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Quarterly Newsletter
January 2009

Welcome

Dear Reader,

Another year has gone by fast and a very eventful one at that, just to say the least.
So what will 2009 have in store for all of us?
We will try to answer that question from a variety of different angles in this newsletter.
It is obvious that the housing market continues to play an important role in our economic recession, but so are the global economic slowdown as well as the credit markets and the new threat for this year: the commercial mortgage backed securities market.
We will examine each aspect and paint a picture for the year to come.
It may not look very rosy at first, but we will also put into perspective the positive signs that will ultimately lay the groundwork for economic recovery.

Happy reading,

Nick Doms

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Economic Outlook

The past year has been difficult and we have watched our economy slide into a serious downturn. What I personally find ironic is the fact that while some of us knew that we were on the verge of a serious recession in the summer of 2007; it took more than a year for people to start realizing that.

But, I am not going to re-hash history, nor will I pretend that my vision in hindsight is 20/20. Instead I will share what I see happening for this year and the next few years to come.

At the time of writing, we have not seen the GDP figures for the 4th quarter yet. My estimate is that we will look at a serious negative growth for the quarter, to the tune of minus 5%.

What we do know is the unemployment rate and that gives all of us an indication of what is to come.

We started 2008 with an unemployment rate of 4.5%. We ended the year at a rate of 7.2%. While these figures worry me from a short-term perspective and they are high in comparison to other industrialized nations, it does not factor in the artificial postponement of unemployment.

What does that mean and how does this work?

I believe in pure mathematics, economics and data analysis. That also means that when I look at charts and figures, I know how easy it is to manipulate the real data and change the outlook temporarily.

We know for a fact that the unemployment figures at year-end were not accurate and did not include the unemployed whose employment ends on January 01, 2009.

That means that the true data, which will not be released until February, will be far higher than the announced 7.2%.

My prediction for the New Year is that unemployment will continue to rise to 10% or higher, depending on whether the automotive industry survives.

Retail sales at year-end and during the holiday season have been written about and documented as reasonably good.

We cannot measure the success of the retail industry by the number of people walking in the mall. We have to measure by real empirical standards if we want to get a real sense.

Consumers purchased goods over the holiday season but at very deeply discounted prices and less than the years before.

Secondly, they purchased their goods with plastic instead of cash.

And, lastly, they did not purchase gift cards as usual.

All three factors have a major impact on the economic outlook for the retail industry because it directly impacts the projected revenue stream of such companies.

The financial industry continues to de-leverage their balance sheets and restructure but does not extend any credit to start and revamp the investment market. Of the total 350 billion currently spent, not one USD has found its way to the economy. The remainder of the rescue package will travel the same route in 2009: into the balance sheets but not where it belongs and can make a difference to revamp a slumping economy.

The proposed tax rebate, to be implemented early this year, will not have a positive effect on our economy, independent of whether we sell the idea as “a much needed stimulus”.
Any rebate amount will only serve one purpose. It will partially offset the consumer credit card debt that was created by buying presents they could not afford and, as the first “stimulus” package, will not increase consumer spending.
The only difference is that we now put 1 trillion USD at risk in addition to the current deficit, which brings me to the next observation.

It is obvious to all that we do not have the funds to pay for such a “popular stimulus package”, so we will have to either print it or borrow it.
If we print it, we dilute the value of the USD even further and we will have to sign ever-larger swap agreements with the ECB and the BoJ. In my opinion, that does not make sense and represents a large risk for the long-term future of our economy and our exposure.
If we borrow it, then we must take into consideration that some government institutions are making plans to invest their reserves into more favorable investment vehicles with a higher rate of return, rather than continuing to purchase US-Notes and US-Bills at auction.

The outlook for 2009 looks worse than the past year. However, if we can weather through the storm this year, we will be able to recover or at least start in 2010 with a vision for a stronger economy in 2011.
We will have to make some intelligent decisions in order to do that.

The best solution is to start focusing on stimulating the supply side of our economy, instead of the demand side. Without support for the manufacturing and service side or corporate America in general, we will only apply a temporary band-aid instead of implementing a cure.

