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Quarterly Newsletter
January 2010

Welcome

Dear Readers,
Let me take this opportunity to wish you, your family and loved ones all the best for the New Year. May you find hope, happiness, health and all other things that money cannot buy but are the most valuable.
Over the past three years and 11 newsletters later, I am extremely pleased and very flattered by the fact that so many international readers have joined us.
The international community that stretches as far as Japan, Australia, China, Russia and Europe now make up 40% of our readership.
I hope this trend will continue to grow in 2010 and beyond.
Thank you for your continued interest (including the silly headlines) and please do not hesitate to contact me with questions, comments or suggestions through ndoms@sirudorealty.com or ndoms@gppllc.us.

Happy reading.
Nick Doms

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Economic Outlook

Another year came and went by but I believe that a lot of people are breathing a sigh of relief and are glad they are still standing.
2009 was by no means a year with calm seas and a slight enjoyable breeze, on the contrary. We certainly saw are ups and downs, and the downside we witnessed in March of last year should not be ignored nor forgotten.
The lesson to be learned is not that we are on the path of recovery and from now on everything will be fine and business as usual.
If such is the case, then you are still wearing your rose-tinted glasses from New Year's Eve when you read this.
My advice, take them off and put them away somewhere safe. Maybe next year you can put them back on for one evening, we'll see.

If 2009 has taught us an important lesson, it is that while the seas can seem calmer and the waves are not pounding the shores as was the case in 2008 and the first quarter of 2009, it can still be very tricky to take the boats out.
The surface can be tempting, but the undercurrent exists and can easily sweep you off your feet.
We have seen and experienced some form of stabilization in certain market segments such as commodities (primarily oil and gas prices), retail and the housing market and I do not ignore the positive side of such.
In my opinion, this year is not the time to become euphoric and go back to "the good old days". This is a time to realize that an equilibrium can and is a very unstable and easy to disturb condition except when built on a solid foundation.
Think about it this way: when I want someone to walk on a rope, which I lay out on the floor, most people will easily walk it, but when I stretch the same rope between two buildings at 100 feet high, most if not all will fall, hoping for a safety net.
The US is in exactly the same position. We saw a positive GDP in the latter half of the year, a bounce in retail sales (although minimal) and a reduction of home inventory levels.
On the other hand, we still struggle with high unemployment (officially 10%, unofficially 17.5%), a continued budget deficit and an ever-increasing debt/GDP ratio.
In my opinion, the positive signs will be short-lived unless we are willing to tackle the negative sides above, which are hanging over our head like the sword of Damocles.
One can pray it will never fall, but it will, no matter how many candles we burn asking for a miracle.

So, how should we proceed in 2010 and further into 2011?

One thing we should never do is simply turn the page and start writing again without the lessons from the previous years.
In order for an economic recovery to take effect we should focus on the following existing problems:

-The Fed. will have to drastically reduce its balance sheet and orchestrate an exit strategy in an orderly and timely fashion. Such is possible given the fact that Private Equity capital is sitting on the side lines, primarily invested in 1-3 month T-Bills, and ready to step in, toe first.
The current proposal to start and continue with reversed repos will not have the expected positive effect they hope for.
This coordinated effort will ensure that the Gov't resumes its role as regulator instead of being an ATM for all. It will also keep the market liquidity at current levels and will not have a negative effect.
-The Gov't will have to focus on their fiscal deficit first. This can only be done in two ways, neither one of which will find a positive reaction among the public but patients do not write prescription drugs either, the doctor does and we swallow if we wish to get better. The time has come. No more "cash for clunkers", no more "tax credits", no more "cash for caulkers" and forget about funding to study the behavior of the black bear in Nebraska. Put the money where it counts: repayment and reduction of debt.
-The Gov't and the US Treasury in particular, will have to focus on reducing our outstanding debt, which we can no longer comprehend mathematically. A good math teacher will tell you that if you do not know how many zeros fit into an amount, you should play with smaller figures.
-Unemployment figures have to stabilize and we need to see job growth. The problem is that we do not have a much-diversified workforce and we are losing know-how in comparison to other economies.

If we do not start focusing on these issues then I can almost guarantee that the US will sell whatever it has left: LAND and we have plenty of that.

2010 can become a turnaround year or at least a continuation of some sort of stable ground to begin with.
The danger that lurks around the corner though is not inflationary pressure, at least not immediately, but there is a looming risk of deflation.
It seems that this word has been banned from the US dictionaries, but I'll gladly reintroduce it at the beginning of the year and will continue to write about it.

