SiRuDo Realty, LLC
10 West 40th Street
Savannah, GA 31401
912-232 8686

www.sirudorealty.com

Quarterly Newsletter
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Welcome

I hope this newsletter finds all of you well.
The issuance and distribution is a little bit delayed because so many things are happening in the markets, it is hard to keep track of it all.
But I will try to make some sense of it in the newsletter.
The focus of this newsletter is really centered around the different forces that are at work right now. It is like solving a puzzle, but if you can look past each individual piece you will be able to see the long-term picture.

Happy reading,

Nick Doms

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Economic Outlook

The economic situation becomes more complicated and complex as time goes by.
The reasons for that are multiple, but can be broken down into four main categories.
-The conflict of multiple Government plans.
-The constant change of previous Government plans.
-The contradiction between Government intervention and private capital.
-The unemployment rate.

The conflict of multiple Government plans.
It seems that every day there is a new plan being proposed, whether it is TARP, TALF, TSLF or PPIP.
Nobody knows how all these plans are ultimately going to work in conjunction or whether one will contradict the other. The other dilemma is that once another plan is proposed and enacted upon, that plan 1 is changed completely from its original version.
That does not seem like a strong and determined strategy or vision for our future.

The constant change of previous Government plans.
This is a very curious phenomenon indeed.
One would think that once a plan and strategy has been carefully thought out and orchestrated, that upon enactment such would then be implemented in its entirety.
TARP has now been changed and altered twice already and I don’t think anybody really knows anymore what the real plan is.
TALF, so far, is a disaster because only 1.7 billion has been extended in loans, which is far less than envisioned and what the financial industry needs.
TSLF is nowhere to be found and dead in the water.
The two last ones are crucial to the recovery of our financial sector and yet neither one of them seems to work as planned.
But, let’s look at the future of the newest plan: the PPIP.

Government intervention and private capital.
This is by far my favorite one: the PPIP.
The first test of the Keynesian principle, i.e. Gov’t investment to attract private capital afterwards and stimulate the economy was: Chrysler.
That test failed because all the hedge funds and bondholders walked away from the table, which left Chrysler no other option but to file for Chapter 11.
Independent of whether Fiat will get a 35% stake in Chrysler or not, the fact that the Gov’t cannot attract much needed private capital to replace their initial investment does not bode very well for our future.
I will not write about GM just yet, but the same scenario will play out there as well.

The unemployment rate.

While we are seeking to create 3.5 million jobs through infrastructure projects, the job market will have lost an additional 6.5 million jobs by then.

The unemployment rate keeps creeping up and will reach at least 10% by year-end. Such figure will rise depending on the outcome of the jobs lost in the automotive industry.

What is important to note, and which I mentioned in one of my articles, is that the real unemployment rate currently stands at 16.5% and will continue to reach new highs.

On another note, we should also take into consideration what the effects are of the Federal Reserve intervention (adding 1.3 trillion USD in newly minted currency to buy US Treasuries) and the refinancing of our national debt by the US Treasury.

We have seen the yield curve steepen over the past two weeks. While in normal circumstances that is a good sign for the economy long-term, today it has a negative side effect.

The steeper the yield curve and the higher the long-term interest rates go, the less chance that mortgage rates will come down. We have already witnessed this in the underwriting market.

In order for the economy to stabilize, we need a solid and stable housing market. Such can only happen with low mortgage rates.

So, in conclusion, two forces are at work that contradict and offset each other, both of which are Gov’t initiated.

I will write more about the influence of the currency markets and its effects on the economy in another article.

ND – 05/01/2009

The G-20

The G-20 meeting that occurred early April is interesting enough to write about, not because of the TV coverage about protesters trying to storm the Bank of England, they would not even know where to begin even if they got inside, but because of some of the topics that were discussed.

Two major topics deserve to be mentioned and are very positive in my opinion.

-**The creation of an international regulatory agency**, which I will call the IRA for the time being.
Looking back at the demise and future of AIG, and why this occurred, this is a very positive development and will lead to two things:

- The creation of a regulatory agency that can oversee international financial conglomerates from an overall perspective rather than being based on country or state of incorporation. In addition, this will allow such agency to oversee. Control and regulate the entire holding company as a whole, instead of the current fractional approach, which only has authority over single entities within the holding company.
- The standardization and streamlining of local regulations. This is equally important since we know that there is great disparity between a multitude of country-regulators with regards to financial standards and requirements as they pertain to quarterly or annual reporting.

-**The implementation of a universal currency.**
Only a few months ago, this was unthinkable, but the idea is certainly floating around. I do not think that such is in our immediate future and I do not believe that the USD will be replaced as the favorite reserve currency tomorrow.
What I do believe is that the way is being paved by first replacing the USD by a basket of international currencies, i.e. the Euro, JPY and GBP.
The second phase will be to replace the SDR within the IMF with a more stable basket of currencies, based on GDP.
The last phase will be to create an international or universal currency.

Both are positive signs that came out of the G-20 meeting and will move us in the right direction.

ND – 05/02/2009

The Global Economy

Overall, the global economy is showing signs of recovery or stabilization in certain regions.
China and India are both growing, even though at a slower pace. The question is whether Brazil and Russia, as part of the BRIC countries, can keep pace with their counterparts.

The US is certainly not recovering yet and I do not foresee stabilization in 2009, let alone a recovery.

Europe is holding up pretty well, as is the UK but time will tell whether they also can emerge from the current global recession.