ND – 01/05/09

Global Economy

Needless to say that our global economy has seen a serious decline and contraction during 2008, from the US to Europe, Asia and Japan.
While we wait for the final 4th quarter GDP figures to be released, we expect a dramatic drop and negative growth across the board and one that will continue during 2009.
No matter where we try to look for a rosy and immediate future, we continue to see serious problems occurring.
Just take the Chinese economy as an example. In one year, their GDP growth declined from 11-12% annually to a mere 4% growth.
While this, in essence, still looks a lot better than other economies, it is something to follow very carefully.

So, where and when will the road to recovery start?

While it is being asserted that since the US was the first to fall into recession, we will also be the first one to emerge, but in my opinion this will not be the case or at least not from a practical and global perspective.
Europe is suffering from a serious recession and is one of our largest offset and export markets. So, just as one example, if Europe does not recover, then neither will we.
The same argument can be made about other continental economies as well.
We are so intricately connected that the global economy has to be fixed in order for any domestic economy to recover.

Now I will go back to my favorite saying: the entire sandbox has to be stirred, cleaned and raked.
That means we are either going to find a global solution so we all benefit or we will prolong the pain we are currently in. Central banks across the globe will have to implement a solution to stabilize the financial markets and restore the international credit markets.
This has to become a concerted effort and can no longer center around individual monetary policies.
The solution will lie in the establishment of a global monetary policy and oversight instead of a continued continental approach.

ND – 01/22/09

Inter-Currency Markets

Watching the currency markets in 2008 reminds me of the currency crisis of 1993 and 1998.
Does anybody remember?
In 1993, the GBP and ITL were priced out of the then existing EMU system without warning.
In 1998, most Asian currencies were under so much pressure that their interest rates went sky-high just to defend their trading bandwidth.

Today we can see the same scenario but yet in opposite directions, which makes it even more interesting to watch and follow.
Smaller currencies seem to withstand a weak USD very well, at least so far. That should be questioned in 2009 because a small economic balance sheet can only sustain so much defensive pressure.
The Euro has jumped up and down at a faster pace than a Yo-Yo, going from 1.60 to 1.24 and back somewhere in the middle.
The GBP movements were even more dramatic: from 2.02 to a mere 1.34 and hardly sustainable at this time.
As I have mentioned before, the currency to watch closely is the JPY.
Last year the JPY came close to it's all time high of 86 (back in 1993-1994). Today we are trading in the 90 range, which is still strong given the lower interest rates in Japan.

Anyone interested in the international currency market should very closely watch the parity between the Euro and the JPY. I know I have mentioned this before, but in my opinion that is where the credit dilemma, the currency disparity and ultimately the global economy is going to get played out.

Behind all these fluctuations and currency tensions, lies a very logical explanation.

It is not because of the economic slowdown, per-se, but because of the solutions that are being implemented across the globe to save the international financial arena that really affect the currency markets worldwide.
It is called: Financial Nationalism.
I will elaborate on this concept later in the newsletter.

ND – 01/21/09

Housing Market

The housing market has now been in a crisis since mid 2007 and the new year will not bring any change soon.
The market is still overvalued by 10 to 15%, depending on the region, and independent of all the interventions that were implemented, we have still not found the bottom yet.
Besides lowering our Fed. Funds interest rates to almost zero, providing a stimulus package, saving the homeowners that could not read the fine print properly, we are now trying desperately to keep everybody in their home. Not by adjusting their interest rate, but by adjusting their loan amount.
Independent of where these measures may lead, it will ultimately raise a very important question.

If the housing market tumbles by another 15% across the board, will the financial institutions be able to sustain such a decline on their balance sheets and will the secondary markets, with barely any liquidity, be able to absorb another decline.

In my opinion, the answer is no, absolutely not and definitely not in the current environment.

So then where will the ultimate solution be?
Exactly where it was to be found from day one: let the bubble burst until the air is out and the realistic bottom is found. Let the properties that risk foreclosure go into foreclosure without further intervention. Let the sellers either decide to bring down their demanding prices and sell or let them hold on to inflated prices ad infinitum.
Let the inventory stay where it is for a while and over time it will slowly be reduced in an orderly and justifiable manner.

I know and understand that this is a very tough pill to swallow, but it is the shortest and most logical way to a rational and speedy recovery.

The next danger from a real estate perspective and by far more dangerous than the personal real estate market is the commercial real estate market.

