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Letter

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Bubble Economics 102
Financial Market Update
The Economy

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YOLLES-SAMRAH WEALTH MANAGEMENT, LLC

BUBBLE ECONOMICS 102 (Government Intervention)

The domestic stock market experienced another leg down in June and early July with European, Asian and eventually emerging market stocks following the U.S. market lower. The decoupling rally, discussed in our April report ultimately failed by the end of May as the global economic slowdown became more evident to market participants. Many global stock markets have followed the U.S. down and reached “bear market” levels as defined by a 20% decline from the previous cycle high with the S&P500 breaking below 20% on July 3rd. China’s and Russia’s main indices have dropped over 50% and 25%, respectively. As of 8/15/08, the emerging markets and international EAFE indices are both down over 25% the since Oct07 market top.

Second quarter (Q2) earnings for S&P500 companies declined more than 20% matching similar Q1 results as large losses from financials and earning misses by the likes of Exxon and Chevron combined with rising inflation drove equity valuations lower. The earlier 2008 economic guidance provided by the Fed, private forecasters and even some of the best-run companies in the world suggested a second-half recovery. Clearly most were too optimistic as the general consensus for recovery has gradually drifted into mid-2009 and even 2010 with many forecasts tempered by continuing high energy prices and related inflationary pressures on the overall economy. Since markets turned lower, investor sentiment and consumer confidence has collapsed with closely watched indices declining in excess of two standard deviations from their decade average. The U.S. has

been in a severe confidence recession which started in Aug07 although real GDP has shown modest growth in 2008, due in part to government stimulus although Q407 real GDP was revised to -0.2% from +0.6%.

The second major development in 2008 is an increasing role of government in the management of financial markets in addition to extraordinarily high levels of monetary and fiscal policy targeted at “better” managing the economy. The Fed funds rate has been reduced to 2% despite consumer inflation exceeding 5% with the Fed’s discount window now open to investment banks for funding their illiquid investments at 2.25% including most recently the likely funding to repurchase illiquid Auction Rate Securities (ARS) from disgruntled investors. ARS are severely mismatched funding vehicles that many of the same banks profited from during the credit boom.

The **Economic Stimulus Act of 2008** resulted in a \$78b (billion) tax rebate funded with more government debt. Technically many received a rebate check without paying any tax in 2007. Now the **Housing and Economic Recovery Act of 2008** (seventh version passed) will include among many other costly “solutions”, \$3.9b to purchase homes foreclosed by financial institutions many of whom ignored lax underwriting standards, excessive home price appreciation and overbuilding when making these loans, a \$300b pool for lending to “troubled homeowners” as defined by Congress, an unlimited GSE credit line for the likes of Fannie Mae plus an increase in the conforming loan limit from \$417k to \$625k and a first time home buyer tax credit up to 10% or \$7,500. The ability to secure a mortgage

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in today's environment is another matter unless Uncle Sam is also willing to co-sign the loan.

Treasury Secretary Paulson's **Blueprint** proposes that U.S. regulators (Fed, SEC, FDIC, etc) be **reorganized by function rather than the financial institution** being regulated including a market stability regulator, safety and soundness regulator and a regulator focused on protecting consumers and investors. Paulson is a well-respected former investment bank CEO who apparently has had just a little too much Washington Kool-Aid as is evident in his remarks on 7/31/08 where he explains;

"we should create a system that gives us the best chance of foreseeing a crisis, including a market stability regulator with the authorities to avert systemic issues it foresees and providing the information, tools and authorities to deal better with unexpected events when they inevitably occur."

The obvious problem is many on Wall Street doubt that the government will foresee unexpected events and intervene to save investors from their mistakes. Government has mastered the intervention part, especially after the unexpected event has occurred which is substantially unnecessary post-event although perhaps politically useful. The chance of the Fed or Treasury foreseeing a crisis is almost zero and this should be obvious because anyone who had such ability would not be working for the government or anyone else for that matter.

So how has the world's free and democratic superpower created a situation where more government begets more government? One conclusion, after thinking and rethinking the series of

events that have created such a fragile economic landscape is that the **post-9/11 government intervention resulted in a credit cycle that was too easy for too long and resulted in too much debt for too much consumption relative to too little income growth**. In the end, way too much household and financial institution balance sheet leverage which now is painfully being unwound.

