



Friday, August 6, 2010

## 'The Right Stimulus'

The Great Recession, now in its 33<sup>rd</sup> month, drags on relentlessly and painfully as headlines such as today's unemployment number perpetuate the gloom. The US economy lost more jobs in July than was expected and the unemployment rate remained fixed at 9.5%. But beneath the din, there are substantial reasons for hope of improvement.

While the economy remains lethargic in many areas, corporations continue to do quite well. More than 75% of S&P 500 companies reported better-than-expected earnings for the second quarter, far better than economists expected going into the earnings season. With 90% of S&P companies reporting, total earnings are 42% better than the same period last year. This strength of the reports imply that earnings are sustainable beyond just the cost-cutting measures taken at the outset of the recession. Corporate sales, a better measure of sustainability than earnings, are up 12% over the same period last year. Companies are doing pretty well in a slow economy.

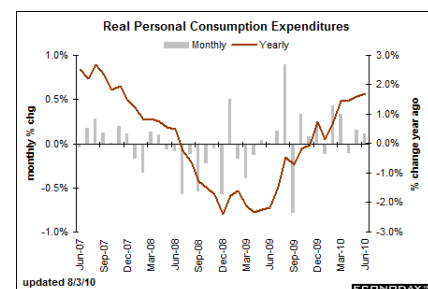
In a resounding vote of confidence by bond investors, International Business Machines Corp. was able to borrow \$1.5 billion yesterday at 1%, the lowest corporate interest rate on record. It is a bold statement that investors believe the economy will not slip back into recession, and that inflation will not be a problem for the next two to three years.

On a significantly positive note, the ISM's non-manufacturing index rose to 54.3 in July vs. 53.8 in June. New orders rose nearly 2-1/2 points to 56.7 while employment climbed more than one point to 50.9 for its best reading of the recovery. Export orders were strong with a four point jump to 52.0, though exports are not a major business for non-manufacturers.

Manufacturing slowed in July, but not as much as economists expected. The Institute for Supply Management's manufacturing gauge dropped to a one-year low of 55.5 last month, but still points to growth (readings greater than 50 indicate growth).

Fed Chairman Ben Bernanke, speaking in Charleston SC said that there is a "considerable way to go to achieve full recovery," but in the question and answer session he assured the Fed would maintain "strong monetary policy support for the recovery." He said that state and local government budget cuts are weighing on economic activity and that job growth of just 100,000 per month would be insufficient to cut unemployment. He was upbeat, however, on consumer spending saying that it should rise for the recent moderate pace. He also sees considerable reason for optimism in Europe on as the bank stress tests reduced concern assistance to Greece continues.

Unfortunately the government's report of Personal Income and Outlays this week did not provide immediate confirmation of Mr. Bernanke comments. The gauge was unchanged for the month of June, following a .35 increase the month before. Consumer spending has slowed over the past three months. Increases in gasoline prices slowed spending for the latest month. Overall personal consumption was flat, following a 0.1% rise in May.



Construction spending came in higher than was expected for June. Outlays in June edged up 0.1%, following a 1.0% drop in May. The June number is better than the median forecast for a 0.5% decrease. The rebound was led by a 1.5% jump in public outlays, following a 0.3% decline the prior month. In contrast, the private residential component declined 0.8% after a 1.5% fall in May. Private nonresidential outlays slipped 0.5% in June after dropping 1.3% in May.

In the wake government stimulus for housing, that industry continues to suffer significant declines in performance. Pending home sales index fell 2.6% in June to 75.7. Year-on-year the index is down 18.6%. The National Association of Realtors warns that near-term sales of existing homes are likely to be "notably lower" in contrast to the spring surge which was fed by government stimulus.

The Mortgage Bankers' Association purchase index is a good leading indicator for single-family home sales and housing construction because it tracks applications at mortgage lenders. Unfortunately it provides little indication the trend in housing is going to improve soon. While the index is up 1.3% in the July 30 week for the third week, refinancing made up 78% of all applications. During the week, rates on 30-year mortgages declined to an average of 4.60%.

Nobel Prize-winning economist Joseph E. Stiglitz said the U.S. economy faces an "anemic recovery" and the government will need to enact another round of "better designed" stimulus measures. IN his view the Obama administration took "a big gamble and it doesn't look like it's paying off. The recovery is so weak that it is not strong enough to generate new jobs for the new entrants in the labor force, let alone to find jobs for the 15 million Americans who would like a job and can't get one." He said "it's absolutely clear that you need a second round of stimulus. It needs to be better designed. It needs to be focused more on returns on investment, education, infrastructure, technology. And if you do those kinds of high-powered investments, the long-term national debt will be actually lower and the growth in the future will be higher."

With all due respect to the Nobel laureate, we would argue that government is at best a horrible allocator of capital. Once grabbed from producers, capital invariably flows to politically designated beneficiaries, with little if any thought given to its long term economic benefit. Taking capital from the most effective and efficient producers and giving it to inefficient political favorites is not stimulus, it is folly. It was expensively tried, failed, and is now left to the next generations to repay.

We believe that leaving capital in the hands of those who earn it is the very best form of 'stimulus' a government can provide. Extend the tax cuts, no make them permanent, and then watch what happens to this, the greatest economy in the world.

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