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Quarterly Newsletter
July 2009

Welcome

Dear Readers,

This newsletter is slightly different from the previous ones. Instead of focusing on statistical data and analytics, I just wrote general observations about each topic.
Sometimes we need to be able to pause and catch our breath, and what better time to do this but during the hot summer months.
I hope you enjoy the reading.

Nick Doms

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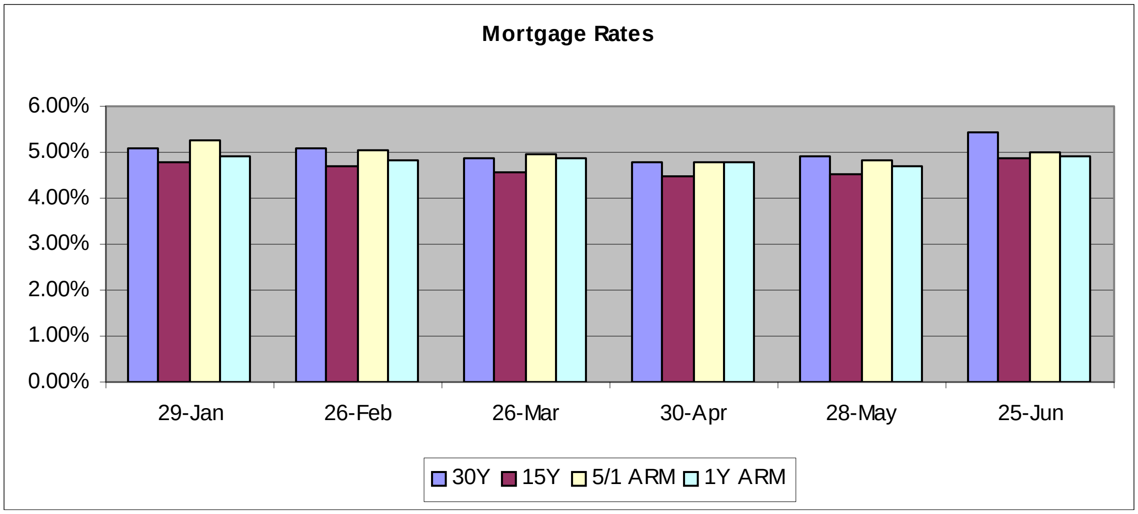
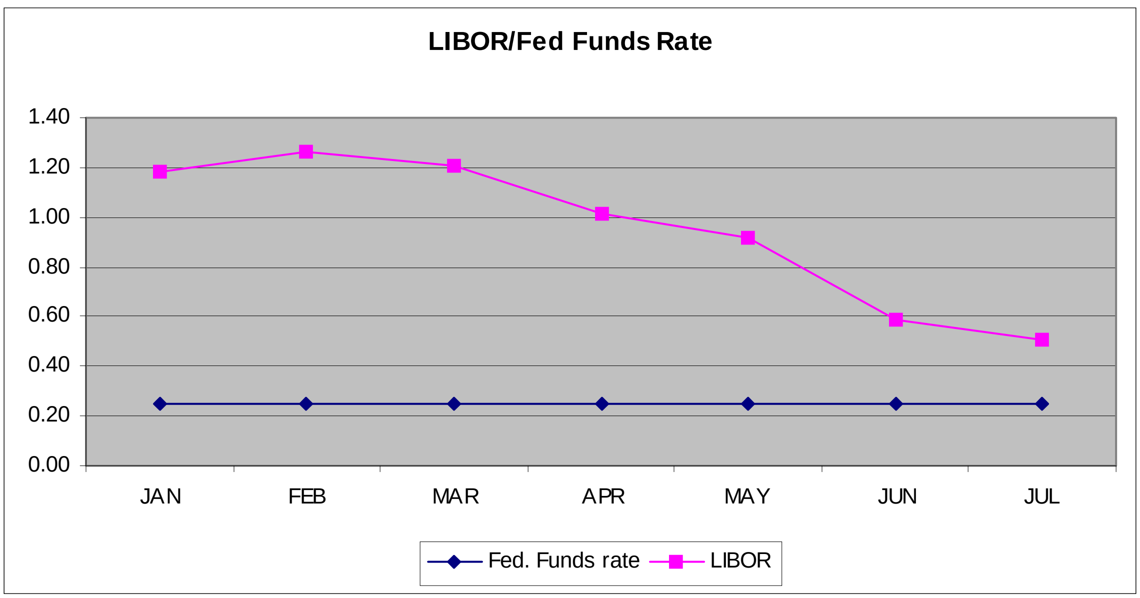
Graphs



