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Quarterly Newsletter
July 2008

## Welcome

Dear Readers,

Another quarter went by so fast and it did not look very pretty either.
I tried to keep the articles focused on what is really playing out in the market together with some general information that I think you will enjoy and find useful as background information.
As always, please feel free to contact me with any questions or comments.

Enjoy,
Nick Doms

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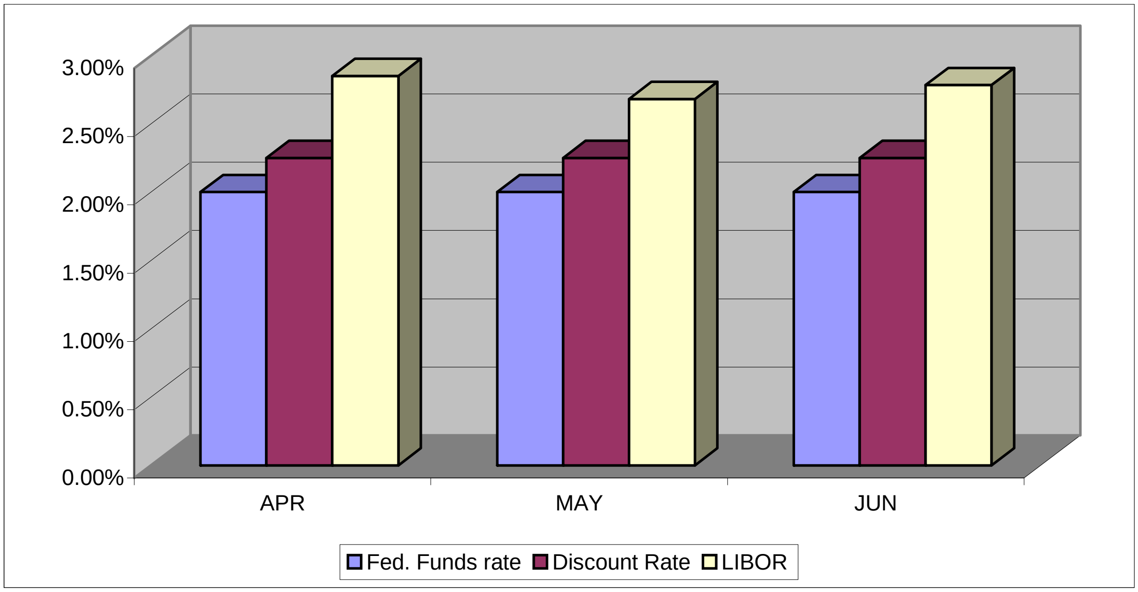
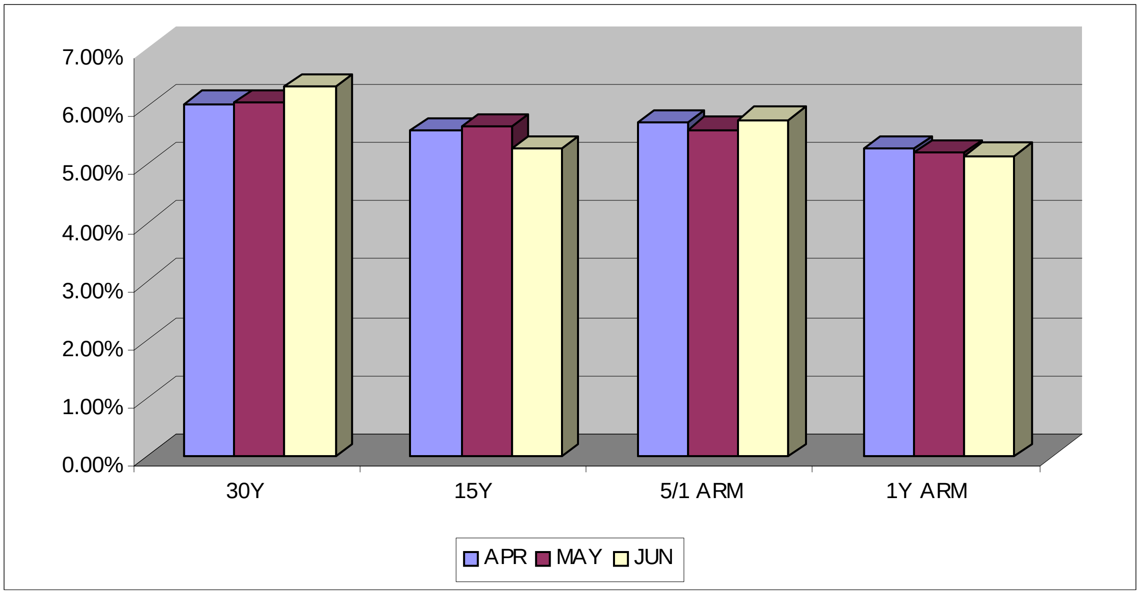
# Graphs

**Short-Term Interest Rates**




**Mortgage Rates**





# The Credit and Liquidity Markets

As we move into the latter half of the year, we continue to see a serious and prevailing credit crunch, not just in the US but globally.
Even though the Federal Reserve has worked closely with the ECB, the BoE and other institutions to inject liquidity into the markets, not a lot has changed.

