

July 5, 2010

Dear Client,

In our last newsletter we said “we would expect... the recent runup in the market to end by early May, at slightly above the current level, and then decline into the fall.” On May 3<sup>rd</sup>, the market did indeed begin a correction of about 13%, from about 11,200 on the Dow, to around 9800. The stock market is traditionally weak during the summer, and we guess that this year will not be different. The greatest risk for deviation from that norm would be to the downside, based on possible continuing bad news from lenders and employment figures. We do not expect the market to surpass the May 3<sup>rd</sup> level for the remainder of the year, though technical analysis indicates it could briefly rally to as high as around 10,800 on the Dow.

Longer term, many of our best and brightest economists foresee very low growth and sustained high unemployment for a good part of the next decade. Yet most analysts do not expect a so-called “double-dip” recession. Our view is less cheery. We believe that so long as household debt remains high, national debt continues to climb, and the US continues to run a large trade deficit, a second leg down remains a very strong possibility.

As we’ve noted in prior letters, at the core of the current crisis are four concerns: 1) consumer debt, mostly secured by home loans, 2) unfunded retirement programs, 3) the large, untamed federal deficit, driven by underfunded entitlement programs and defense spending, and 4) a large U.S. balance of payments deficit, driven by comparatively cheap energy and consumer goods. In this letter, we will provide an update on conditions in the housing market, which lies at the heart of our financial crisis, and why we believe that government has a reduced ability to cope with any new declines in financial markets.

### **Housing**

Home loans are the biggest source of household debt. We believe that loan defaults will continue to rise for at least another two years, due mostly to high unemployment and coming resets on so-called Option-ARM and Alt-A loans. These loans were generally made to lenders of lower quality than prime, and were issued on substandard terms or documentation, or permitted borrowers to pay less than the full market rate of interest, and no principal, for a limited period. Upon reset, the debtor must begin to repay principal, plus interest at rates equal to a short to intermediate term interest index (e.g. the one year US Treasury note rate), plus a solid profit spread, often around 2.75-3.5%. While subprime loans defaults have peaked, defaults in Option-ARM and Alt-A loans, and even prime loans, are growing rapidly.

According to the Mortgage Bankers Association, as of May, about 4.3 million Americans, or about 8% of all mortgages, are in default for at least three months, or in foreclosure. By some accounts, more than a third of all mortgages are underwater. Defaults are expected to rise at current prices, but will rise even further if prices continue to fall. So-called “shadow inventory,” or homes on which the loans are in default, but have not yet reached the market, are around four to five millions units. At the current rate it will take several years to clear this shadow inventory from the market.

Meanwhile, the interval from loan default to foreclosure has been climbing. Banks are reluctant to rush into foreclosures, which are costly and require that they write down their losses on the

underlying loans. According to the New York Times and Reuters, time to foreclosure had risen to 438 days (from around 251 days in 2008), and this interval is climbing by about a day every 4.4 days. This growing interval only extends the time to recovery of housing markets.

Today, most homeowners continue to make payments on their loans, even where the loan exceeds the value of the mortgaged property. Opinion polls show that most Americans view payment of their home loans as a moral obligation. But homeowners will only go so far to support these obligations. Eventually, underwater borrowers may need to move, or may become unable to make payment due to a decline in income, a reset on the loan payment, or other financial pressures. If they default, under current conditions they may be able to enjoy free rent for many months as lenders decide whether to foreclose. At some point most lenders will choose to either renegotiate or foreclose. Because there is a high cost to foreclosure, many banks prefer to permit borrowers to make a short sale, where the home is sold by a broker, hopefully at a higher price than would be obtained in foreclosure.

Fraud apparently played a major role in creating the home loan mess, and may continue to affect lenders. While data is limited, one small study, conducted by Fitch Ratings in 2007, found a large number of the loan files exhibiting evidence of fraud, abuse or missing documents. When attorneys for homeowners request proof of loans prior to a foreclosure, some lenders are unable to find the documentation, and if they do, these may be incomplete or show evidence of fraud or other violation of law. Many of these loans were originated by one lender, and then sold to others, often without adequate preservation or transfer of documents. The original lender may no longer be in business. In such cases, borrowers may be able to minimize or avoid liability for the loan, and holders of the loan face even greater losses.

Fraud also seems to be playing a role in the amount lenders receive in the event of a short sale. Based on anecdotal evidence, including news stories, in an unknown but growing number of cases, dishonest real estate agents are depriving lenders of a portion of the expected return on sale. These agents, who now rely heavily on short sales for their income, are conducting fraudulent sales, in which they conceal the best offers from the lender, and sell the property for a low price to a friend or business associate. The agent may then reap a profit on a subsequent sale to a third party. To obtain the collusion of the underwater owner, the selling broker may arrange a small back-door payment to the homeowner.

We are hearing lots of stories from people who have bought real property with loans that are now far underwater, and are unable or unwilling to continue to make payments. These situations affect people at nearly every level of income. Current tax laws may treat a default differently depending on how the loan is resolved. For example, in the event of a short sale or modification, a homeowner may have to pay tax on the principal that is evaded, while in cases of foreclosure the portion of principal not paid may or may not incur a tax on debt forgiveness. Loans resolved through bankruptcy generally permit the former homeowner to avoid taxes on the unpaid principal amount, but the bankrupt party may incur significant limitations on his or her ability to obtain credit for several years. But each case is different, and resolving these issues requires good legal and financial advice, and, often, hard choices.