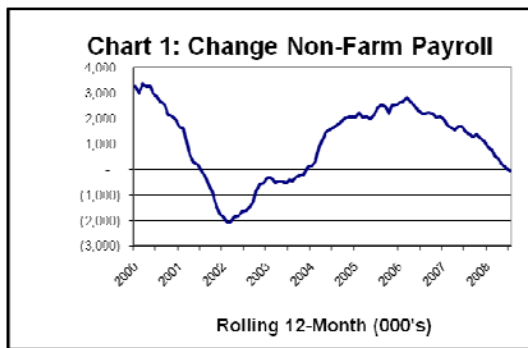
This cycle is analogous to a flawed strategy of teaching ever American how to use financial leverage instead of growing income and saving to achieve prosperity. When the leverage goes bad because markets turn lower, create more borrowing rules to be supplemented by more government borrowing for those who borrowed unsuccessfully. Seem upside down and backward?

Capitalism is the engine that generates continuous improvement, more efficiency and more effectiveness. **Failure is necessary; a disciplining force that is hard to replace with rules, government imposed or otherwise. Earnings growth, not financial leverage is ultimately the only sustainable answer** and sustainability is everything on Wall Street.

If we step back and look at the entire decade, the U.S. economy experienced a steep recession after the **tech bust** where employment growth on a rolling 12-month nonfarm payroll basis (Chart 1) turned negative in July 2001 and remained so until November 2003 resulting in 2.7m job losses after growing at an average annual rate in excess of three million during the late nineties and into early 2000. A pretty tough multi-year period for the economy and stock market which barely exceeded

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its 2000 closing high some seven years later (Oct07). **A very short recovery period relative to historical averages with the current bear market pushing many benchmarks to levels first surpassed a decade earlier.** This is also a very unusual occurrence and a low probability outcome that is painfully real for U.S. baby-boomers looking for sustainable retirement cash flows. The levels are the same but the sector imbalances changed as discussed in our April report (see 5/29/08 Appendix for data).



Growth in this decade has been weak because imbalances in a single sector such as real estate or energy drove growth with leverage rather than a sustainable balance across segments and industries (equilibrium) as economic theory would expect in a highly developed, information-based, just-in-time economy. Remember by the late-nineties many very talented economist and business leaders argued boom-bust cycle were a thing of the past. Clearly the science of business has improved during the last decade yet the business cycles persist.

The economy subsequently added 8.4m jobs during the next four years (2003 - 2006) with unusually easy credit fueling an unbroken series of monthly nonfarm payroll increases through Dec07. The technology boom waned but the

productivity gains from network computing and the internet continue to drive earnings growth and asset pricings.

The **real estate boom** lasted approximately four years but quickly ended after the financial engineering used to fund the boom failed to perform as expected. Too much counter-party risk and ultimately just the illusion of safety as **more and more yield deprived investors** chased very crowded trades which always end badly as the herd exits the space simultaneously. The credit market's willingness to fund mismatched assets (mortgages) and liabilities (commercial paper) was gone with many secondary markets literally frozen by the summer of 2007. Auction rate securities accounts were also frozen as credit tightened in early 2008 and the auctions stopped functioning leaving high-yield money market investors holding illiquid long duration bonds. Both the so-called money market investor and structured product underwriters looked the other way until the cards started to fall.

Should the king send horses and men to put ... or perhaps it's was just a very bad idea to buy a 700k house in a "hot" region that had appreciated three-fold then use a 100% loan to asset mortgage signed by a would-be home owner making \$50k after tax. Does this scenario constitute home ownership according to Congress? If the home owner is unable to pay the mortgage and the home value has retraced below the purchase price and is now worth less than the mortgage, does this owner qualify as a "troubled home owner" under Housing and Economic Recovery Act of 2008? One of the earlier six versions was actually called the foreclosure avoidance act but apparently

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at least one of 465 members of Congress had enough sense to change the wording. The enough sense part is an unconfirmed rumor! This is the very unpleasant reality that many of the most explosive regions must work to resolve and also the source of billions and billions of loan losses by financial service firms across the globe.

In retrospect, it seems increasingly clear that the real estate boom provided little long-run economic benefit or synergies that could alter the pace of innovation or productivity growth. Much too much of the growth was a function of leverage and inventory build rather than **demand based on sustainable employment and income growth**. Instead, this period seems more like a once-a-century zero-sum game with fiscal and monetary policy helping to pick winners including the sellers and builders of excess real property plus related supporting sectors like R/E brokers, mortgage brokers, title companies, appraisers, Fannie Mae executives, etc. and losers including property speculators, structured-product investors, mortgagors and many “unsuspecting” mortgagees who purchased over-priced homes with very aggressive funding structures and not enough income or income growth. Why grow your income or skill set when you can access government subsidized cheap capital and borrow your way to prosperity? Well it seemed like a good idea for at least three or four years and is certainly much easier than working hard and saving for a 20% down payment.