We have now reduced our short-term interest to 2% from 5.25% a year ago.
We have initiated TAFs and TSLFs to allow banks more access to borrowing power.
We have extended the borrowing terms to 90 days.
We have opened the Federal Reserve window to investment banks and have granted them the same access to capital as commercial banks.
We have lowered the collateral requirements and now accept any kind of paper as collateral for banks to borrow government funds.

Yet, the credit crunch persists and the liquidity in the secondary market is still at a low.

Why?

While we have seen capital injunctions from foreign investors into our banking system, multiple write-offs for bad loans and earnings being placed into reserve for future write-offs, we are still not seeing a recovery.

The reason for such is complex but can be addressed by two major components:

1) The financial institutions are still not finished writing off their balance sheet leverage. They cannot sell their leverage in the secondary market, therefore the only remaining solution is to continue to write off their losses and put earnings into reserve. That is a very bad sign of what is to come for shareholders.
2) The banks who now have more than ample access to government money through auctions, the Federal Reserve window and other relaxed borrowing restrictions, are just not borrowing money. This creates a credit crunch, which has a ripple effect on the primary and secondary mortgage market.

The other side effect that now comes into play is the de-leveraging of on and off balance sheet exposure. A perfect example of this is Lehman Brothers who for the last few weeks has been trying to do just that. What is important about this is the fact that the more our financial institutions try to de-leverage their balance sheet, the less earnings they will generate and therefore the less they are willing to borrow at the “Window” hence contributing to the existing credit and liquidity crunch.



We have put ourselves in a very tight and precarious position, not just here in the US, but now it has a ripple effect across the global markets.

While some may still think that this "little" problem started with sub-prime loans, please think again.
Sub-prime loans made up approximately 3% of the total outstanding loans in the secondary market. Hardly anything that can cause a total meltdown.
The problem was and is the fact that we created an artificial structured product market where we re-packaged the sub-prime loans with other mortgages and sold them to the world as AAA paper.
For years, our financial institutions have made generous benefits by doing so and have passed on the little package to other investors.
In essence, we sold a nicely wrapped gift without telling anybody what was really inside.

The solution to the problem is for banks to start using the available credit and to pass it along to their customers.
Neither the Federal Reserve, nor the ECB, independent of how much liquidity they try to create in addition to what is already available, will make a difference.

Banks will now have to make up for their mistakes and the customers are waiting patiently…but not for much longer.

ND – 06/12/08



# The House of Cards

A lot has been said about our financial system, the sub-prime market and more recently the commodities market, primarily oil of course.
When I analyze our financial system, I can't help but compare it to a house of cards.
When you shake the table or blow on one of the cards, the whole structure comes down or is under pressure.
That is exactly what we are witnessing today. Our systems are under pressure but that does not mean we should all panic and have a stress attack. We just need to understand the underpinnings of our own system and then fix it for the future.
For argument's sake, let's just look at how the different components of our markets were created and how they continue to exist. I'll also try to explain where the underlying problem is and how we may be able to fix it.

1) **<u>The Stock Market</u>**

Sounds very simple and everybody understands it since most of us are invested in stocks directly or through mutual funds, ETFs or I-Shares.
However, one of the fascinating things is that our markets are based on the theoretical principal of "constant equilibrium".
This means that the market can only exist if there is a one-for-one parity at all times. Any disruption of such will automatically result in trade halting and non-execution of manual or electronic trades.
For that purpose and in order to maintain this equilibrium at all times, we assigned market makers to execute trades at the best price possible for both sellers and buyers.
However, at the same time, and in order to achieve such, we also allowed the same market makers to take positions in the stocks they were and are allowed to quote and execute.
This is where the vulnerability sets in.
One person is responsible for fluid and rightful execution but at the same time can become a counterpart for any purchase or sale and therefore take positions in the stocks they list.
That, in and of itself, can at any point in time cause the system and the fundamentals to be questioned.
If a market maker has a mandate to execute trades on behalf of buyer and seller and at the best price possible, but at the same time has the right to act as a counterpart on either side of the trade, then what would be the best possible price? And for whom? The buyer, the seller or the market maker?
The solution to this would be to strictly regulate the market makers and not allow them to take positions in the stocks they sell. Instead, there should be a clearinghouse, similar to the options market that would act as a counterpart for all buyers and sellers. This clearinghouse would be a neutral party under the supervision of the SEC.

