BEACON ROCK RESEARCH

OCTOBER 1, 2009

MARKET COMMENTARY

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Growing Long-Term Unemployment May Signal Stagflation

The gains recognized in the stock market may be short lived. Despite reactivated liquidity moving into the stock market, a loss of confidence in discounted future earnings may lead to a correction in the near term. If rapid growth in the U.S. economy is slow to materialize, and the ranks of the "long-term unemployed" continue to swell, the Federal Reserve will become increasingly frustrated in its mission to achieve "full employment."

The Fed may have few options available beyond increasing the money supply to historic levels and reducing interest rates to below 25 basis points. It is becoming apparent that Fed officials are now more aware that the increase of the monetary base may be inflationary. Reticent to go against their Keynesian roots, the Fed will be adverse to reverse monetary easing or reduce liquidity. This raises the specter of stagflation, with stagnant growth and above average inflation ahead, holding gold at historic price levels and benefiting gold producers.

What is Driving the Bull Market?

The recent bull market in equities has been impressive, but should be balanced against the rapid declines in 2008. The recent enthusiasm seems to be due more to the psychological relief of not going over a financial precipice rather than confidence in robust economic fundamentals. Prudence would suggest that the initial signs of recovery, following the greatest economic decline since the 1930s, should be approached with a good dose of skepticism or at least cautious curiosity.

The combination of easy monetary policies and reactivated sidelined cash may have induced "money illusion," or economic blindness, that plays into momentum trading of equities, temporarily pushing stock prices higher. Clearly, relative to earlier suppressed valuations and to returns on Treasuries, the stock market is again attractive. On the other hand, inflation, appearing absent in interest rates between global currencies, may only be reflected accurately in record gold prices.

Liquidity, sidelined over the last year, has been coming back into the market following expanding margins and improving corporate profits. This expansion appears to be a result of "excess capacity," primarily through reduced labor and other costs. These factors lead market pundits and other "smart people" to conclude that a "V-shaped" bull market in stocks is foretelling a "V-shaped" economic recovery in the U.S.

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Chronic Unemployment May Dull an Otherwise Potentially Robust Recovery

An increase in unemployment in the business cycle is generally considered to be positive as it redistributes labor to its most productive utilization. The academic argument for a robust recovery in 2009 does not stand up against the tested but folksy definition that "a recession is when your neighbor loses his job; a depression is when you lose your job." Increasing ranks of the "long-term unemployed" may suppress top-line growth of corporate sales and eventually corporate profits.

Reported unemployment in the U.S. is at its highest level since WWII, and one third of those counted as unemployed have been unemployed for over 27 weeks. This group is now estimated at about five million. While "unreported unemployment," consisting of those who have given up finding work or are underemployed as part time labor, is likely in the high teens; this extended period of unemployment for the "long-term unemployed" provides an entirely new dimension to the U.S. economy.

Those who are "long-term unemployed" find it increasingly difficult to locate employment in their field of expertise or at previous pay levels. This underutilized labor pool, now affectionately regarded as "excess capacity," run the risk of becoming a permanent recipient of government support or entitlements. A compassionate government may actually subsidize and prolong the period of unemployment. The longer it takes the unemployed to adjustment and return to productivity in a competitive world economy, the less likely we may see a "V-shaped" economic recovery.

Stimulus Efforts to Boost Economic Recovery May Have Little Effect

Government stimulus and other encouragement have provided questionable benefit to reestablish confidence in the economy. It is uncertain whether short-term stimulus for first time home buyers and "cash for clunkers" programs support long-term growth for the economy. While positive for special interests such as home builders and the auto industry (and those lucky enough to be in the market for a new home or car), it is too soon to know how these activities helped or whether they simply disrupted the market.

The most important message in the current bull market is that the financial crisis of 2008 is behind us. Beyond expanding liquidity in the system and propping up institutions selectively deemed "too big to fail," confidence by all others participants, including the unemployed, is essential for a functioning economy. This confidence is essentially lacking for both consumers and commercial interests.

Individuals appear unconvinced that the recession is over. Although economists are anticipating GDP of -2.6% in 2009 rebounding to +2.5% in 2010, higher reported and unreported unemployment has cooled both consumer spending and demand for credit. Consumer spending makes up 70% of the U.S. economy, and although consumer confidence is being reestablished, it remains below half its historic level and below the lowest levels of the 2001 recession. Savings of U.S. households swelled to $566 billion in the second quarter, four times the rate at the beginning of 2008. Even though the market rebound returned $1.1 trillion to U.S. household net worth, they are still out $10.8 trillion.

Lower demand for credit has been offset by a reduction on the supply side for available credit by the chilling effect of increasing regulations on commercial bankers. A clear takeaway from the recent Group of 20 summit (G-20) is the U.S. push for increased global financial regulation, capping executive compensation, and increased capital requirements. This emphasis in the U.S. is contrary to free markets, which include risk taking and commensurate returns. Clearly, bankers (and regulators) are more interested in keeping their jobs than taking risks essential for a growing and expanding economy.

Lack of consumer confidence may be a drag on a "V-shaped" economic recovery. This may be prolonged by lower levels of household income and assets with high debt levels and growing ranks of "long-term unemployed." In addition, as regulators move down the food chain from institutions deemed "too big to fail," smaller community banks will come under pressure. This environment of low interest rates, which typifies both low demand and supply of credit, argues against a "V-shaped" economic recovery. When queried on when inflation would commence, one banker attending a regional banking school responded "when I am confident of my job."

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Confidence is Essential for Increasing the Velocity of Money

Irving Fisher's Equation of Exchange (MV = PQ) again provides some useful insights. The Fed's success in increasing the money supply has failed to inspire sufficient confidence in market participants to accommodate increased liquidity. The increased liquidity with higher savings has partially found its way back into the stock market. The slower rate of liquidity moving through the system has reduced economic output and increased unemployment. What about the remaining independent variable, inflation?

The Fed's mission is to provide for both "price stability" and "full employment." Should the money supply remain unchanged and confidence (velocity) increase, without a commensurate increase in economic growth, inflation should ensue. Likewise, should confidence stagnate, economic growth may likewise, which is inflationary as well. The Fed does not appear to have the antidote for what ails the economy.

In the Fed's mind, they would expect that their actions, including increasing liquidity, would rapidly restore confidence. This would be followed by increased economic growth, which when combined with surgical monetary policy would hold inflation in check. Unfortunately, growing ranks of the "long-term unemployed" are a drag on confidence, and a successful monetary policy operation has yet to be performed on this scale.

Well intentioned domestic economic initiatives may have dire consequences for growth of the U.S. economy essential to sop up liquidity and check inflation. Health Care Reform, even in its nebulous form, is taking shape as another tax on productivity to be enforced by the Internal Revenue Service. Environmental Cap and Trade policies are expected to increase the cost of energy. Recent experience of $4.00 per gallon gasoline in the summer of 2008 slowed the economy, and exacerbated loss of household income met with rising mortgage defaults. Ambivalent policies for lowering taxes and reducing regulation in the U.S. may lead to lower production of goods and services relative to an increasing money supply, which is inflationary.

Global Inflation Appears to be Inevitable

The recent G-20 summit has brought attention to an increase in global liquidity, which is evidenced by gold rising against international currencies. How nations individually address the stability of their currencies and domestic economies is yet to be seen. Interestingly, China and India continue to grow and are developing their domestic consumer base with less reliance on exports to the U.S. Germany has recently tilted to what resembles a more free market economy. Until actions of this sort take hold internationally, the only stable store of value and currency is likely to be gold.

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