

BEACON INVESTMENT MANAGEMENT

THE FRIDAY BRIEF

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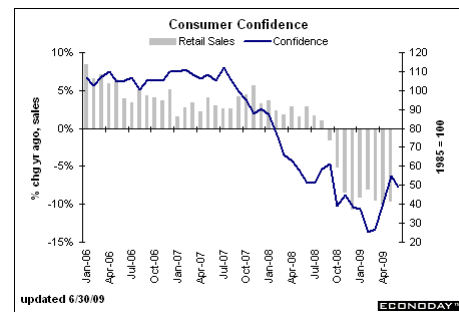
Thursday, July 02, 2009

A Bright 'New World'

Stocks posted their best quarter since 2003 as the second quarter came to an end. Stocks held on to the majority of their increase as the S&P 500-stock index finished the quarter up 15% and the year up 1.8%. As investors who missed the rally buy on dips, the vast majority feel the best is behind until the economy can prove it is up to expectations. The next big test is corporate profits for the second quarter which will be released in the coming weeks. They must match or beat analysts' projections to sustain stock prices at current levels.

In what has traditionally been a very slow week accomplishing anything in the US, it has actually been a busy one for economic data. And as we have grown accustomed, the reports are still negative, but more predictable and not as scary as in months past.

The traditional engine of the US economy has been the consumer. Investors, retailers, economists, and government officials all want to know what he is thinking and planning. The latest report from the Conference Board this week dashed hopes that the consumer would be a compelling economic force anytime soon. As you can see on the chart on the right, June's results reversed a rather compelling rally in confidence. But both the expectations and the current conditions components fell, dropping the index a disappointing 5.5 points. The rising stock market had delivered hope, but rising gasoline prices and the continuing bad news on employment overcame his optimism.



For the first recession in memory, it looks as though the consumer will do as the polls project. The Fed's Redbook showed that June store sales are down 4.4% compared to May. The year-on-year rate for the June 27 week is minus 4.3%. Chain-store sales for the past week, as measured by ICSC-Goldman Sachs jumped 1.6% for the biggest weekly gain in six months, but not enough to salvage a dreary month for sales.

Two great big concerns for the consumer are his job and his house. Employment data released today did nothing to ease his worries. Employers in the US cut 467,000 jobs in June, the unemployment rate rose to 9.5%, the highest in 26 years, and hourly earnings flattened. Recent job reports have provided little evidence that Obama's stimulus package is doing anything to slow the loss of jobs. In fact, unemployment is projected to keep rising for the rest of the year, just as the income boost from the stimulus package fades.

The economy will recover, but it looks increasingly like a jobless recovery. Companies are probably approaching the staffing levels they need to ride out the recession after slashing about 6.5 million jobs since the recession began in December 2007, the most of any downturn and the longest recession since World War II, according to Bloomberg. Initial

jobless claims dropped by 16,000 to 614,000 in the week ended June 27, from a revised 630,000 the week before, the Labor Department said today in Washington.

Once an economic crisis passes and recovery begins, there are always forces in a free market (as long as the government doesn't impede them) that nurture new growth. A key component in that mix is low interest rates. Rates have stopped their ascent as bond buyers project a slower economic recovery and no immediate inflation.

The most important consideration on the mind of a bond buyer when he makes his purchase is what inflation is expected to be. He must increase his bond's return as inflation expectations rise in order to maintain his purchasing power at the bond's maturity. There are other components in the pricing mix, such as risk of loss, but inflation is primary.

As it looks like the recovery is going to be slow and resources such as labor and plant capacity are in near record supply, inflation is not likely to be a problem in the next couple of years. This 'window' could be just what is needed to keep mortgages down to give housing the boost it needs. If Congress wants to provide some targeted stimulus they could pass the incentive bill talked about last week, and make it applicable to both new and existing homes. It now looks stalled until the end of the year.

So far, applications for mortgages are not signaling any improvement. MBA's mortgage applications index fell a steep 4.5% in the June 26 week to 267.7. The refinancing index, after spiking during the spring on record low mortgage rates, is back at a year-and-a-half low at 1,482.2, down 30% in the week. Rates are coming back down after jumping in early June with 30-year fixed loans averaging 5.38% for a 10 basis point decline in the week.

Houses are getting cheaper, but the declines are slowing and may soon turn. The S&P/Case-Shiller® home price index which tracks monthly changes in the value of residential real estate in 20 metropolitan regions fell only .6% in April. The rate has been falling at 2% plus for many weeks prior. The year on year rate improved 6 tenths better than the two months prior.

The pending home sales index, released yesterday was up .1% in May, at 90.7 and showed an improving year-on-year gain of 6.7%. Data on the home sector have been mixed, as is this report which doesn't point to much future improvement in existing home sales but at the same time doesn't point to deterioration either. The Congress could help with incentives aimed at both new and existing homes.

On the commercial side of the economy things are looking a little better. The Chicago Purchasing Managers' Index rose 5 points to 39.9. Anything under 50 suggests contraction. The Institute for Supply Management's PMI rose 2 points to 44.8 and may be at 50 in the third quarter. They report that customer inventories are very positive as more purchasers see inventories at their customers as too low. Continued destocking will limit future layoffs, which are continuing but at a slowing rate based on the employment index's 6.4 point improvement to 40.7 according to Bloomberg. And production, a vital component of growth shows up 6-1/2 points to 52.5 represents the largest factor in the PMI's improvement.

Corporate profits coming out in the next few weeks will provide fresh evidence of how companies are weathering the downturn. Investors, as stated before, are demonstrating considerable confidence in their performance. The S&P 500 is trading at a price-to-

earnings multiple of 15.7 times expected 2009 operating earnings, close to the historical average, according to Thomson Reuters.

Analysts estimate profits in the S&P 500 declined 34% during the second quarter and will slump 22% on average in the third, before rebounding 62% (all sequentially) in the final three-month period, according to Bloomberg data. Estimates are still falling for the second and third quarters as conditions continue to deteriorate. But they expect earnings in the fourth quarter to soar 181% from a year ago, compared with an estimated 169% increase forecast on April 3rd.

Expectations are that the global economic recovery will be driven by the emerging market economies where demand for raw materials is high. Economist Dr. Ed Yardeni suggests that consumer spending in the 'Old World' economies (US included) is likely to remain depressed by weak employment, rising taxes, and tight credit conditions. Also, populations are getting older faster in the Old World. With low fertility rates, and increased longevity old people tend to spend less today to have enough to spend into longer lifetimes.

'New World' economies have lots of catching up to do to raise their standard of living and catch what we now enjoy. The good news for the 'Old Economy' is there are many US, German, UK, and Japanese companies willing and able to help supply their needs. This could be the first time in post-WW1 history that the US does not lead the world out of recession. To Brazil, Russia, India, and China; please buy American!

Hope you and your family have a wonderful 4th of July. Despite our challenges, we remain the most richly blessed nation on earth.