**2) <u>The Bond Market</u>**

The bond market is slightly different because it is so influenced by weekly or bi-monthly auctions and subject to the behavior of prevailing interest rates in addition to the strength or weakness of the USD.

Yet, in essence, it is quite similar given the fact that market makers are allowed to first “make a market” and at the same time are allowed to take positions to offset a buyer or a seller.

The same regulation should apply.

In addition, the underwriters of auctions should not be allowed to create the “gray market” afterwards and should only be allowed to trade either in the primary or secondary market.

**3) <u>The Stock Options Market</u>**

Stock options trading is very different from the equity markets in many aspects. The main difference is the existence of a clearing house that issues contracts to buyers and eliminates contracts for sellers.

The underlying driver for stock options is the variance in price of the stocks in question, but there is no one-for-one parity since the open contract volume fluctuates on a daily basis.

The second characteristic, which is unique to options trading, is the sheer volume and the size of the market in general.

**4) <u>The Commodities Market</u>**

Compared to the options market, the commodities market is very small. It is like comparing an ocean (options market) to a pond (commodities).

The driving factor here is pure supply and demand of underlying natural resources and the availability of such.

Some may point out that speculators are influencing the market and therefore drive prices higher, but I would like to point out that these are hedgers that create liquidity in the market and offset the industrial buyers.

Regulating these hedgers would be the biggest mistake we can make.

I will write more about this soon.

Keep your focus on natural resources and the natural supply and demand. Also, what we have witnessed since mid last year is really the fragility of our financial system. Our economy relies on a strong and stable system, without it we will experience the same meltdown a decade from now. I agree we need oversight, but let’s not start regulating a system that politicians do not understand.

Leave it to the financial experts to do that, such as the US Treasury, the SEC and the Fed.

ND – 06/27/08

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# Economic Outlook

Things don’t seem to lighten up any time soon, but that was expected.
It takes time for the first signs of a slow down to really materialize and this is what we are experiencing today.
Our economy has slowed down considerably since the fourth quarter of 2007. While normally we should see a steady growth in GDP of 3% annually, we grow at a slow rate of 1% or less.
The housing market shows no clear sign of relief nor does the unemployment market.
The latter is the one that concerns me the most at this point in time.
The unemployment rate is still at 5.5% but will go up in the months to come when the airline and automotive industries continue to cut their payrolls. We may see an unemployment rate of 6% easily by year-end.
The second factor is the end of our famous stimulus package. By now every American family has spent their $600.00 check on bills, gasoline or anything else and the stimulus is over and finished.
As predicted, most of the funds did not alter or change the consumer spending and most funds were either used to pay bills or were not spent at all.
Wham, bam, thank you ma’am…life goes on as before and nothing has changed.

My prediction is that the economy will not further decline but will see a very slow growth for the remainder of the year and will not compensate for the prevailing inflation rate.
High and rising food prices will continue to put a damper on consumer spending.

I do not foresee an economic recovery until the second half of 2009, if any.
Much of this will not only depend on our own domestic economy, but also on the occurring slowdown in the global economy.

Until the US Treasury starts to strengthen the USD and focus on the inflationary pressure, we will see a slow recovery.
In order to achieve such, the Federal Reserve will have to start raising interest rates soon but that will interfere with the current slow economic growth (see 04/08 newsletter) and they should seriously think about USD intervention to slow down the recession and promote growth.

Consumer spending is down due to high and rising food prices, which are more important than to watch than oil prices. We can stop driving when we want, but we can’t stop eating.

ND – 07-08-08

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# The Housing Market

Do you ever get the feeling when driving around Savannah that everybody has a colorful sign in their front lawn that reads “FOR SALE”, “JUST REDUCED”, “SPECIAL” or “OPEN HOUSE”, preferably with as many balloons as possible?
When I drive around, I get the feeling that there is an upcoming election and everybody wants to show who they prefer.
I was trying to count them all and thought I was working for the government taking a census, but that is two years away.
It is clear that the housing market is not getting better any time soon.
On the contrary, we still have ways to go.
I have written and spoken out about this before, but I will say it again. If the Fed last year would not have tried so hard to save the housing market for the poor people that bought a house they could not afford, we would have seen the bottom already and could have started climbing up again. But that is not the way politics work, hence I am not a politician.
Now on top of all the bad news we already had, they throw Fannie and Freddie at us too and of course the Housing Bill because these same poor people need an FHA guarantee to ReFi their loans so let’s give them a $300 billion guarantee.

The second persistent problem is the sellers.
Why can’t someone explain to them that their house is not worth what they think and should therefore either reduce the price drastically or just take it off the market and continue to live in it.
The fact that all of them got their first tax bill, showing an increase in value based on 2007 sales figures, only exacerbated that.
Good luck to the volunteer that will explain the economics behind the fact that the value is now down but your tax bill went up because of the previous year.

