

BEACON INVESTMENT MANAGEMENT

THE FRIDAY BRIEF

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Slowly, But Surely?

Equity markets continue to cool as investors consider whether the meteoric rally starting in March was overly optimistic. The S&P 500 run-up of nearly 40% from March 9th to June 12th is now 6.8% below its high point. The MSCI Emerging market index is 8.75% off its high, also reached on June 12th, but that index rose 72% from its depths in March on signs of greater economic strength in developing economies. It is becoming clear that the world is emerging from the worst economic slump since WWII, but just how fast remains in question.

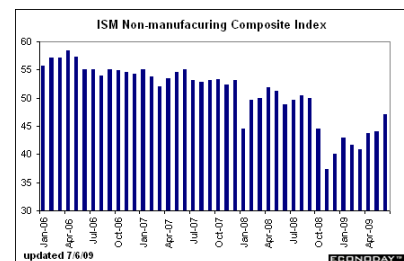
The latest Bloomberg survey of 57 economists indicates the US will recover faster than previously forecast in the second half of this year and in 2010. Economists believe that signs of stability in the housing market, improving consumer confidence and smaller declines in auto sales are reinforcing forecasts for gains in consumer purchases. They project that GDP growth will average 1.5% in the July to December period compared with last month's projection of 1.2%. They look for growth to expand to 2.1% next year.

It is still easy to paint a bleak picture if one were so predisposed. Unemployment continues to climb, household wealth is eroding, credit is tight to non-existent, housing shows few signs of turning and the market rally is floundering. All these factors weigh on consumer confidence, yet there is still sound reason for hope.

Initial jobless claims in the July 4th week fell a steep 52,000 to a much lower-than-expected level of 565,000, the lowest since the beginning of the year, extending a trend of improvement. However, the reading should not be taken out of context. Bloomberg points out that labor experts warn that the week's report benefited from a shift in the timing of auto layoffs and other layoffs in the manufacturing sector. The severe layoffs have already happened. The government makes seasonal adjustments at the beginning of the year and are not adjusted to reflect current events; the bankruptcies of General Motors and Chrysler.

Business inventories continue to dwindle as managers do not yet have sufficient confidence in recovery to begin replenishing them. May wholesale inventories fell .8% even as sales rose slightly. However the pace of contraction is slowing; April saw a 1.4% reduction. The positive side of waning inventories is that eventually they will have to be replaced providing a boost to the manufacturing sector. The latest two gains in durable goods orders may point to a bottoming in inventories.

On Monday, the government reported that the ISM's non-manufacturing report was stronger than expected showing a 3 point rise in the composite headline index to 47. The chart to the right demonstrates an eight-month trend of improvement. Anything less than 50 suggests contraction. Bloomberg points out that despite signs of



life, non-manufacturers leery of recovery, like manufacturers, are drawing down inventories aggressively with the inventory index down 2 points to 45.0.

As the stock market cools off, the bond market is growing inversely. Bond investors seem increasingly convinced that not only is inflation not going to be a concern, neither is the possibility of another huge deficit-increasing stimulus measure. The 10-year Treasury yield has fallen from its June 10th peak of 3.98% to this morning's 3.30%.

Corporate earnings for the second quarter are being released daily now and have some potential to reinvigorate the stock market if their surprises are positive. Companies' cost cutting might boost margins sufficiently to offset weakness in sales and provide a positive surprise. The S&P 500 index is now trading at about 14 times its companies' earnings, compared to 10 times on March 9th. The price earnings ratio peaked on June 2nd at 15.5.

Unless corporate earnings surprise considerably to the upside, it is likely that stock prices will languish for a time. For you traders out there, if you followed the old adage to "sell in May and go away" you are pleased with yourselves. You long-term investors, be patient. This is a deep recession with considerable systemic infection still to cure. It will take considerably longer than usual to recover, but we will.

On Wednesday the International Monetary Fund said the global economic rebound next year will be stronger than it forecast in April as the financial system stabilizes and the pace of contractions from the US to Japan moderates. They said the world economy will expand 2.5% in 2010, compared with an April projection of 1.9% growth. A contraction this year will be 1.4%. The recovery will be uneven across the globe, with emerging economies including China doing the heavy lifting. Europe lags behind the US and Japan and will likely recover last. IMF chief economist Olivier Blanchard said "the global economy is still in recession, but a recovery is coming." He also said that unemployment around the world may keep rising into 2010.

Both domestic and international economists see compelling signs of recovery. At the same time they warn of unevenness and slowness. The data they base their projections upon are compelling and broad based lending credibility to their projections. The challenge for investors will be to reconcile their recent recovery experiences against the new reality of slow and unsteady. Equity markets got a bit ahead of themselves earlier this year. The next move up will require considerably more good economic news than we have seen so far, but it will come.