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Quarterly Newsletter

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Second Quarter 2009

Investment Summary- The second quarter of 2009 continued to see the global economic "Great Recession" slow its decline and saw confidence grow that the GDP will turn back up in the second half of the year. Prices of stocks, bonds and commodities all rebounded sharply in April and May before stalling in June. A tension exists between balancing the early signs of recovery with prospects of a "jobless recovery" and economically unhelpful government policies presently being proposed. Our near-term outlook is neutral with little expectation of further price appreciation. Our overall strategy continues to be focusing on low/medium risk income producing investments along with a smaller allocation to inflation/weak dollar hedges.

U.S. Economy- While recent economic news suggests that the worst of the current economic contraction is soon to be over, it has left us with considerable damage to be repaired and fewer tools to do so with. Between securities and home values, Americans have lost about $26 trillion dollars (or about 25% of their overall net worth) during this downturn. In addition, our current 9.5% unemployment rate is well above the 8% post-stimulus rate the Obama Administration projected and is close to 11.7% if part-time employees, shorter work weeks, unpaid leaves and workers who have given up actively looking are added in. Interestingly, government jobs actually grew in the first half of 2009 by 3%. The "official" unemployment rate is likely to peak at about 11% in mid 2010 and stay above 10% for an extended period. This is consistent with the "jobless recoveries" experience over our last two recessions. The $787 billion "stimulus" spending bill went mostly to transfer payments like lower taxes for the poor, medical and jobless benefits. The spending that creates jobs, particularly an infrastructure, is only about 10% of the stimulus bill.

U.S. households are rapidly reducing debt and are now saving at a 7% rate. Every dollar of savings comes out of consumer consumption – 70% of our GDP. Recoveries are normally banking/credit problems this is not possible. Instead, the paycheck has returned as the primary source of spending. This debt reduction, saving and living within your means consumption, is healthy long term. However, it will also mean that our economic recovery will oscillate between sluggish growth and modest decline for several years until the rebalancing of excess household debt has been completed.

While economic recoveries normally produce an initial rapid rebound in GDP of 5-6%, we (along with most economists) believe that this recovery will be the weakest since WWII and take many years, not quarters, to return to old highs in asset values and earnings. Impediments to this recovery are the damaged consumers, fragile banking sector, slow job growth and anti-business policies and taxes. Helping our recovery will be growth in housing (see U.S. Housing), Asia and Latin America growth, healthy corporate balance sheets (unlike consumers and state/U.S. government), new business starts and innovations. The purging of weaker business models (Circuit City, AIG, GM, etc.) will be providing more customers for surviving companies.

The wild card will be inflation. Clearly we will have higher inflation and a weaker dollar in the years ahead. However, after the recent recovery bounce in commodities, valuations appear in line with current supply/demand for a weak recovery. Like stocks, we expect commodity prices to be range bound for the next few quarters and inflation tame until at least next year.

Policies and Taxes- Despite the dire state of the economy and our current $2 trillion 2009 deficit, the Obama Administration and the super majority Senate/Congress democrats are rapidly advancing their expensive social agendas. The proposed spending over the next 8 years is greater than all budgets from George Washington through George W. Bush – COMBINED! According to Stanford University, this will require a 44% increase in everyone's taxes. The tax burden is being laid on small business owners who make up the majority of the $350,000+ per year income bracket and who create the most jobs. Unfortunately, the overly optimistic revenue projection will end up moving the real tax burden down to the middle class and eventually to everyone via a future U.S. V.A.T. (value added tax). The new proposed tax rates are higher than even the most socialized European countries for high tax states like California and New York.

Our current taxation is already a very lopsided "progressive" structure. The bottom 40% of Americans not only pay no tax, but actually receive net payments of 3.6% of total income tax revenue (according to the latest congressional budget office data). The actual middle class, the middle 20% of income earners, pay only 4.4% of the total federal income tax revenue. This means that the combined bottom 60% pay less than 1% of our annual federal income tax. This is worrisome because this majority sees no reason not to vote for limitless social spending programs.

At the very top, the numbers are even more skewed. In California, the top 1% of wage earners pay 50-55% of the total state income tax. This is why our state's revenue swings so wildly. A flat tax of 6% across the board (vs. the 11% top bracket) would produce more revenue and be more stable. But why would the majority vote for that?

There is some good news: the American people will not let this current administration get everything they want. The Obama Administration is rushing to get their central health care reform done before the August Congress break and further erosion in popularity. Republicans will fight it and Democratic legislators will be hesitant to vote for something that would hurt them in their 2010 elections. The end result will likely be a drawn out battle for the remainder of 2009 and result in a more rational proposal (like only free catastrophic coverage for all, etc.)