If we polled Americans today, would more select job stability and wage growth over cheap capital and non-home ownership. Functionally many non-owners were renters but the actual owner, the structured-product holders

failed to take appropriate steps to protect their interests and function as landlord. It is very unlikely that home owners, lenders and investors will repeat this painful experience and therefore it is in the **stock markets best interest if the economy can quickly reestablish a sustainable equilibrium between income, income growth and property value**.

The real estate boom gave way to the current **commodity boom** which started after the Iraq invasion but accelerated quickly in early-2007 as the also very over-crowded cheap-labor strategy resulted in more and more industrial building in export-driven emerging economies. The second wave of Fed policy accommodation (5.25% to 2%) which began in Aug07 helped push the dollar index down another 10% which drove dollar-dominated commodities like crude oil and natural gas higher. During the spring and summer, new record prices occurred almost weekly across many commodity complexes with the CRB commodity index peaking in early July up 32% YTD 2008. Again, more winners including many not-so-free and non-democratic nations with natural resources or abundant cheap labor, energy and material industries and perhaps the communities they operate within; more losers including the auto and transportation industries, manufacturing states and consumers of energy, raw materials and food.

Excessive global liquidity and the pricing of capital are once again at the center of the storm except Uncle Sam is now getting help from Uncle Chavez and Uncle Saad as they put their growing fortunes to work in the global economy. Statistically the economic outcome will always be better if millions

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of well informed economic entities make millions of economic decisions as compared to three guys making the decisions.

Even real smart guys like Paulson, Bernanke or their foreign equivalents are unlikely to foresee unexpected events and take steps to mitigate the crisis before it occurs. More competition and much less government seem more likely to generate better employment and income growth and provide energy choice at the pump and in the dealership. These are solvable problems although Professor Shiller argues “bubbles are primarily social phenomena”; i.e., behavioral (we believe there is not enough food and energy) rather than scientific (2008 will likely produce record output of corn, crude oil and many other commodities).

FINANCIAL MARKET UPDATE

In our April report, we discussed some encouraging signs including credit spreads appearing to peak on March 11th and the stock market appearing to bottom on March 17th in response to aggressive Fed policy actions. The stock market rally continued well into May before topping on the 19th then reversing sharply lower as the extent of unrealized credit losses became clearer with each additional company report and completed balance sheet deleveraging transaction. Secondly, the scope of real estate credit losses continued to widen far beyond “formerly-hot” U.S. property markets and financial institutions including Europe and Asia.

Sharp rallies inside a bear market are quite common with large and often sharp intra-day price changes including single

day 4% to 6% sector rallies driving 2 to 3% market moves. The sector rotation in recent weeks has been fast and furious at times with commodity and dollar price volatility often closely linked to changes in stock prices.

The below Table 1 shows the date-to-date price change in the S&P500 since the beginning of the year for each important inflection point; starting from the bottom of the table, the first sell-off bottomed on 3/17 after falling 13.1%, then rally back 11.8% by 5/19, only to break down for a second time before bottoming on 7/15 down 14.8%.

Table 1: S&P500 Price Change		
Date	Date to Date	YTD 2008
08/15/08	6.9%	-11.6%
07/15/08	-14.8%	-17.3%
05/19/08	11.8%	-2.8%
03/17/08	-13.1%	-13.1%
	4q07	-5.2%

On 7/15/08, the S&P500 reached an intra-day low of exactly 1,200 representing another 57 point drop from its 3/17 low or -4.5%. Financials and REIT securities led the market lower falling 34% and 21% respectively during the 5/19 – 7/15 period. Corporate bonds, mortgage-backed securities and high yield bonds also dropped sharply retracing early gains with date-to-date price declines of 4.9%, 1.5% and 8.5%, respectively. The benchmark ten year Treasury bond held flat during the same period while the two year Treasury rallied slightly despite upward inflation pressure.

Since July 15th the S&P500 has rallied almost 7% with the small cap R2000 index advancing 14% as of 8/15. Historically, small caps tend to lead

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large cap out of bear markets but as was the case in the period ending 5/19, small cap stocks sometimes out-perform during a bear-market rally.

Three other technical developments increase the likelihood that the market may have found a bottom;

- 1) Financial stocks and REITs lead the rally while energy stocks continued to decline
- 2) The dollar index has reversed sharply advancing 7.5% to recover much of the decline since March
- 3) Commodity prices have also reversed sharply with crude oil dropping over 22% from its peak with dollar-hedges like gold and silver experiencing large losses.