Data Source: FMAC's PMMS



Data Source: BBA USD LIBOR

Economic Outlook

I have been writing my opinion about the domestic economic outlook for a while now, based on data and statistics.
Now I want to shift gears a little bit and just make a general observation of what I see happening in the short and long-term future, based on the impact of monetary policies that are currently in place.
The basic questions I keep asking are whether we are at risk of a secondary wave of a recession that will deepen the existing one and whether this will give cause to a high inflationary period in the near future.
In my opinion, the answer to both is yes.
Instead of seeing an economic recovery by the end of 2009, I predict a slowly flattening and stagnation of GDP growth.
While the CPI and PPI figures may stabilize and the production inventory may not increase, such figures are artificial at this point in time and are not a realistic reflection of the state of our economy.
The figures are largely driven by other indicators such as unemployment, productivity and consumer spending, and therefore distort the true economic data.

The second argument I will make is the constant flow of USD into the market. Such funds are made available through the increase of the Federal Reserve's balance sheet, i.e. printing new money at a very fast pace, and their intervention in the US Treasury bond market.

The third argument is the large issuance of US T-Bills, Notes and Bonds. I already mentioned in the previous newsletter that the 10-YR note auction caused some serious ripple effects in the bond market. The shorter term paper auction in late June went pretty well, given the circumstances, however this is reason for concern given that we need to raise 2.4 trillion USD to fund our budget shortfall.

So, how will this then all affect our economy?

The effects will come in two waves: a short-term deflationary wave, followed by a long-term inflationary period.

-The deflationary period.
A further deepening of the current recession will be caused by the continuing increase in the unemployment rate. Independent of whether we are capable of creating 3.5 million jobs through infrastructure projects, we will need an additional 6.5 million by the time we are done. That is of course if we can create those new jobs.

The thought of building TGV or fast-speed trains in America to create jobs is not a viable option, and I am trying to put this mildly.
The deterioration of the housing market and the threat of a serious meltdown of the commercial real estate market will have a major impact.
Just these two factors will cause the second deflationary wave in the short term, which will last through 2011.

-The inflationary period.
This period will start at the end of 2011 and will last for several years. While some are comparing the US situation to the Japanese economic problem of the 90s, we are actually creating the opposite.
The solutions, or so we call them, for the current recession are actually creating the foundation for a high inflationary economy to come. So in essence what we perceive to be the solution is actually a future problem.
Why?
The inundation of the currency markets with USD combined with the intervention and contradiction of several Gov't programs will ultimately lead to a very high debt/GDP ratio as well as a continued weakening of the USD. If such course of action cannot be altered and replaced with private and corporate capital injection then we will see a rise in commodities around the globe once the global economy starts recovering.
That is what will cause a high inflationary pressure on the US economy.
We have witnessed this scenario during the 1980s and lately during the 2000 Tech bubble and we still use the same monetary policy: cheap money for too long of a period without looking ahead.

Depressed yet after reading the prediction?
Don't despair. I will leave you with a simple thought and with some sarcasm, as usual.

We in America need to understand something. Our days of dominance are over. The days of flying a flag and tying a yellow ribbon around a tree no longer suffice to function in a global economy. For those who are familiar with ancient history or have a classical education, you will remember from your history classes why Rome and an entire empire fell.
The US is on the verge of doing the same thing.
But, here is the good news. There is a solution.
We need to look at the "sandbox" and watch who is playing and building a sandcastle. Instead of standing by and telling others how to build it, we should offer our help and assist them in achieving their goal and ultimately our goal.

