series that began in 1967. The news in manufacturing was largely expected and did not serve to significantly worsen investors' moods.



Some good news came for the construction component of the housing industry. The government reported that housing starts in May showed surprising strength. Starts rebounded 17.2%, following a sharp 12.9% drop in April. The May pace of 0.532 million units annualized was better than expected, but was still down 45.2% compared to last year.

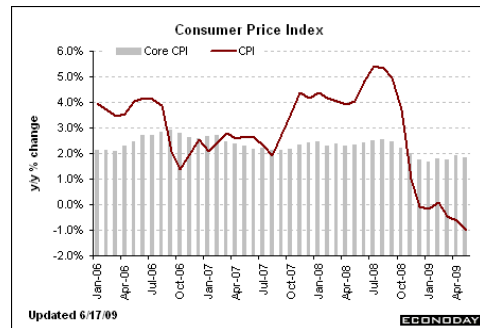
The strength in the rebound comes largely from the multifamily component which posted a 61.7% comeback after falling 49.4% in April. The single-family component gained 7.5%, following a 3.3% rise the month before. Permits which show future activity also made a

comeback, gaining 4.0% in May after slipping 2.5% the month before. The permit pace of 0.518 million units annualized remains down 47.0% from last year. The slower pace of new homes is good in the sense that new homes will not quickly be added to already swollen inventories of unsold homes.

On Wednesday bank stocks took the averages down further as they suffered a double whammy of new regulations and S&P credit rating cuts. The White House unveiled its new regulations aimed at mitigating future booms and busts, streamlining regulation of banks, and more tightly regulating financial products for consumers. Mr. Obama said he hoped to see more "plain vanilla" financial products offered.

Standard & Poor's reduced its credit ratings on 18 US banks, including Wells Fargo, Capital One Financial Corp. and KeyCorp. The rating agency cited tighter regulation and increased market volatility. "Financial institutions are now shedding balance-sheet risk and altering funding profiles and strategies for the marketplace's new reality," S&P credit analyst Rodrigo Quintanilla said in his Wednesday statement. "Such a transition period justifies lower ratings as industry players implement changes." The downgrades imply that the bottom is not yet in for banks.

Wednesday's report of the Consumer Price Index showed that inflation remains muted. The cost of living in the US fell over the last 12 months by the most in six decades, easing concern that government efforts to revive the economy will lead to an immediate outbreak of inflation. The consumer price index dropped 1.3% in the year ended in May, the most since 1950, according to the Labor Department. Prices increased only 0.1% in May and saw no change in April.



The lack of rising prices overall is good for the consumer who is watching his home value decline and gasoline prices rise. Company profits may be eroded, however as they are finding it difficult to pass along increases in fuel costs. Given the overall slack in the economy in capacity utilization and unemployment it is very difficult to see inflation as a problem for the rest of this year.

As Mr. Obama is now in the auto business, he must sell cars. He has decided to use our tax dollars to fund an aggressive incentive program. On Thursday Congress attached legislation for the "cash for clunkers" program to a must-pass bill to fund troops in Iraq and Afghanistan. The program would provide up to \$4,500 in government-funded discounts to consumers who trade in old cars, including large pickup trucks.

Here's a business idea for one of our more enterprising readers: Develop a website to match owners of "clunkers" (who cannot afford a new car, but could use some extra cash) new car buyers who do not have a clunker and cannot resist the idea of an additional government discount on a new car. Help them negotiate a fair exchange and re-title the clunker and take a small fat (I mean flat) fee for the service.

On the home front; Senator Johnny Isakson, a Republican from Georgia, introduced legislation on Wednesday that would increase the tax credit for home buyers from \$8,000 to \$15,000 to anyone buying a primary residence. The bill would also remove the income

limits that had prevented individuals making more than \$75,000 a year from claiming the credit, which would be available for a year after the date of the bill's enactment.

The \$787bn stimulus program promoted by the Administration, and passed by Democrats in Congress on February 13th, is not working so far. On Sunday's "Meet the Press" VP Joe Biden said that "everyone guessed wrong" on the impact of the stimulus plan because the economy was worse off than anyone thought. He backed away from the estimate that the funds could create or save 3.5 million jobs, and instead promised 600,000 by the end of the summer. It would be good to know what kind of jobs.

Ed Yardeni in his usual wise manner says: "My main complaint with Washington's numerous rescue programs has been that they've been focused on moderating the economic downturn rather than on reviving economic growth. We need to stimulate an economic recovery, not just to stabilize the recession. While there is less concern now about the dreaded 'negative feedback loop,' than earlier this year, it is still a danger. If the recession lingers into the second half of the year, banks will continue to be challenged with mounting bad loans, which might once again impair their capital. We don't want to go down that road again."

The two incentive measures currently in Congress could be very effective in jumpstarting auto and home sales. The market has largely discounted the economy's potential to date and will likely be range-bound until more news (such as increasing home and/or auto sales), powers the next up-leg.

On the bond side, yields want to go higher. If the 10-year Treasury tops out at 4% as it has threatened to do once before, mortgage rates would further impede the much-needed recovery in housing. As Mr. Yardeni points out Congress and the White House would therefore be forced to meet the demands of the Bond Vigilantes for fiscal discipline. Their tax incentives for cars and houses may fall short of revving the US economic engine. Housing is fundamental to economic recovery; therefore keep a trained eye on interest rates and inflation. If they rise too soon, the current momentum could be stalled again.