U.S. Housing- The fall out from rapid appreciation/speculation in housing, along with high levels of mortgage debt, got us into our current problems, and housing will get us out as well. Like the world stock markets and oil prices in March, housing prices are now oversold (too low) and are primed for a 10-15%+ recovery bounce. Fueling this will be the $8,000 first time home buyer tax credit, 5% mortgage rates, steep price drops since 2006, low 2008 and 2009 new housing starts and "affordability" at an all time high since the statistic was started in 1981. Nationally, it is now cheaper to buy than it is to rent. However, the rebound will be uneven and take place over the next 12-18 months, then stabilize at a modest 90's pace of 3-4% appreciation annually.

This in turn will "un-toxic" mortgage pools, allowing banks to lend to businesses, real estate and consumers again. While this may seem far fetched, we believe it is only when, not if, this will happen.

Commercial Real Estate- Investment real estate (office, multi-family, retail, industrial) vacancies and lower rents will likely peak, along with unemployment, mid 2010. Until then, properties will be under-performing (little or no pay-outs to owners) and re-financing will be problematic. Once in a decade opportunities will exist for distressed properties and debt over this period for forward-thinking, all cash buyers. Self-storage, our in-house specialty, has suffered the least in this downturn and appears to have bottomed in April. Month-to-month leases will help it recover faster than other real estate as the economy improves.

Stock Market- The 40%+ rebound of the major index from the March lows has been welcomed, however, the markets appear fairly priced today and are likely to be range bound between 7500 and 9500 on The Dow Jones for the near- term. Earnings are coming in slightly higher than expected and estimates for 2010 have been increasing. This rebound, and expected future sideways action, allowed us good timing to switch our (your) stock accounts to Pacifica Capital Investments, LLC. Purchases will be made on market dips, with future progress more dependent on good company selection than on advancements of the stock indexes.

Overall, we still favor small and medium companies and large companies that do significant business in healthy Asia and Latin America. While we like emerging countries more than developed (see recommendations in our Third Quarter 2008 Newsletter), recent advances seem over done (China's stock market is up 79% and India's is up 57%) and we would wait for a dip before adding positions.

Fixed Income- The second quarter continued to see the twin diverging trends in the bond market. Treasury bonds, after the flight to the safety during the peak of the financial crisis, continue to drop in value as more investors move money out of these low paying, but safe bonds, and into higher yielding investments. These higher yielding investments (munis, mortgage bonds, corporate bonds, and foreign government bonds), after losing 30-70% of their value in 2008, continue to gain ground as we start to emerge from the recession. In fact, many have risen so fast that we are taking some profits to lock in gains.

For our mostly income oriented accounts, these liquid bonds and bond funds play an important role. We are still cautious regarding our fragile economy and overall maintain the majority of our funds in AA/AAA bonds with medium term maturities. We have smaller allocations to junk bonds and municipal bonds to increase income. We also are fearful of future inflation and a weaker US dollar and hedge most of our accounts with some foreign and hard asset (commodity) based bonds as well.

This balanced overall combination has grown nicely throughout the first half of this year and has limited volatility. We will continue to actively manage this sector as we expect the coming recovery to be jerky as corporate earnings improve while bad real estate loans and high unemployment drag on.

Forecast and Strategy- We believe that we will officially emerge from our current "Great Recession" in September/October 2009. Already, we have had three consecutive monthly increases in the "Leading Economic Indicators" – an important threshold in past recessions. However, structural problems of high unemployment, bad debt, huge government budget deficits and weak consumer demand will persist for at least another couple of years. Bright spots include Asia and Latin America, a potential housing knee jerk rebound and basic commodities (food, metals, oil, gold, etc).

Ordinarily at this point in the recovery cycle, investing heavily into the riskiest stocks/bonds/real estate has been well rewarded. While the riskiest of stocks and bonds have improved dramatically over the last two quarters, we are not convinced that they are still undervalued given the weak recovery we are envisioning. Two to three years from now we will enjoy a more stable and healthy economy, but getting there will be volatile and involve halting growth.

Our strategy for this "Economy 2.0" is maintaining core positions in the high quality assets while being light on our feet with smaller allocations to riskier ones. Specifically, maintaining overweighting in high quality bond funds, conservative real estate and value businesses and trading high yield bonds, munis, riskier real estate and commodity investments. In addition, our present hedge fund allocations are providing solid returns as well and we believe they will benefit from this future environment.

It is actually a very good time to be a cautious, income-oriented investor. The majority of the downside risks are behind us and you don't have to stick your neck out much to achieve attractive yields. In addition, buying riskier growth assets on future price dips, although scary, will be well rewarded.

Mark Van Mourick
July 23, 2009