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The Global Economy

We have definitely seen some hick-ups across the globe in 2009 that caused a panic reaction throughout the markets. Such was short-lived and most probably exaggerated but when you live in a very fragile and unstable environment, one stray bullet from far away can easily resonate as an immediate and imminent attack on local markets and economies.
With the CMBS markets still in turmoil, the announcement of Dubai World certainly caused more than just a little ripple effect. The US markets were spared from the initial reaction because of the Thanksgiving Holiday and by the time the markets opened again for an abbreviated session the next day, most of the panic was contained and had subsided.

The second event occurred in the Euro zone, when the rating agencies announced a downgrade of Greek Gov't debt to BBB+ because of their high debt/GDP ratio and high unemployment. This led every analyst to put Spain, Italy, Ireland and Portugal on their radar screen for close monitoring and potential downgrades.

From a global economic perspective, it certainly puts into question the cohesiveness among the Euro participants. Nobody doubts that either one will be forced to leave the Euro zone, but the question is whether the EU has the stamina to make these countries adhere to the Treaty of Maastricht.
The second question is that if Europe starts showing cracks in the system, what impact this may or can possibly have on the inter-currency markets and the US economy in particular.
I do not predict a high and sustainable GDP growth in Europe for 2010. If there is any positive growth, then it will be minimal at best and will fade in the shadow of an ever-increasing budget deficit among a multitude of participating countries.

The US does not fare much better, independent of a projected 3% GDP growth in 2010, which again fades in comparison with our fiscal deficit and total outstanding debt. The continuation of existing social programs and the creation of new ones in the form of stimulus or healthcare reform will again have a negative impact on economic recovery.

To add a little more news on top of this, Japan is quietly struggling with their budget deficit. While in the past Japanese investors purchased most of the BoJ bonds, such will no longer be the case going forward. This means that the BoJ will have to find foreign investors to start bidding at auction, which is precipitous to say the least.

So, who in the world are the Clydesdales that pull the economic wagon?

Needless to reiterate that India and China will again take the lead in 2010 with continued positive growth even though I indicated in my last newsletter that their models will need adjustment and diversification going forward.
It may seem that Brazil holds its ground for the short-term, but it still has negative GDP growth to deal with. I do not foresee Brazil to continue to be a strong partner in the BRIC countries.
Russia may become a problem but this will primarily be influenced by a potential change in the socio-political environment, i.e. Medvedev versus Putin or both.
One thing to consider is the possible inclusion of Indonesia and we will commonly refer to all of them as BRIIC countries.

Australia surprised the world by increasing their short-term interest rate with 25 Bp, the first country to do so during a continued economic crisis. Maybe we should pay close attention and follow suit in a careful and planned fashion.

Overall, the global economy will continue to struggle and faces some serious challenges, one of which is to combat deflationary pressures while preparing for a potential inflation at the end of 2011 or beginning 2012.

The problems we are facing may not be as severe as the prior two years, but self-control and a reduction in spending will be key to maintaining the vulnerable equilibrium in order to ensure future growth at sustainable levels.

If this crisis has taught us a lesson, then I cannot stress enough that global cooperation will be needed to move economies towards a new phase of global integration. The streamlining of possible solutions should take precedence over continental protectionism. That includes a global regulation of international financial markets as well as regulatory oversight of financial conglomerates, holding companies and offshore SPVs.
Add to that a dedicated approach to renewable energy resources rather than a continued reliance on fossil fuels, and we may see a new era.

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The Housing Market

During late 2009, we have all seen, heard and read the positive signs trickle into the overall housing market. Inventory levels have gradually been reduced to an almost normal level and have come off their peak of 11.5 months worth.
Existing home sales are slightly up as are the new home sales.
One of the main drivers is the tax credit for first time homebuyers, which has since been extended to April 30, 2010 and has been expanded to include existing homeowners.
To briefly recap how these two integrated programs work, first time homebuyers can get up to $8,000.00 as a tax credit and existing homebuyers can receive up to $6,500.00.
Please note the connotation of “up to” which means that such credit will vary depending on the home in question.
Secondly, the programs have been extended to April 2010, meaning that a firm and agreed upon purchase and sale agreement has to be in place prior to the deadline in order to qualify. Buyers receive an extra two months to secure a closing and transfer of deeds until June 30, 2010. If both criteria are not met, then the tax credit will not apply.

