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Dear [Client]:

Happy New Year! There goes another exciting year, with lots to reflect upon. In early March the stock market ended a decline unmatched since the Great Depression, and began a long climb back to the present level. By our last quarterly newsletter in the first week of October we warned that prices had climbed too high. As I wrote,

“We’re not sure of the precise timing of the next downturn. The current rally could end in October. On the other hand it might extend...into the beginning of next year, based on year-over-year improvements in earnings and the return of merger and acquisition activity.”

Since mid-October, key market indexes have moved up only slightly. More importantly, stocks are selling at very high multiples of corporate earnings, and dividend yields are at historically low levels, indicating that the market may be facing a correction. Nevertheless, the correction may wait a bit, particularly if earnings significantly exceed expectations. During that time we will continue to look for underpriced stocks with momentum and solid fundamentals.

Transient Market Gains

The gains in the market have been driven by three things: (1) government stimulus, (2) a favorable earnings comparison to the awful numbers of the prior year, and (3) earnings gains based on corporate cost cutting. Some of these gains will probably reverse when the stimulus is removed, while the gains from cost cutting may actually reduce future business.

Earnings gains based on cost containment are generally considered unsustainable – you can only reduce costs so far, and then you need new revenues to grow profits. Productivity grew at an 8.1% annual rate for the 3rd quarter of 2009, far in excess of the typical 2% annual rate. That means that business got increased sales out of a smaller workforce. For the quarter, employment and hours were down, but output dropped less markedly, or increased. Because the productivity increase exceeded the drop in unit labor costs, we assume that workers are being worked to the bone, or that quality of production is declining, or both. Many firms cut costs in sales and marketing, training, and research and development. Such cutbacks may cause future declines in productivity, sales and product development. The productivity boost explains most of the recent increase in corporate earnings, which are based on lower wages and other expenses.

Continuing Financial Concerns

The markets do not appear to have priced in remaining issues in finance, both at home and abroad. One continuing area of concern is our banks. Some of our largest banks, including Citibank, Wells Fargo and Bank of America, are raising billions of dollars of debt and equity to pay off preferred stock issued to the US government under the Troubled Asset Relief Program (TARP). The preferred stock provides for low interest rates for the first five years, so the banks are paying these off primarily to free themselves from TARP restrictions on compensation. They claim they need high wages to attract and retain talent. But they are diluting shareholders and increasing debt for the purpose of rewarding top employees, many of who took very bad risks over the last few years. The repayment comes after these banks suffered the biggest losses in history.

Worst among these is the Citi repayment. After the Citi TARP investment, Treasury Secretary Geithner caused the Treasury to buy additional common stock in Citi, and authorized Citi to convert some of the preferred stock to common, leaving the taxpayer with 34% of Citi common stock. This week Citi retired the preferred stock still owned by the government, freeing itself from TARP restrictions, leaving the U.S. with inferior common stock. Moreover, the TARP repayment was funded by the sale of common stock at a meager \$3.15 per share - well below the most recent market price of Citi common, and below the exercise price of warrants issued by Citi to the US Treasury under the TARP investment. The new sale of common stock also reduced the U.S. common stock ownership interest.

Adding insult to injury, the banks are lobbying the government to cancel the warrants issued to the US Treasury as compensation for the TARP investments. The banks complain that the warrants, which remain unexercised, are excessive, in that they were expected to be exercised after a number of years, rather than in a year or less, and that the cost of the warrants will negatively affect their bottom lines in the year the preferred stock is retired. So instead of retaining the TARP investment and paying low interest rates to the government for the next few years, the banks are refunding these loans early in order to pay bonuses to their executives, and then complaining about the resulting consequences for their bottom lines.

Some Americans find comfort in the banks' ability to raise large amounts of money in the public markets, and potential gains on some warrants. But that's not the whole story. Even after repayment, Citi and other financial firms have had hundreds of billions in assets guaranteed by the federal government. The government is still at risk on those guarantees. Meanwhile, hundreds of banks that did not receive TARP money continue to be taken over by the FDIC, which is running out of funds. Replenishing FDIC reserves will require higher bank contributions or taxpayer subsidies, probably within the year. So the outcome of the bank bailout remains unclear.

Banks must still digest troubled commercial real estate loans, adjustable rate "option ARM" home loans, and the like. Home prices remain above the 100-year inflation-adjusted average, and we may yet see prices drop below that level by as much as 20% or more. Such declines are typical in major corrections, which tend to overshoot the long-term average. One recent survey suggests that bad loans will continue to mount until 2014-2016. The same survey suggests that most of the "Too Big to Fail" banks are earning enough current income to avoid net losses during this period. They are doing this by reducing lending, and by taking advantage of low borrowing costs while raising rates on existing credit card balances. These conditions will have long-term negative consequences for the economy and the average American.

