THE FRIDAY BRIEF
A weekly discussion of events and their impact on your investments

BEACON INVESTMENT MANAGEMENT

Friday, January 8, 2010

Interest, Stocks, and Dollar Rising; Gold and Unemployment Topping, Democrats Sinking

> *"If pro is opposite of con, then what is the opposite of progress? Congress!"* Found in the US House of Representatives restroom

The critical number for our economy is in; unemployment remains at 10%. While the headline number shows signs of topping, a significant rebound in job growth remains frustratingly elusive for the economy and for an administration that could use a boost. The economy lost an unexpected 85,000 jobs in December after showing the first increase in payrolls in almost two years. Economists fear that this recovery will be jobless just like the prior two.

Fed minutes from the last meeting show that officials remain worried about the labor market's weakness. "Several participants observed that more than one good report would be needed to provide convincing evidence of recovery in the labor market." They predict that the unemployment rate will average between 9.3% and 9.7% in the fourth quarter of 2010 due to a slow recovery despite expansion in other parts of the economy.

Interest rates are rising steadily on the long end. The turning point for the dollar and for interest rates was December 8th; both rising steadily since then. On that day the Dow fell 1% when Dubai said it would postpone payments on debt of some state-controlled entities. The day before, Fitch Ratings downgraded its credit grades on Greece to triple-B-plus from single-A-minus, citing "concerns over the medium-term outlook for public finances given the weak credibility of fiscal institutions and the policy framework in Greece." Moody's also said the US and Great Britain may test the boundaries of their triple-A sovereign ratings due to deteriorating public finances, although Moody's said it doesn't see an immediate threat to the ratings of any of the 17 nations for which it has a triple-A rating.

The huge spread between the 2-year and the ten–year Treasury bonds hit its widest margin ever last week. Banks are making a risk-free 'killing' by borrowing money at historically low two-year rates of just under 1% and buying ten-year bonds yielding 3.82%. With a near 3% risk-free spread on their money, why would they lend to businesses that might fail to repay? With the Fed vowing to keep short term rates historically low as long as it takes to get employment rising again and long-term rates rising on credit quality and inflation concerns, the credit dearth 'catch-22' drags on 'indefinitely.'

In an "advisory", regulators told banks buying long-term assets funded with short-term liabilities they are endangering those earnings and their capital if interest rates rise. But if short-term rates rise, banks' cost of funds will increase while the prices of their securities are certain to tumble. Duh? That the Fed and other regulators found it necessary to remind banks of this just now is indeed interesting. The obvious inference is that the monetary authorities are

planning to raise the federal-funds rate target from the current rock-bottom 0-0.25% range: Perhaps not right away, but the jawboning begins.

Lending is further pressured by rising commercial loan losses. While unlikely to threaten the US financial system, bank examiners are concerned for smaller lenders. "Losses from commercial real estate will be quite high by historic standards" according to Eugene Ludwig, former Comptroller of the Currency. "Hundreds of banks will fail or will be resolved over the course of the cycle." Federal Reserve Governor Elizabeth Duke said in a January 4th speech that credit conditions in commercial real estate "are particularly strained." The failure of these loans may impede recovery as small- and medium-sized banks reduce lending and conserve capital to absorb losses, say analysts. Total loans and leases by banks in the U.S. fell to $6.79 trillion in November from $7.23 trillion in the same month a year earlier, according to Fed data.

American savers are scrambling to find some kind of yield they can feel good about. CDs offer no returns when inflation is backed out. But do they ever? Five-year Treasury bonds yield only 2.625%. Unfortunately these are the times when savers in search of income, wind up invested in bond funds advertising high 'safe' yields. Some even show a long history of success to assuage concerns. But extraordinary yields, particularly at the retail level, always suggest less diversification and greater risk. Investors in a certain very popular long-term 5-star Morningstar-rated bond mutual fund lost 12% in 2008 while the index it measures itself against was up 5%.

We wouldn't advise rushing out to buy gold either, even though everyone seems to advising it. Despite 2009 as gold's best year in three decades, an investment in the metal has yet to match the returns of an interest-bearing checking account reports Bloomberg. Anyone who bought during the last peak in January, 1980 at $850 an ounce earned 44% as gold reached a record $1,226.56 on Dec. 3, 2009. That return annualized is only 1.3%. The S&P 500 produced a 22-fold return with dividends reinvested over the same time period. Treasuries rose 11-fold and cash in the average U.S. checking account rose at least 92%.

Single Party Leadership

The United States seems now to be under a single party system. The Democrats have shut out Republican voices on the Healthcare debate as the White House referees a compromise between the House and Senate versions of the bill. Democrats have openly stated that getting a bill passed is more important than getting a good bill. American voters are increasingly outraged.

President Obama, pushing this bill with extraordinary earnestness, is watching his credibility with voters fall at an historic pace. According to Gallup, he now holds the highest disapproval rating (44%) of any US President at this time in his tenure. Today Rasmussen reports that 41% of the nation's voters strongly disapprove of the job Mr. Obama is doing and only 27% strongly approve. The same poll adds that "42% of U.S. voters say a group of people randomly selected from the phone book would do a better job than the current Congress."

Of course our difficulties with Congress go back to the very beginning our young country's history. Exasperated over what he viewed as a useless job as President of the Senate and finding that body directionless as a result, our first Vice President John Adams lamented "In my many years I have come to a conclusion that one useless man is a shame, two is a law firm and three or more is a congress."

Let's turn to the relentlessly rising stock market. In view of all the issues facing our economy, one has to wonder how much longer the market will climb. While we don't try to predict market turns any more than we do the weather, we do like to know when to carry an umbrella. Even a peak out the window provides some insight; and there are clouds. The market is up 71% from its March lows and bullish investors crowd the markets with a rapidly diminishing number of them to continue buying. The number of bearish investors (a source of potential bullish investors) is down to a low not seen in 22 years. The Trillions proposed and spent for stimulus are largely behind us, not ahead. And the Federal Reserve one day certain will have to begin mopping up all this excess liquidity, taking away the proverbial punch bowl.

The S&P 500 is now trading at 25 times the sum of its companies' reported earnings from continuing operations, the highest since 2002. Going into the earnings season for the fourth quarter of 2009 analysts project that profits increased by 60%. The index's price to earnings ratio falls to 15 against the profit estimate for 2010. So from a valuation standpoint, an argument could be made that the rapid run-up in stock prices was simply a snap-back from extreme pessimism and that earnings (so far) support prices.
As earnings announcements are made, we will get a better sense on the credibility of analysts' estimates.

So are we in for a storm, light showers, or sunny weather?
Yes, but please don't ask me to say when.

We plan for the certainty of risk assuming it can occur at any time, even when it is nice and sunny outside.

Information provided in this Brief has been prepared from sources believed to be reliable, but it is not guaranteed by Beacon Investment Management and is not a complete summary or statement of all available data necessary for making an investment decision. Past performance does not guarantee future results. Information provided is intended only to inform and does not constitute a recommendation to buy or sell.

The opinions expressed reflect the judgment of the author as of this date and are subject to change without notice. All email sent to or from Beacon Investment Management's corporate e-mail system is subject to archival, monitoring and/or review by Beacon personnel and regulatory authorities.

BEACON INVESTMENT MANAGEMENT 4001 Barrett Drive, Suite 103, Raleigh, NC 27609
919-821-5225 • Toll Free 888-621-5885 • Facsimile 919-821-1033 • www.beaconinvest.com