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Quarterly Newsletter
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Welcome

Another quarter gone by and year-end is approaching fast. This newsletter will look at the future and what it may bring from different perspectives.
It may not sound like the most upbeat message, but then again I am not a politician either and I don't participate in popularity contests (I would never win anyway).
It is a realistic view and one I believe we should take at heart.
I will write to all of you again in January of 2010 and I wish all of you an early and successful New Year.

Enjoy the reading.

Nick Doms

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Economic Outlook

We are entering the last quarter of the year and we have been able to take a good look at where exactly we stand at this point in time based on revenue reports, GDP, unemployment, trade deficits, CPI and PPI.
The prediction that 2009 would be a year of recovery has fallen well short of the promises, but such was what I expected and warned people about.
It may very well be that words come easy and play on the sentiment of the American consumer, but hard and factual data tell a very different story. The feel good story never translates into actuality and realism. It sounds more like a fairy tale that makes everybody sleep through the night only to wake up with the same headache once we open the curtains.
Now we need to take a look at what 2010 and the years ahead of us may bring.
Shed the rose tinted glasses and take a very good and hard look around to get a dose of reality.

GDP will show a growth in the 3QTR but when stripped from the “cash for clunker” sales, then we will get a flat or negative growth figure. The projection of GDP for the 4QTR and 1QTR is negative with a possible positive growth overall for 2010.

Unemployment keeps going up and currently stands at 9.7% (as of 08/09) but the real unemployment rate is 18.3%. Translate such into tangible figures and you see that 20 million Americans have lost their jobs. I don’t believe that this should send a wave of panic through anybody because this indicator will only recover slowly and will be the last one to restore itself once a recovery starts.

The USD remains very weak and has a tendency to drop further versus major currencies. I will elaborate on that in another article in this newsletter.

The price of gold, although used as an indicator, is no longer relevant in my opinion because instead of being used as a safe haven previously, it has now become an asset class for any diversified portfolio.

The fact that productivity is increasing is often used as an indicator that things look very positive. One has to define productivity in its true measurement:

Productivity = Output – Input

The output is the total of goods/service produced, while the input is the labor force used to produce such goods.

So realistically, if you constantly reduce the workforce then obviously the productivity goes up. We do not produce more then before, so we don't grow GDP.

The Fed continues its quantitative easing by injecting extra capital into the markets, although at a slower pace then before. The US Treasury in the meantime cannot quantify the value of the remaining toxic assets on the balance sheet of our financial institutions. That is very strange because most of the banks went through a stress test. In addition, they cannot calculate the exposure of smaller banks to commercial loans. Not exactly encouraging.

OK. Now that we have looked at the true colors, most people will grab their rose tinted glasses again because then it does not look so bad.
It sounds all bad, but it isn't. There are signs of positive things that occur, but we just have to look rationally and without sentiment.
The spreads in the market are getting tighter and liquidity and credit is restoring itself.
Such signs need time to trickle down to main street before they become readily visible.

My outlook for the short-term future is another wave of deflationary pressure at least through 2010 followed by a short period of stagflation. What will follow is what is starting to bother me the most: high inflation with high interest rates and expensive borrowing costs. While we are trying to get out of the current two-year decline, our actions are also potentially laying the foundation for this future economic climate.
What should worry economists more than me is the fact that the Gov't cannot retrace its steps and interventions in time, meaning if they cannot implement a successful exit strategy, we are looking at higher tax rates, high overseas borrowing costs to fund the budget shortfalls and we will create pressure on the mortgage market and the housing market once again. More about this later in the newsletter.

I have revised my previous outlook for a potential recovery from 2011 to a sign of stable recovery between 2012-2014.

This is no longer a discussion about whether the glass if half full or half empty. We are well past that point. If and when I see the glass filling up again through job growth and a sustainable GDP growth, then I will become bullish on the American economy.
We have not reached that stage yet.

ND – 09/18/2009

The Global Economy

The global economy is running in different directions, at least that is what it seems like when looked at from a distance. This is not really a surprise because the tendency is to survive and tend to our own store first before we tend to each other.

Nevertheless there are some points to be made.

The BRIC countries (Brazil, Russia, India and China) are holding up very well in this climate. India's GDP is growing by 5.8% this year with a continued growth projection of 6% for 2010. What is remarkable about this is that their GDP consists of 70% local consumer spending and only 30% trade activity. This has to sound familiar to all by now because that is the exact mirror image of the US GDP, except we have no positive growth.
China's GDP is growing at a steady 8%, but as a connotation, we should be careful with this figure given the controlled environment in which such figures are published. Also, China's economic model is the exact opposite of India and such may not be sustainable for much longer.
I don't worry about Brazil in this group but I do have concerns about Russia. Maybe not necessarily from a pure economic perspective but because of the socio-political climate that may turn the tables on them fast.
Europe is a story in itself and the PIGS countries (Portugal, Italy, Greece and Spain) are feeling the pain. If they do not get a serious grip on their economic situation as well as their budget deficits, then I do not see a fast recovery for them. That does not mean that the Eurozone is in trouble. France and Germany are steadying themselves, but they are also the largest European economies.
My confidence in their recovery lies with Trichet (president of the ECB) and his clear view on monetary policy.
It will be interesting to watch the next G-20 meeting in Pittsburgh and what the topic of conversation will be in addition to the ultimate outcome.
Australia is not an issue at this point in time. Energy resources and raw materials will remain in demand and certainly after a recovery starts. They are also the first country to start raising their interest rate by 0.25%.
Japan on the other hand is on a slippery slope and at risk of sinking back into a prolonged deflationary period unless they can solve their budget shortfalls pretty soon. Do not be fooled by the strength of their currency right now. Such is the immediate result of the large amount of the carry trades and not based on economic performance.
Apocalypse now, anyone? Maybe, but only if you believe in the true meaning of the word: revelation and renewal.