The new area of concern in home loans is now "prime" loans, or loans to borrowers with good credit and reasonable downpayments. Many of these loans are now underwater, with defaults up based on rising unemployment. While these homeowners may have other assets, they will be reluctant to use them to pay their mortgages because they no longer have any equity in the property. If unemployment grows more than anticipated, or incomes continue to fall, or interest rates spike, the number of prime defaults may grow markedly, and even the biggest banks could face serious consequences.

Commercial property is another area of concern. According to the Wall Street Journal, by early fall vacancies in outdoor shopping centers rose to 10.3%, compared to 8.4% last year, the highest rate since 1992. Mall vacancies were up to 8.6%, up 2% year over year. An analyst quoted by the Journal said they don't expect a return to 2008 occupancy levels until 2016. Properties completed in the last year are 30% vacant.

Consumer spending continues to recover slowly, but this too may be unsustainable. Wealthier consumers have increased spending as they begin to see improvements in their portfolios. But the average Joe simply can't continue to spend at the levels seen in the last decade. Real unemployment, being the level of both unemployed and underemployed, known by the Department of Labor as U-6, is hovering at just under 18%, the highest level on record (just below the estimated comparables for the Great Depression), and consumer credit lines are shrinking at an unprecedented rate.

Financial problems continue to beset state and local government. Some institutions are reducing their holdings in municipal bonds, indicating more trouble ahead for issuers. Bloomberg recently reported that Allstate cut its municipal holdings by 8.3 percent in the third quarter as tax-exempt yields plunged to a 42-year low, and governments struggled to maintain budgets amid the recession. State tax collections declined by 16.6% in the three months through June from the year-earlier period, the largest quarterly decline since at least 1963, according to a report cited by Bloomberg. We can expect a particularly hard impact here in the Golden State, where the state continues to borrow money and has not yet adjusted spending to the new reality. Even the most prosperous California school districts are making plans for deeper cuts over the next few years. Many communities throughout the country face abysmal credit ratings, declining revenues, and no prospect for material improvement or substantial federal assistance for years to come.

Financial risks also abound in foreign countries. Recently a Dubai company with strong ties to the government defaulted on tens of billions of dollars in debt. At the same time, some European nations, including Greece, Spain, Italy, and several Baltic States, continue to experience serious financial troubles, both at their biggest financial companies, and in national credit ratings. Even China is experiencing serious challenges. Chinese has a very high vacancy rate for residential and commercial property, and inefficient real estate and capital markets, due largely to an underdeveloped legal system. Many analysts believe that Chinese bad loans are large, and that the country may be building excessive inventories in certain commodities, such as steel. Meanwhile, other analysts, and reportedly some government leaders, question the reliability of national statistics on economics, the environment and business. This problem is due in part to strong financial incentives for bureaucrats to report the best possible results.

The Economy in Brief:

Increases in money supply and fiscal stimulus have stabilized the equity and debt markets. An increasing money supply has calmed bank deposit holders. Unemployment growth has slowed, and certain indexes for trade and manufacturing are looking better.

But there are large areas of trouble looming, and plenty of weak statistics. Housing prices and sales remain weak, with potential for very large numbers of additional foreclosures, and millions of Americans continue to face reduced prospects for the years ahead. On the governmental front, Congress and the President seem unable to craft a health care bill that will result in meaningful cost controls, and financial regulatory reform seems uncertain at best. The TARP program appears to have become a revolving line of financing - bank repayments come in the door and new lending goes out to other troubled institutions or sectors. Nothing about this recovery remains certain, and additional stimulus, in the form of infrastructure programs and job-creation incentives, may lie around the corner. Given this situation, our views on the dollar and inflation continue to hold. Until at least the latter part of the year, the dollar should not see a large decline, because in times of insecurity the dollar becomes a safe haven; inflation should remain muted, because slack capacity, particularly labor, is abundant

Roth IRA Conversion Opportunity

This year brings one clear opportunity for tax planning: holders of traditional IRAs may convert these accounts to a Roth IRA, regardless of their current income. Persons who do this must pay income taxes on the full value of the IRA account, but thereafter all income and growth in Roth IRA accounts are tax free, assuming the funds are held until age 59 ½. Furthermore, there are no required minimum distributions, so holders can leave the accounts to their heirs without any income taxes (estate tax may still apply). For these reasons, establishing a Roth IRA can be useful to many of our clients, and Roth conversions can benefit younger workers, with years of appreciation ahead of them. Even middle-aged account holders may benefit from paying the tax now, if tax rates rise appreciably over the next few years. Those electing to convert a traditional IRA to a Roth in 2010 will be able to spread the tax payment over both 2011 and 2012, which will help ease the pain. Calculating the merit of the Roth conversion is complex, and requires consideration of expected tax rates, inflation, anticipated returns and other issues. While much of that is guesswork, we can help you with that decision, and we look forward to discussing it on your next visit.

Sincerely,

Stanley Q. Mok
President