ND- 06/30/2009

The Psychology Factor

I have been wondering for a while what impact a depression or a recession has or can have on human behavior.
The reason I think this is extremely important is because once a depression/recession is over and the economy restores itself to normal levels, the behavior of consumers afterwards will influence the health of such economic stability in the future.
This is even truer for the US economy, given that we have lived through a very consumer spending driven economy for decades and since the mid 1940s.
Looking back at the generation that survived the great depression of the late 20s and 30s, the hardship they lived through definitely determined their spending habits afterwards.
They became frugal and careful and they also saved for a rainy day, just in case.
The next generation, who lived through WWII, reacted very differently when the war was over. They went on a spending spree partially because life was good and jobs were plentiful but also because a new era had begun: consumer spending.
From large cars to electronic appliances and anything in between that were sold door to door out of a suitcase or through TV ads. The influence was very clear: if you did not have this “latest” gadget then you were not living the American dream.
At the same time the opposite happened in Europe. The European generation that survived the hardship of WWII for five years, either through occupation or worse yet through incarceration and more, was very influenced by the experience. They rebuilt, they saved and they were careful.

A crisis, whether it is economical or a historic tragedy, definitely influences the human behavior and spending habits. But how, and can we predict this?
I do not have a specific answer to this question but I can make a prediction about what the consumer’s behavior will be after this recession is over.

In my opinion, the American consumer will go back to old and die-hard habits. While today they turn in their large SUVs for smaller, more efficient cars, tomorrow they will buy back their loved SUV.
Today the savings rate stands at a more or less healthy pace of 5%, but tomorrow the spending will find new roots.

In general, I do not believe that the current or next generation will change their overall spending habits based on lessons learned from this recession.
We should, because that may ultimately protect us from the next wave, which will come our way.

ND – 07/06/2009

Global Economy

The global economy, in general, seems to find some traction, at least in certain parts of the world.
Besides the productivity output and some of the GDP figures being released by India and China (although we have to take these with a grain of salt given the political climate and control), the one indicator I find encouraging is the decline of the 3-month LIBOR rate.
The previously existing wide gap between LIBOR and the Fed Funds rate has now narrowed to 40 Bps.
That is good news for the inter-banking system and for the international financial lending arena, but now we have to wait and see whether such easing of the credit markets will create enough liquidity to find its way to local and global economies and ultimately the consumers.
If such can happen in 2010, then we may expect stabilization globally and perhaps a recovery in 2011.

While China and India, in particular are “cruising along” in comparison to other world economies, and while smaller Asian economies are holding their ground through this recession, there are some things that still worry me.

Japan is not in very good shape and in dire need of funding for their budget shortfall. At the same time, their currency seems to gain more traction versus the USD, which ultimately will work against them.

Brazil and Russia still remain a question mark and whether they can follow the pace set by China as far as GDP growth is concerned.

I believe that Europe is in good shape and that their monetary policy, focused on curbing inflationary pressure, will find its benefits and will pay off, even though they have been critiqued heavily in the past for not following the American model.

Having said that, if the current American monetary policy does not work and causes another recession, then Europe will become an innocent victim and will be dragged into another downturn.

ND - 7/04/2009

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The Housing Market

A lot has been written about the housing market and how we would be able to save it with lower interest rates, but I have not seen a positive sign yet since the bubble burst at the end of 2007.
While figures may indicate that the market is stabilizing and/or recovering, I do not see a real and sustainable bottom yet that would warrant a slow recovery.
The pending home sale figures, inventory and new home sales figures certainly do not indicate a recovery in my opinion, whether such are national, regional or local.