A trend is starting to appear in the secondary CMBS market (Commercial Mortgage Backed Securities) that alarms me for the remainder of this year and into 2010.
The liquidity in the market is drying up and has found its way into the primary market.
What is disconcerting is that this time we are not looking at possible foreclosures of personal homes with values of 300K or 600K, we are looking at several billions in value that may and will go into default.

Not only that, the buyers who may want to step into the market, cannot find sufficient funding to ensure a purchase because financial institutions are not willing to lend except with conditions attached that can either not be met or I find unreasonable and not economically viable from an investment perspective.

Taking this thought to the next event that I foresee happening is: private investments, owner financing and private loans.
While in essence there is nothing wrong with such an alternative, it should at least raise a certain alarm bell given that such lending market is again synthetic and unregulated.
We should ask ourselves, what if, then what?
We have certainly witnessed unregulated markets and we should have learned our lesson by now, or so I hope.

To end, I will mention one thing however as a personal note.
The downtrend in the real estate market has eliminated many of the real estate agents that never belonged in this industry to begin with. I have since dubbed them as the “Barbie and Ken agents” who looked cute, talked fast but had no knowledge or understanding, except for looks and clothes.
Today we have fewer agents and brokers but they are not only knowledgeable about real estate, they also understand all of the driving forces and markets underneath. They are versatile and serve as advisors for loans, structures, insurance etc.
That is what we needed as well.

ND – 01/10/09

Financial Nationalism

A new trend has been creeping into our markets and economy over the past year.
This phenomenon is new to all of us and we are not sure what the ultimate outcome will be.
From a historic perspective, we have always been used to the idea of our capital and financial markets to be financed and managed through private and corporate capital while under the regulation of government institutions.
Today however, our corporate world is not only regulated by supervisory agencies, it is now also owned by the same entities, hence my reference to financial nationalism.
This new phenomenon is not really new at all and is actually the result of a road we paved as a society many decades ago.
Purely looking at the US, we started paving the road to socialistic capitalism or capitalistic socialism, whichever term is more applicable, back in 1932.
During the Great Depression, when inflation and unemployment rates were high, the government, through the initiatives of FDR, did not directly intervene in the capital markets. Instead, they created social programs to revive an economic disaster with the purpose of restoring faith and trust in a system that had failed and was in disarray.
The creation of social programs such as welfare, healthcare and social security, helped to restore such trust and was called the beginning of a new economic era.
Fifty years went by and again our new economic era was under siege and needed another rescue plan.
This time the solution came from government guarantees on depository holdings, bank accounts and savings accounts through the creation of FDIC and SIPC, again to restore the people's trust in our financial system.
Thirty years went by and passed, including the partial breakdown of the EMU (at least temporarily), the Russian crisis, the Asian crisis and the dot.com bubble. Our government or governments worldwide did not intervene directly in either case.
Last year, we saw a completely different approach across the globe with the US leading the way for the rest of the world to follow blindly.
Our social programs of the 1930s had failed, our government guarantees of the 1980s had failed and still we were facing a serious financial and economic crisis. Only this time, because of continued globalization, which started with the implementation of the Marshall Plan in 1947, the problem was no longer containable within one continent. It spread throughout the entire international financial markets.

While we witnessed our own financial world crumble and being at serious risk, we realized two things:
-Our regulations were poorly enforced and needed revisions.
-Our creation of synthetic markets were uncontrolled and unsupervised.

The first action to take was to find out what the ultimate fall-out would be for other economies, given the fact that we had wrapped so many loans in one shiny basket, we did not even know what the value or content was, nor did we know who ultimately held the potential exposure.

The next step in the process was to find out how we were going to value all the long-term paper while the secondary market could not give an accurate valuation anymore.

Let me pause here for a second to explain the valuation process in the secondary market because it will ultimately explain why we ended up with financial nationalism.
When a synthetic OTC market is created, it is purely driven by supply and demand. As long as there is liquidity in the market, we end up with a fair closing price of such paper.
However, given the fact that the secondary mortgage markets pertain to long-term investments, that automatically means that the traded investment consists of an intrinsic value (based on the underlying mortgage or loan) and a time value (based on the terms and duration of the loan).
Because the markets are OTC, they cannot and do not take into consideration the time value, only the intrinsic value as based on daily volume and liquidity.