The residential housing market
With the implementation of the Home Affordable Modification Program or HAMP, it was widely expected that such would have an immediate positive impact on the real estate that was vulnerable and represented a high risk of foreclosure or short-sale because of default by the owner.
However, HAMP has proven to be more difficult than anticipated and for several reasons. Both borrowers that default on their mortgage payments as well as lenders contributed to the slow progress that has been made. Before I go any further, one has to admit that such an endeavor is a complicated task that can be very time consuming for both parties involved.
On one hand the borrowers need to meet the documentation requirements in order for the loan modification process to commence, which is not the case. A large number of initial and subsequent requests are in pending status because of incomplete and/or insufficient disclosure by the borrowers, which only slows down the entire process. In addition, lenders are sometimes bombarded with requests that do not meet the required guidelines and requirements.
On the other hand, lenders are slow in processing requests that meet all the qualifications. Both contribute to the fact that out of +/- 700,000 mortgages currently in trial status, only 31,000 have been approved and processed, well below the expectation level.
Few of the loans in question reduce or forgive part of the borrower’s principal. Instead, such shortfall is simply deferred, which increases the risk of future payment defaults and reduces the incentive to keep up with regular payments going forward.

The slight improvement in the number of negative equity homeowners will prove to be short-lived. Such was the result of a rise of median home prices of existing homes.
A steady and sustainable growth will not occur until late 2010. Until then we will see more short sales and foreclosures hitting the market and again depleting house values.
That does not mean we will yet again be in a free-fall, but the default rate, which has now stabilized around 2.8% is still 100 Bp above last year's level and eight times higher than the level of 2006.

If HAMP becomes more efficient and the jobless claims continue to decline with potentially a slight job creation figure, we might see a sustainable plateau upon which we can build.
The only other kink in the cable may very well come from the FHA and VA, both of which are critically under funded at this time. Without Gov't intervention, both institutions may disappear from the underwriting market at least temporarily and such is based on the assumption that the existing FHA and VA loans do not go into default in large numbers.

The commercial real estate market
A decline of the leasing rate per square footage combined with an increase in vacancy rates has dominated the commercial market throughout 2009.
While worrisome, given the size of the market, I think we should be relieved that we did not have to watch a complete or partial collapse. We were literally standing at a precipice, but such was quietly avoided and we are standing on more solid ground.
The one thing that will not change very soon are the rental prices but I believe we should focus our energy on occupying the empty spaces before we worry about yield.
2010 will continue to be a very difficult year for this specific sector both in the US and abroad.

The mortgage rates
The rates remain vulnerable due to the fluctuations in the yield curve and primarily the sometimes-erratic behavior of the long-term bond. We have not seen such a steep yield curve in a long time and my prediction is that sooner rather than later the entire curve will gradually move vertically upwards.
This will impact the mortgage rates negatively for homebuyers and certainly for those who currently hold an Alt-A loan.
Therein lies another risk for a repeat of defaults but not at the same level as before. Still the housing market will have to be able to absorb such when it occurs.

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Will Big Ben Survive?

If you think you had a very bad year in 2009, just ask Ben Bernanke and he will not just give you a concise and brief description of the term “bad” but will share with you what a living re-occurring nightmare feels like.
Bernanke knew what would hit him when he took office in 2006 even though everything around still seemed quiet and peaceful. He knew what was brewing underneath the surface but how does one go about describing an oceanic volcano that is on the verge of exploding and ultimately disrupt land and sea when there are no visible or even tangible signs.
Convincing economists and academics may be one thing, but try doing the same in front of a senate banking committee and you are faced with a serious intellectual challenge.
I think I would be more successful teaching fractional geometry to a kindergarten class.

But independent of the challenges he faced, there have been some serious missteps that cannot just go by unnoticed.

Rumors of a potential economic crisis started circulating early 2007. The exact scope or magnitude was not defined but it was not until late summer that the first warning bells started ringing, primarily through Ben Bernanke. Instead of clearly focusing on the pending and imminent collapse of the secondary market and the global fall-out, all eyes were directed towards the housing market instead.
The result was the effective strategy of convincing Congress that a monetary easing was the only solution to stop the real estate market from collapsing and so the interest rates went fast and furious until of course we reached zero and the fun was over.

In a nutshell, TARP, TALF and TSLF did not have any real impact, even though the two latter programs seemed very promising but were clearly underutilized. The continuation of the pretext that if nothing had been done, things would be a lot worse, no longer resonates.

Will Big Ben stand in January? Probably but with a lot of skepticism, harsh criticism and serious warnings. The reason for re-confirmation is twofold:
-You don’t switch dogs in the middle of a political race.
-There is no replacement in the bullpen to close out the game.

Mr. Bernanke should enjoy the holidays and prepare for a long and serious frontal attack, after which he will probably lick his wounds for some time to come.
Patience is running very thin and the approval ratings are falling fast.