I do not see the light at the end of the tunnel yet until well into 2010.

What caught my attention as well is the number of “FOR RENT” signs. Just take a stroll on Victory Drive, it looks like the whole street is available and that is becoming increasingly disturbing.
The housing market can be bad but if now there is going to be a spillover to the rental market, than we are in real serious trouble.

ND-06/28/08



# Global Economy

We have seen the global economy slow down more than anticipated. The growth in Europe is down to a mere 1.4% and continues to slow down. I expect the growth to continue to go down to 0.9-0.6% for the rest of the year with an increase in inflationary pressure due to wages and price increases.
Expect the ECB to slowly continue to raise interest rates from 4.25% to 4.75% by year-end.

India and China are also showing signs of a slowdown, but given that their economies have been growing at such a fast pace for the last years, that should not necessarily have a large economic impact.

Latin America remains strong primarily because of Brazil. However, I expect a slowdown there as well due to the high risk of inflationary pressure over the next two to three years.

Japan is still growing at a very slow and controlled pace and has had no need to raise their interest rates.
However, that may change if the slowdown persists everywhere else. If and when that happens, they do not have a lot of room to maneuver, given their very low interest rates.

Now we all focus on the global economy and how it behaves and not just the local economy. We are so intricately tied together that I have to bring up my favorite allegory again: the infamous sandbox.
If one child pays attention to how another one plays, then there is no crying and everybody is happy.
If one starts a little problem, then the whole sandbox is in trouble and you know what that means….
It takes fifty mothers and several hours to calm everybody back down before anybody can play again.

ND-06/01/08



# Inter-Currency Markets

Currency markets are always volatile and subject to so many different factors, but that is what we have experienced again this quarter.

The USD/EURO trade fluctuated between 1.59 and 1.57 between March and June.
This is a very big swing and partially due to the tightening by the ECB. The second reason is the continued confidence in the USD even though it is still weak.
Where the EURO will go for the remainder of the year will depend on the monetary policy of Europe given that the Fed is not in a position to raise rates and strengthen the USD.
What I am watching now is whether there will be some sort of USD intervention to take the pressure off and prohibit the USD from sliding further.
I still predict that, under the current circumstances, the USD will weaken to 1.60-1.62 by year-end.
The breaking point for Europe is 1.62, after which they will have to intervene. The only problem is that growth is slow and inflation is rising, which does not give them a lot of options to do so.
The next six months will be very interesting to watch, but if the Fed continues to work with the ECB then we may be able to control our exchange rates through joint efforts.

I am not too worried about the USD/JPY rate for the remainder of the year. It will probably continue to fluctuate between 102 and 108 and most of that fluctuation is due to the carry trades in the markets (see previous newsletters) and not due to a strengthening of the Japanese economy.
These trades unwind when they come to expiration only to be replaced by others.
I do not expect any dramatic change in the next six months.

ND-06/30/08

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# Headlines

## This Bud's for Me

InBev announced their intent to acquire Anheuser-Bush a few weeks ago and the offer was accepted.
This is a great deal for the shareholders but especially for me.
You see, Budweiser has been using Clydesdale horses since 1933 when they delivered their first case of beer to the White House after the prohibition ended.
These beautiful horses are Belgian bred and raised and are a pride of my country.
Now that a tiny little country like Belgium acquires an American icon, you have to see the irony in it, independent of the deal.
I know some of you will question whether America is being sold out to foreign investors, but this deal will make Anheuser-Bush part of the largest beverage company in the world with a huge marketing advantage.
I don't particularly like the beer, because I prefer a Stella Artois, but I sure am happy that I finally get my horses back.
This Bud is really for me….

ND-07/01/08

## Fannie and Freddie

After all the bad news in the financial markets, we got some more from the GSEs.
After the bailout of Bear Stearns and the acquisition of $ 29 billion by the Fed, we are now watching what congress will do with Fannie Mae and Freddie Mac.
If Paulson gets his way with congress, he will not only receive a blank check to support both, but he will also receive the power to acquire portions of both publicly traded companies.
That is a dangerous proposal because the latest calculations show that this could cost up to $ 25 billion, depending on the current solvency.
Dangerous, yes.
Needed, probably.
After all, knowing that both underwrite and securitize about 50% of the loans in America, it would be foolish to let them fail.
However, is the proposal really the long-term solution or should we rethink our entire securitization process and overhaul it for the future.
It is clear that Paulson is trying to apply band-aids where possible to stop the bleeding, but the question is: has he found a cure yet and how long will it take?

ND-07/03/08

**Contact SiRuDoRealty.com with any questions or comments at ndoms@sirudorealty.com**

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