Now, we are getting to the nationalism.

Each asset held by US banks and worldwide, lost its theoretical value because of the lack of liquidity, not because of reduced time value.
When the US Treasury proposed to Congress to approve the TARP, their intention was to purchase such depleted assets from banks to strengthen their balance sheets and thereby keeping them in line with the enforceable capital ratio requirements.
The banks, in turn, lobbied the SEC to temporarily suspend the “Mark-to-Market Rule” which in turn would have allowed them to artificially inflate their on and off-balance sheet assets without taking into consideration the daily closing price of the synthetic market.
Such action, which was not approved, would have resulted in TARP paying a premium to our financial institutions and taking on even more risk than we face today.

Instead, the US Treasury decided not to buy troubled assets from the banks but to inject capital directly into the financial industry in exchange for preferred shares or warrants with a guaranteed dividend payment of 5% for the first 3 years and 9% afterwards.

With the first 350 billion spent and invested in most of our national banks, the US government now owns a very large portion of our financial industry as well as our entire automotive industry, let alone AIG and all the other companies that are standing in line for the next distribution: credit card companies, car rental companies, etc.

As a recap, we changed our policy from implementing social programs, to insuring bank accounts, to actually owning the companies, over the course of less than 80 years.

But the story does not end here.

Since our government now owns all these assets, they have to park them somewhere.
So, the FRBNY (Federal Reserve Bank of NY), has established three separate Special Purpose Vehicles (SPVs) named Maiden Lane I, II and III and has placed the management of such assets under the care of a public investment management firm (Blackrock).
Why can this pose a problem and exposure?

The exposure does not come from the appointed investment firm. It comes from the fact that the US Law does not currently have any provisions to rule or regulate SPVs under our Common Law, independent of whether the FRBNY holds and reports such acquired assets on their balance sheet. For more information regarding the actual reporting, you can log on to www.federalreserve.gov/releases.

This phenomenon is not unique in nature to the US. It has spread in popularity to the entire world: Iceland, Ireland, the UK, and Continental Europe.
The first sign of financial nationalism actually found its roots in Japan in the early 1990's.
Anyone familiar with the duration and depth of the Japanese recession this caused in the aftermath, should follow very closely on how we will manage all our assets and for how long.
Personally, and looking at the track record of governments in general, I would not trust them with my assets.
After all, I have contributed to the SSA for 17 years only to receive a quarterly statement that informs me that my "theoretical restitution" based on contributions will be the maximum, but that by my time of retirement, they will not be able to send me a check.

So much for nationalism and social programs.
I think I want to go back to pure capitalism and take care of myself.

ND – 01/24/09

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Headlines

Religion Thrives in Bad Economies

While people all over the country feel the pinch of the recession, it seems that no money is lost on religion, candles and miracles.

This is not a new thing since history has showed the same occurrence since, well since religion was invented.

But this time, I think we have an opportunity to implement some efficiency.

You see, instead of paying someone to mail the tithe envelopes, collecting them manually each Sunday, open them, count the contributions, write the deposit slip and run to the bank, I think it is time to implement a 21st century solution.

Someone should stand at the church entrance each time mass commences with a credit or debit card swiping machine.

When entering, each church member will present a VISA, MasterCard, Discover or, for the elite, an AMEX card.

One would then enter their PIN number and a receipt will be handed out for tax deduction at the end of the fiscal year.

Each swipe would represent one electrically lit candle in front of the statue of a saint of their choice. Such candle will only be lit part of the day, to save energy, but will still be considered a request for a miracle.

Each platinum card tithe will represent two candles that will burn alternately, to save energy, but will count as two wishes for a miracle.

Candles may be traded during officiating hours on the secondary market as long as the bid price is equal or higher than the asking price.

An official closing price will be established at the closing of the ceremony and will serve as the opening price for the next Sunday.

During the week, no trading will be allowed except on pink sheets and OTC only.

The Church does not take any responsibility and will not admit any wrongdoing in the event of insider trading, price fixing or market manipulations.

In case of a dispute, the Vatican will act as the regulatory body to settle such disputes at its own discretion and its decisions will be final.

I will act as a personal and independent consultant without prejudice in this matter.

ND – 01/25/09

**Do not let your past
Dictate who you are.
Allow your past
To be part of who you can become.**

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