As defaults increase, and first-time homebuyer tax credits lapse, both new home construction, as measured by permits and starts, and existing home sales, appear to be weakening. The construction industry often jumpstarts economic recoveries as interest rates decline. The absence of such a jumpstart now is bad news. Even more troubling is the impact on the financial sector of all of the non-performing loans. Yale economist Robert

Shiller suggests that home prices have a good deal more to fall before they hit long-term averages. His data shows that home prices tend to fall below the long-term average before stabilizing.

A further drop in home prices would have a devastating effect on the credit and spending habits of the American consumer, and on the financial condition of our banks. A severe downturn may lead to a downward spiral of all asset prices. We are concerned that this process is incomplete in the United States, and that the huge indebtedness of the U.S. government makes it less capable of coping with this problem. Such a spiral in home prices tends to reinforce itself, with lower property taxes, less upkeep, and consequent insolvencies of state and local governments, causing loss of local jobs in the most affected regions of the country.

### **Government's Role**

Government has, for better and worse, played a major role in this crisis. It contributed to the crisis by its failure to regulate the growth of private debt. It helped avert or delay the worst outcome of the financial crisis, through bailouts, and funding of stimulus and entitlement programs, including unemployment insurance extensions. But the federal budget deficit, at \$1.5 trillion for each of the last two years, is likely unsustainable for more than a few years. **For that reason, government's role in stimulating the economy going forward will likely be smaller than its role during the last two years.**

The Federal Reserve still holds well over a trillion dollars worth of securitized mortgages and other instruments that it purchased from financial institutions and government-backed agencies in late 2008, as well as investments in GM, Chrysler and AIG. Unfortunately, with the money supply growing very slowly, it may be years before the Fed can unload these instruments, and it is unlikely to recover all of its investment. **We believe that in the weakened state of the economy and the government balance sheet, the government is likely to keep interest rates low, but is not likely to move as boldly to intervene in markets if the economy hits additional bumps in the road. As such, the economy faces greater downside volatility risk than it did in 2008.**

For the next few years the federal government faces a number of big ticket spending risks, including underfunded government guaranteed pension plans and underfunded entitlements in medicare, healthcare and social security, and a continuing cost for unemployment insurance and underfunded state and local governments. At the same time, the government needs to reduce the existing budget gap. Congress and the American people will have to make difficult choices. These will ultimately include higher taxes, lower entitlement benefits, delayed retirement, and a reduction in other government spending.

These changes in government may ultimately be good for America. But we will have to take some bitter medicine that will be very hard to swallow.

### **Learning From Our Mistakes, and Tweaking Our Advice:**

Over the last few years, we've made some good calls about developing economies, about shortages of commodities, and most recently, about the depth of the financial crisis. But we've made mistakes as well. Our analysis missed some of the vast borrowing by foreign governments, which in the case of many European countries easily matched US debt, and in some cases was obscured by misleading national bookkeeping. Last month, just when we were being told that Germany was the savior of Greece and the other PIIGS, we noticed that total German debt (private, business and public) was at a similar fraction of their GDP to the sorry debtor nations it was bailing out.

We've also learned that, even more than we had expected, globalization has created very strong links between conditions in different parts of the globe. These links are more powerful at times when economies are stressed, and operating with little wiggle room. In time of crisis, both economic and political difficulties can have very large impact in areas normally remote from the source of the problem. As a result, during the next few years we face much greater exposure to economic troubles in Greece and the slowing of the European economy due to budget austerity, a slowdown in China, potential conflicts in Iran or Korea, drug violence in Mexico, and growing tensions in Israel and Gaza.

Also, last quarter we said that interest rates had likely bottomed after a decades-long decline, and were likely to turn up, leading to a decline in the price of bonds. While we remain convinced that bonds must be near to a low, we think we overstated the immediate risk of rising rates. So long as the money supply or the rate of turnover of money continue to be weak, interest rates could in fact stay at or near to the current lows for some time. Moreover, so long as the government moves to narrow the budget gap with higher taxes and lower spending, interest rates may remain very low even after we begin to emerge from the current crisis.

Despite our rather dour view of the economy, we do see good places to invest over the next decade. These include certain insured investment products for our more conservative clients, clean technology for those with a long horizon and a tolerance for volatility, and undervalued companies of all sorts.

We also see buying opportunities with each sharp downward in the markets. One of the most powerful investment strategies, known as "dollar cost averaging," says that investors can lower their average cost of purchases by investing their savings at a constant dollar rate over time. Because constant dollar investing buys less shares when stocks are pricey, and more shares when stocks are cheap, investors who continue to buy during market dips do on average enjoy the lowest cost for their shares. That's why **its important that investors with long investing horizons (a decade or more) continue to invest during this difficult interval.**

**Final Thoughts:** We frequently hear stories of severe financial, legal and tax consequences that clients face after they have made investments without first obtaining unbiased professional advice. If you or a family member is faced with a troubling financial situation, such as an underwater loan on real property, or is even considering any new investment, you, or they, should discuss this with us, and your legal and accounting experts. That advice may save you a great deal of pain.

One final item: every year we are required by the SEC and state regulators to offer you a copy of our form ADV-II disclosure. Please let us know if you would like a copy.

Sincerely,

Stanley Q. Mok  
President