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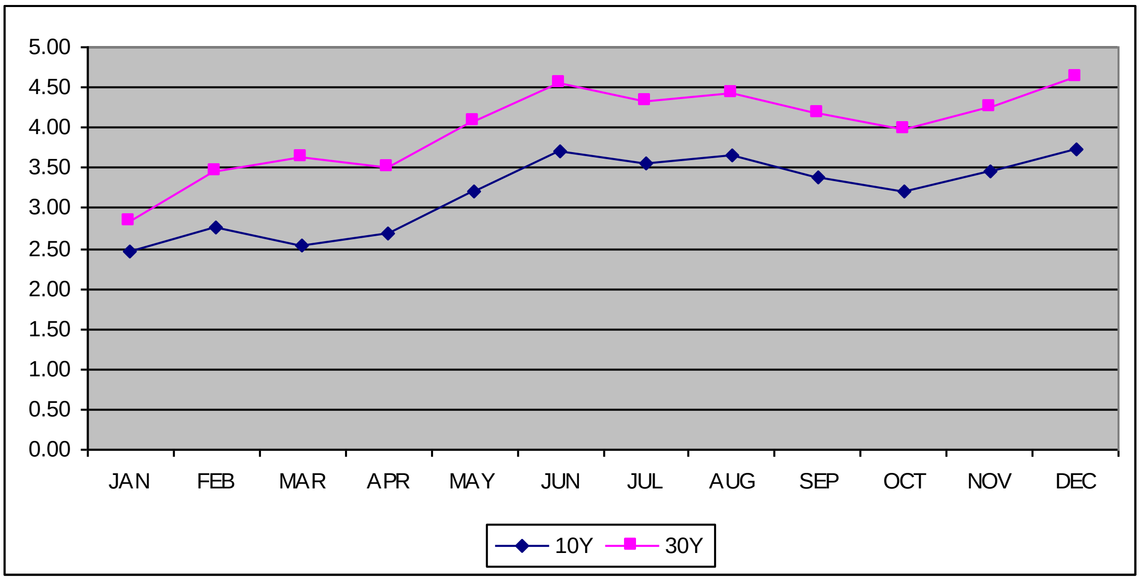
The Bond Market

As mentioned in a previous article, we have seen an ever-steepening yield curve throughout the past year. The graph below puts into perspective the large move upwards in both the 10 and 30-year bonds.
The spread (difference between the short-term yield and long-term yield) has increased by 153 Bps and 177 Bps for the 10 and 30 year respectively.
This is a considerable move for a one-year period.

**UST Yields
2009**



Data Source: US Treasury

While some keep pointing out that this phenomenon is a sign of a pending economic recovery, I do not believe this to be the case in the current environment.
In the old days, yes I know I am a dinosaur of some sort, it was widely claimed that the steepness of the curve was due to the investor's preference for long-term bonds and therefore exuded strong confidence.
Today however, it is not the investor that dictates the yield level but rather the Government's appetite to borrow long at favorable conditions.
The new year will continue this trend combined with a high level of expectation that both mortgage rates and interest rates will go up in the latter half of 2010.
A 30 YR yield of 6% and a 10YR yield of 5% are well within our reach before year-end.

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Headlines

Tan and Tax

Just when we thought all the tricks were out of the Gov't gift bag, there came a new one.
Ladies, if you want to keep up your tan, you will have to pay a 10% surplus luxury tax. Tanning does not pay anymore. Instead it needs to be paid for.
But I have a solution. If my calculation is correct then the Californian Goddesses of Malibu and Venice Beach will pay the entire 3 billion in extra tax revenue in full.
Plus this has another advantage for us mortal Irish-skinned subjects: once the Goddesses are completely tanned, they will need several Botox treatments to get rid of wrinkles and shrinking skin and….yes you guessed it, we have the Bo-Tax for that at the reduced rate of 5%.
My only concern is what to do with a tan from natural sunlight.
Tax or no tax?
Given that Tybee Island has a budget shortfall, my recommendation would be to issue a body sticker for visitors in addition to the car sticker.
When leaving the beach and upon close examination of your skin color, then a tax will be levied.
To be fair to all visitors, the tax amount will depend on what kind of swimwear was worn on the beach according to the following guidelines:
-Fully clothed: no tax
-Full bathing suit: 5.00$
-Regular bikini: 10.00$
-Bikini with thong: 20.00$

For the men only two price categories apply:
-Boxer shorts: 10.00$
-Speedo: 20.00$

Who will volunteer for these close and personal examinations?
Not me, thank you.

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