ND – 09/20/2009

The Housing Market

Who would have thought that after two years we would still be pointing out the fragility of the housing market given that so many plans were and have been implemented, some with maybe a direct effect and others as an indirect stimulus.
We are still talking about it and my sense is that we will continue to do so for a while.
Every time figures are being released, whether it is existing home sales, inventory or new home sales, one has to really be careful on how to interpret the data to get the real picture.
Existing home sales were down on a month-to-month basis but that should not be a reason for panic. I find it perfectly normal in this climate and it will continue to happen, but homes are being sold, although at a slow pace and at the bottom of the market segment. This primarily due to the first time homebuyer tax credit, which I believe will be extended prior to its expiration on 11/30/2009.
The question here is: how do we create an incentive to move the inventory of mid-price or high-price range homes? The answer is certainly not through another tax credit. We simply cannot afford this financially. What we can do is increase the current 250K cap to a higher level, at least temporarily. That may light a fire, or at least some smoke and we will have to throw the wood on top of it so it keeps burning.
Inventory levels are coming down and such may be viewed as positive, but there is one side note to be made. Part of this reduction is also due to the withdrawal of REOs, short sales and foreclosures.
In the long run, this may come and haunt us back because that would mean that the shadow inventories are growing or stagnating at best on a bank level.
Nobody has access to this exposure that resides on financial institutes' balance sheets, but I would be worried about it.
New home sales are down. Well, of course they come down. The homebuilders build less and sell less. No need for mathematics 101.

Overall, I expect a drop in home prices to continue throughout 2010. Some regional markets may just stabilize but that is the nature of the beast because there is no such thing as a measurable national trend. In Savannah, prices have been reduced; sellers are more motivated and have come to their senses (finally, it only took them 2 years) so we will probably see a more stable environment around a further 5% reduction from the current levels.

My final advice to first time homebuyers is: don't step into this market yet unless you can afford the down payment and you qualify for a conventional fixed-rate mortgage. Do not, under any circumstance, agree to an ARM loan because you will be at risk 3 or 5 years down the road when your rate will be reset at a much higher level.

ND-09/27/2009

The Currency Battle

Those of you that follow the inter-currency markets must have noticed an interesting development in the last three months.
I am not just pointing towards the USD but also the fluctuations of the JPY, Euro and GBP.
It is not a surprise that the USD continues to lose ground against the JPY and Euro. Such is the scenario and script that was written a few years ago by the US Treasury. What they are certainly doing is making sure that the continued weakening of the USD happens in a very controlled environment and does not turn in an uncontrollable free fall.
The orchestrated low yielding of US Treasury auctions is certainly the underpinning of the gradual value reduction but one that may be understandable, although I disagree with the strategy. It gives the US access to continued borrowing at a low rate and they are willing to give up a portion of the purchasing power by weakening the USD.
What has become an interesting phenomenon is the GBP/USD parity.
As the USD continues to decline versus other currencies, it holds steady against the GBP and actually gains some positive momentum.
In my opinion this is due to the overall sentiment that the UK economy is still in a very fragile shape, their recovery will be prolonged and they are certainly not the first ones to emerge from this crisis, hence the continued weakness of their currency.
Other currencies, such as the AUD and NZD are stable as expected because their economies and natural resources are providing the foundation for such.
The JPY is still a currency that will be on my radar screen for the next few years. As I mentioned in previous newsletters, the carry trades are something to follow very closely and will be a great indicator of which direction the JPY will go.
The Yuan-Renminbi, although pegged firmly to the USD, is important to follow because of the increase in convertibility created by large swaps and repo contracts with South America and Africa.
As a last comment, I would like to point out again the future influence of SDR contracts in the secondary market and how this will change the entire foreign exchange market. It is too soon to tell, since this market is barely 4 weeks old and we have no actual data on the volume or demand and certainly not sufficient data to draw long-term conclusions, but it is worth watching and following and I will provide updates when they become available.

ND – 09/29/2009

The Commercial Real Estate Market

While I am not an expert in commercial real estate, something has me worried for the future, more so from a financial perspective than anything else.

Rental rates have come down considerably and continue to fall.
Using Savannah as an example, and this is not to be viewed as a national average, it is now possible to rent commercial property at 15-20$ per square foot. This would have been unthinkable 2 or 3 years ago.

Vacancy rates are up and while I cannot provide hard data, this is not a good sign either for the future.

The value of outstanding commercial loans exceeds the true fair market value of the buildings. Given the fact that such loans will have to be reset and refinanced in the next 3 years, and most probably at a higher rate in addition to a higher LTV, that should be a red light right now.

My personal concern comes from the exposure regional and/or local banks have within the secondary CMBS market.
I predict that we will see several banks fail because of their current exposure, which then in turn will put an extra burden on the FDIC who is already under pressure because of under-capitalization.
That in turn will result in extra borrowing from the Federal Reserve with the obvious result of an additional increase of their balance sheet and more quantitative easing.

In order to prevent this scenario from happening, the US Treasury and Federal Reserve should purchase such “toxic assets” from regional banks to avoid foreclosures and bankruptcy filings with a temporary capital injection either through TARP or PPIP.

ND – 06/10/2009

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