Since late 2007, plans and proposals have been implemented to “restore” the housing market in order to “save” the economy.
For the past two years, we have tried to impact the mortgage rates to stop the bleeding in the market and to revamp the American Dream. Yet, the mortgage rates remain at higher than expected levels, credit remains tight and liquidity is still absent, all of which negatively impact the market.
In addition, the number of foreclosures and short sales is on the rise and therefore offsets any increase in pending sales.
But the collapse in the housing market also has had a major impact on other markets, as was expected early 2008. The first impact was the inundation of the rental market with available condominiums that could not readily be sold. This has eroded the rental market and has had a large effect on the average vacancy rate.
The second impact, which will happen soon and certainly in the second half of 2009, will be the collapse of the commercial real estate market. We already see the early signs of this with lower rental income per square footage and a higher vacancy rate.

I believe that we can recover from this “little bubble” but I do not believe we will see positive signs until mid 2010 and until we hit the bottom hard. I can reiterate that if we would have not intervened in the market two years ago that we would have been stable by now and that the fallout would have been minimal, but that almost sounds like water under the bridge and too late. Maybe, but I will write it down anyway because I am convinced of this and have been for a long time.

So, how will and can a recovery in the housing market (residential and commercial) then look like in the future.
The first thought that comes to mind and which is considered controversial and contrarian is to forget about the American dream. Not every American is destined to own a home nor can they all afford one. It was a good ad campaign while it lasted but it was just what it really was: a dream. We have to go back to basics. Those who can afford it and have the funds for a down payment will own a home. Those who cannot should not be allowed to cut corners and should continue to rent instead.

The second thought is that property valuations and appraisals have to be done in a reasonable and justifiable manner. If we skyrocket again in home values after this crisis, with 10 to 15% annual increases, then we know that such are completely unrealistic and not sustainable.

Lastly, the synthetic secondary RMBS (Residential Mortgage Backed Securities) and CMBS (Commercial Mortgage Backed Securities) markets have to be structured and regulated to avoid a collapse in underwriting.

Let us wait and see. I hope that we can reach the bottom soon so we can all start climbing back out of the hole we dug for ourselves, even though nobody really wants to take responsibility for it.

I for one am tired of hearing that if we would not have done anything and we would not have put certain measures in place that things would have been far worse.

I cannot find any logic in such explanation because how can they possibly know this without seeing or experiencing it?

ND – 07/11/2009

Headlines

IOU and YOM

Dear Senator,

I am writing to express my concern with the recent issuance of IOUs to refund state taxes to residents of your state.

I understand your state is on the verge of bankruptcy and has no available funds, given the current financial crisis.

My clients tried to use your state issued IOU to pay their tax liability to the IRS, however such was returned and not accepted as payment.

This bothers me because if the Federal Gov't does not find a state issued IOU trustworthy enough to accept as future payment, then why should my clients?

My clients tried to cash in the IOU with a financial institution, supported by tax money, and they did not accept the paper either.

The third option was to try to buy groceries with the IOU, but the store only accepts state issued food stamps and would not accept your IOU either.

I am hereby enclosing the IOUs with the request that you arrange for your state to issue food stamps instead of worthless IOUs that are apparently not negotiable or exchangeable.

At least my clients will be able to use their refund to spark and ignite the economy with their consumer spending.

I just have one question.

How does your state pay for food stamps and free housing, but cannot pay for a tax refund?

Thanks in advance for your immediate attention.

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Health or Care

Reforms are a beautiful thing, they rise to the surface every ten years like a circus coming back to town.

Everybody gets so excited when they build the tent and then gets disappointed with the elephant and lion act. The good news may be that ultimately the clown will save the day.

Nationalizing healthcare is the same as asking Congress to manage my finances, before you know it you are short cash and nobody knows where the money went.

We have great care and great doctors, but we are in bad health and we abuse the system.

It is the same as eating at McDonalds and super sizing your meal with a diet coke to control the calories, of course. One does not want to be viewed as eating unhealthy.

I have a better solution. I think McDonalds should be in charge of healthcare and install treadmills at the counters so customers can run and exercise while they order fat burgers and fries to go. They should also allow a side order of fat burners that can be taken in advance and lower their cholesterol before they dive into their meal.

Everybody will feel good, nobody will lose weight, but it will cost less.

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