Japan is worrisome because of their budget deficit and they may very well slide back into a deflationary stage unless they can find the financing to recover economically.

What is very interesting to note is that the small economies around the globe are holding up very well in this climate. One would think that they would be more vulnerable to such an economic tsunami, but yet they sustain the wave and do not seem to be in a very distressed situation, unlike the 1997-1998 Asian crisis.

On an overall note, the positive signs are the stable interest rates in the UK, the Euro zone and Japan.
The second positive thing is the decrease of the 3-month LIBOR to 63 Bp and the closing of the spread with US prime and the Fed. Funds rate.
The latter is positive in the sense that this is an indication of the thawing of international and secondary credit markets for the near future.

Some predict that the globalization process will contract and the world will become smaller. I disagree with that. I think that globalization will continue to expand but I agree that there will be a major shift towards other economies around the globe and the end result will be a less dominant effect of the current large economies, i.e. the US and Japan.

ND – 05/04/2009

The Inter-Currency Markets

There has been a lot of volatility lately in the currency markets.
What is probably most notable is the volatility and continued weakness of the USD versus the Euro.
We currently stand at an exchange rate of 1.42 and do not seem to be able to support that level.
Expect to continue to see a further weakness of the USD given that interest rates will remain steady in Europe for the time being.

Versus the JPY, we trade at a rate that fluctuates between 95 and 97 to the USD. While it would be in the best interest of Japan to have a weaker currency right now, this strength is also very influenced by the continued carry-trades, as I have mentioned in previous newsletters.

As I mentioned before, it becomes increasingly important to follow the parity fluctuation between the Euro/JPY. Such will give us a very good long-term view on how things will unfold.

The Yuan-Renminbi story is very different and very interesting to follow as well.
Instead of succumbing to the pressure of the US Gov't to de-peg their currency from the USD and let if float freely, which would put less pressure on the trade deficit, the Chinese opted to sign swap agreements with multiple countries.
This does two things for them:
-It makes the Yuan-Renminbi much more convertible than before.
-It allows them to diversify their reserves and be less dependent on US Treasury investments in the future.

Whichever way we call it, the weakness of the USD versus other currencies is sure to become a game of chess, and it may also pave the road to a change in the way we see the inter-currency markets.
We are on the road to change the SDR as we are on the road to diversify the current USD reserves with foreign Governments.

ND – 05/03/2009

The Housing Market

Each time I read the newspaper and see the headlines “Now is the time to buy!” I cringe. I do not believe that such is the case.
We continue to see a deterioration of the housing market for a variety of reasons.

-The number of foreclosures and short sales.
Even though the number of home sales increases on a monthly basis, such figures encapsulate an ever-increasing number of foreclosures and therefore distort the real data.

-The number of shadow inventories.
As more homeowners walk away from their investment and return their properties to the lending agencies, the higher the risks of the impact of such shadow inventory. We cannot realistically estimate what such inventory exists of, nor can we estimate what such may mean for the real fair market value of the existing real estate market.

-The default rate.
While in 2007-2008 we saw defaults on existing loans primarily happening in the sub-prime loans and the ARM loans, today we see an increasing number of regular fixed mortgage loans going into default because of the creation of negative equity.
We commonly refer to the holders of such loans as “mortgage walkers” and I have written about this new phenomenon in the past.

-The fake inventory data.
I know that real estate agents and brokers are not going to like this, but reality is what it is. We, as analysts, derive our data from a variety of sources, including MLS (Multiple Listing). I have noticed a trend whereby sellers report a sale on MLS on the closing date while there was no active listing prior to the sale. On a few occasions, an active listing for the sold property was created 24 hours AFTER the sale transaction was posted on MLS. This distorts the data when used to calculate the amount of time said property was offered for sale and it affects the data to calculate the real inventory figures.

-The rise in mortgage rates.
While at the beginning of 2009 we have seen a gradual decline in mortgage rates to a reasonable level of 4.5% and we expected this rate to continue to decline even further to stimulate the housing market, we have seen a very fast rise in the last 6 weeks.
The 30-year fixed now stands at 5.25% and will continue to rise.
The reason for this is dubious, to say the least. The Gov’t, as mentioned before, wanted the mortgage rates to decline as a natural stimulus to the housing market. However, because of the large amount of borrowing and issuance of new T-Bills, T-Notes and T-

Bonds, the rates for such had to be reset in order to entice foreign entities to continue to buy our debt.
That has resulted in a fast steepening of the yield curve, with the 30-year yield now at 4.56%. This of course has an impact on the mortgage rates.
Keep in mind that this year alone, the US will have to refinance 2.4 trillion USD alone just to repay the existing debt and that this figure does not include the 3.5 trillion USD for next year's budget.
Combine that with the fact that foreign entities are diversifying their investments, away from the USD, and you can picture where the yield curve will end and therefore the mortgage rates.

Not a pretty picture for the housing market?
Maybe not, but it is realistic.
I do not predict doomsday and I am certainly not a fatalist, but I am a realist who dares to call a cat a cat when I see one.

So what will the future bring then?
In my opinion, we will continue to see rising interest rates and therefore rising mortgage rates, neither one of which will support the weak housing market. Housing prices will continue to decline until we find the true bottom, probably another 5 or 10% decline, depending on the region.
Until then, we will not stabilize nor recover.
On a last note, do not expect the housing market to skyrocket in the near future. These days are over for good. A rise in home prices by a mere 5% annually will be considered icing on the cake. Any higher increase is unthinkable and should be viewed as a sign of unnatural growth.

ND – 06-01-2009

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