

# BEACON INVESTMENT MANAGEMENT

## THE FRIDAY BRIEF

*Distributed to our clients and friends weekly*

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### The Doldrums

*All in a hot and copper sky,  
The bloody Sun, at noon,  
Right up above the mast did stand,  
No bigger than the Moon.*

*Day after day, day after day,  
We stuck, nor breath nor motion;  
As idle as a painted ship  
Upon a painted ocean.*

Samuel Taylor Coleridge's *The Rime of the Ancient Mariner*

In the days of sailing ships one of a captain's greatest fears was being becalmed in the Doldrums. Ships could be trapped for weeks without sign or hope of a breeze powerful or consistent enough to propel them safely out of the morass. These regions exist at the earth's equator and are characterized by extreme low pressures, where the prevailing winds are calm and variable.

For the past two months equity markets have traded within a 3% band. We find ourselves roughly where we started in May, yet we travelled fast and far to get where we are. We stand 36% above the lows of March 9<sup>th</sup>. Perhaps the memory of that burst in prices holds investors aboard, even while sloshing aimlessly; now seven weeks and counting.

Investors also look to the increasing strength of economic signs, though still faint, which point to recovery. Our economic captain, Ben Bernanke (while struggling to quell a congressional mutiny) said on Tuesday that "the pace of economic contraction is slowing" and noted that "conditions in financial markets have generally improved." He also addressed inflation by saying that "substantial resource slack is likely to dampen cost pressures, and the Committee expects that inflation will remain subdued for some time." And he put to rest the notion that the Fed would be raising rates anytime soon by saying the rate will stay at "exceptionally low levels" for an "extended period."

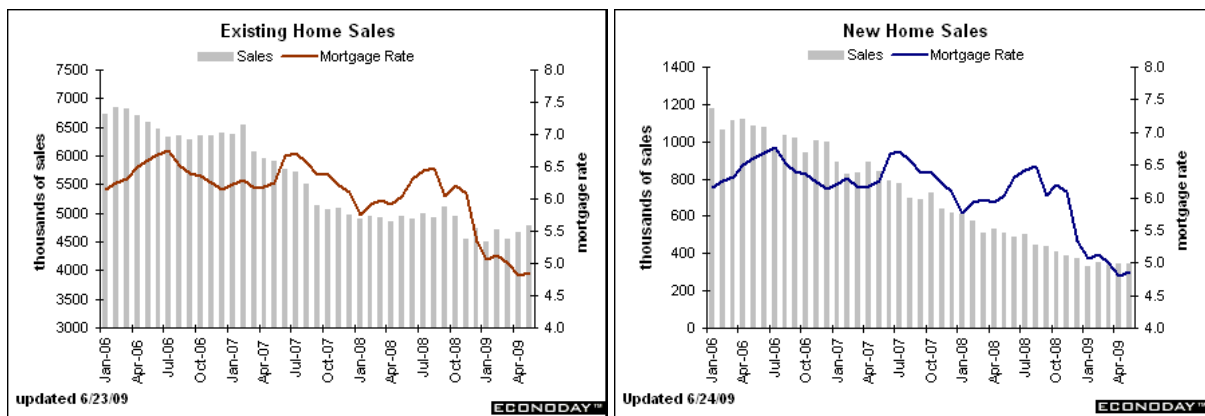
Mr. Bernanke faced a grilling for his conduct in the Fed-arranged takeover of Merrill Lynch by Bank of America. The tough questions came from both sides of the isle yesterday as, according to Bloomberg news, Republicans asserted the Fed interfered with commercial decisions, and Democrats said it should have wrung more concessions in return for taxpayer aid. Given the tone of the congressional hearing, it is fair to say that the Fed may not win new powers in the regulatory overhaul of systemic risk Mr. Obama is pushing.

If anyone can be characterized as being in the doldrums, it is the US consumer. Today's University of Michigan's Consumer sentiment index for mid-June edged up only .3 higher while consumer spending has been flat for three months.

But today's news brings a breath of fresh air for consumers. The commerce Department reports that spending rose .3% in May as incomes jumped 1.4%, the most in a year. The increase comes from tax cuts and Social Security checks from the slice of stimulus that focused on immediate deployment. Some are calling for a second dose of stimulus including Warren Buffett who says we probably need more 'medicine.' What we really need is better aim at the immediate problems and less pork.

That the consumer has not jumped overboard indicates that he can look beyond the constant media drone of declining housing and employment to see reasons for hope. The Univ. of Michigan's assessment of current conditions, which had been motionless for months, jumped nearly 7 points to 74.5.

Pretty soon the media will have to change their tune on housing, if not employment. Existing home sales were up 2.4% in May to a 4.77 million annual rate. Supply fell to 9.6 months from 10.1 in April and prices firmed up 3.8% to a medial \$173,000. Existing single-family home sales climbed to 4.25 million in May, 4.9% above January's 11½-year low of 4.05 million.



New homes aren't faring as well as older ones as they fell .6% in May to an annual rate of 342,000. And previous reports for the two months prior were revised down 24,000 each. The median price for a new home rose strongly for a second straight month, up 4.2% in May to \$221,600. But positively, prices are down only 3.4% from a year ago indicating some stability. The inventory of unsold homes dropped to 10.2 months' in May from 12.4 months' at the start of the year. New home sales actually rose in three of four regions during the month, but not in the South where sales fell 8.5%. New home sales in the South, at 184,000, make up more than the other regions combined.

Mortgage applications jumped 7% in the June 19 week in a rare increase for the index. The thirty year mortgage now stands at 5.51% essentially flat for the week. While mortgage rates are near historic lows, there is concern that they will rise and stall whatever nascent recovery there is in housings.

The greater immediate concern in housing is the problem of low home appraisals. The National Association of Realtors said on Wednesday that flawed appraisal are derailing sales and depressing values across the US. They point to appraisal rules that went into effect on May 1<sup>st</sup> that require lenders that sell loans to Fannie Mae or Freddie Mac to ensure that appraisers and loan officers do not influence one another. The new guidelines require lenders to order valuations through third-party appraisal management companies that use automated systems instead of experienced appraisers who have knowledge of

neighborhoods and include factors that can increase a property's value, such as home improvements or proximity to schools, etc.

On a global scale, the cost of borrowing in dollars for three months in London dropped below 0.6% for the first time as central banks offered cash to financial institutions and signaled interest rates will stay at record lows. The Libor is now down 83 basis points this year. According to Bloomberg, the rate is a benchmark for about \$360 trillion of financial products around the world. It peaked at 4.82% on Oct. 10 following the collapse of Lehman Brothers Holdings Inc. on Sept. 15, 2008.

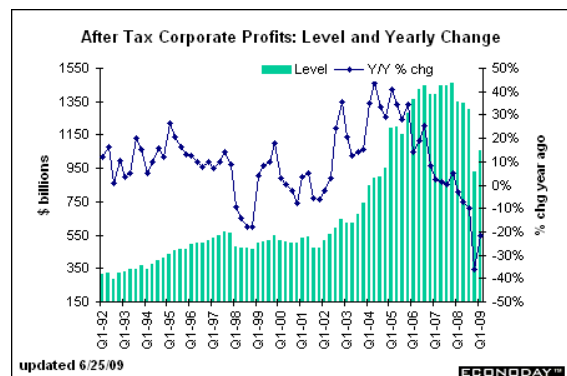
China's central bank is ratcheting up its rhetoric against the dollar as the world's currency calling for the International Monetary Fund to manage more of members' foreign-exchange reserves. The bank said "the dollar should depreciate to address the global imbalance but because it's a reserve currency it cannot." It appears that China's central bank's economic concerns put it at odds with the government's diplomatic requirements. Mr. Obama needs China's support as the US tries to spend it way out of recession.

This rising resentment of the US's fiscal recklessness may be a second door closing on Mr. Obama's plans to spend massively on healthcare and green initiatives. The first and most effective stoppers are the bond vigilantes. They have taken the ten-year Treasury rate up from 2.15% in January to a peak of 4% this month defying Fed Chair Ben Bernanke's efforts to buy-down the rate for the sake of cheaper mortgages. However, as the reality that the recovery will be slower than earlier hoped; rates have fallen in the past couple of weeks to 3.5%, much more in line with Fed goals. This trend will instantly reverse if or when Congress starts talking again of the really big spending.

And lastly, to continue our metaphor, just as a sailing ship needs the wind, stocks need corporate profits. For stocks to be propelled ahead, corporate profits must rise. Unfortunately, the winds are still quite variable, though there is the promise of increasing strength and predictability. The government reported that profits in the first quarter were revised up an annualized 64.3% to an annualized \$1.054 trillion. That performance follows a 73.7% dive the fourth quarter of last year. Corporate profits are down 21.8% on a year-on-year basis, compared to down 36.3% in the fourth quarter.

Hope comes from the fact that businesses have been dramatically cutting expenses which can translate into higher profits. The question is; have securities analysts adequately estimated profits? Any positive surprises will result in higher stock prices.

Another fact to help your patience is this: the S&P 500 stands roughly where it did in 1997 yet corporate profits are twice what they were then.



As Warren Buffett put it, this is a great country and we will get through this significant challenge, better and stronger. Investors and consumers "went crazy on leverage" and they will need time to reduce debt before a recovery can take shape. Be patient and confident. Fair winds are coming.