Table 2: Date-to-Date Price Change			
Sector	8/15	7/15	5/19
SP500	6.9%	-14.8%	11.8%
Dollar	7.5%	-1.9%	2.0%
Gold	-19.3%	7.6%	-9.9%
Silver	-32.1%	11.2%	-15.8%
Oil	-18.3%	9.3%	23.4%
REIT	15.3%	-21.4%	17.1%
Fin'l	24.4%	-34.3%	11.5%
Energy	-10.2%	-11.9%	24.0%
Mid-Cap	6.7%	-12.8%	18.5%
Sm-Cap	14.3%	-10.9%	13.7%

Table 2 which reads from right to left, illustrates the degree of rotation using date-to-date price changes for closely watch stock market and commodity benchmarks starting from the 3/17 trough. The 5/19 to 7/15 move down was both steep and swift. The subsequent

summer rally has exhibited positive rotation but lacked trading volume. Below average volume is always a seasonal factor in August and therefore, tends to increase day-to-day volatility.

The SEC has also taken steps in recent weeks to limit the short-selling in select financial stocks with somewhat arbitrary start and stop dates. These policy actions during a period of high open short positions is certainly going to generate more volatility than might otherwise occur based on a company's fundamental news. For example, the SEC ultimately selected 19 financial stocks including Fannie and Freddie which then resulted in rotation into the other financials excluded from the "temporary rules".

During periods of high uncertainty, investors tend to have a herd-reaction which pushes the segment in focus sharply higher or lower. Clearly that was the case with financials and REIT securities during the second leg down ending 7/15. Since the bounce, the market appears to be sorting out the actual winners and losers with the consolidation phase often required to return the "busted" industry back to good health. The automobile and airline industries are also experiencing large stock prices swings often in the order of 50% or more with the airline XAL index up over 90% since 7/15.

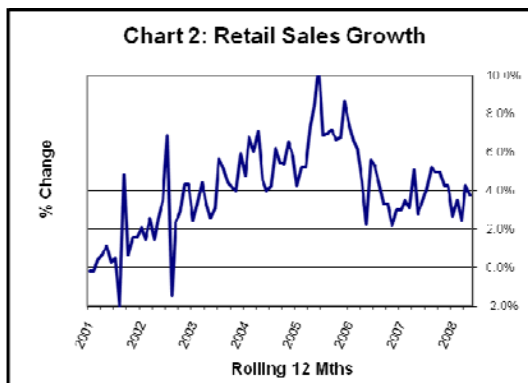
THE ECONOMY

The domestic economy continues to show weakness across many indicators yet real GDP growth did improved during the last three quarters. Q4 was revised lower to -0.2% and Q1 higher to 0.9% with the preliminary Q2 estimate

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jumping to 1.9%. The recent acceleration is attributable to 1) stronger export growth concurrent with imports declining even more than the drop in Q1, both likely related to dollar weakness and 2) stronger retail sales growth related to the completion of the \$78b tax rebate. The consensus real GDP growth forecast for the balance of 2008 continues to decline suggesting that the growth effects from the rebate checks and recent dollar action will quickly dissipate.

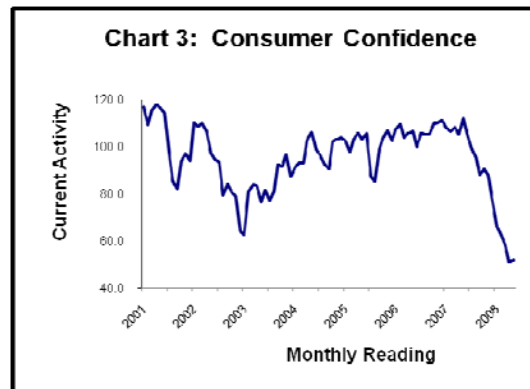
Second quarter **consumer spending** as measured by retail sales grew at an average annual rate of **4.9%** up sharply from a revised **1.6%** growth rate in Q1. Higher inflation accounts for much of the nominal growth as the CPI has drifted higher through-out 2008 and is now running above 5%. **Chart 2** depicts the rolling 12-month U.S. retail sales growth rate from 2001 through Jul08.



Same-store sales figures have failed to stabilize in many middle and upper retail segments and even recent comments from discounters like Wal-Mart and Costco suggest the downward trend is still in place. The decline in demand can be illustrated by adjusting sales growth for inflation using CPI-u on a rolling 12-month basis. This approach suggests real sales or units sales have been **declining at around 2% since January**. Auto

sales were extremely weak in July as large losses on residual values adversely affected lease pricing and availability including Chrysler exiting the lease market and others lowering their residual value assumptions.

Consumer confidence has fallen much more sharply than actual consumption or employment which suggests a slower and longer recovery period, perhaps more of a U-bottom. Conference Board's **consumer sentiment** index dropped to 51.9 in Jul08 which is down sharply from 112 in Jul07 and almost three standard deviations below the decade average of 96. **Chart 3** helps depict the steepness of the recent decline with the index reaching levels not seen since the 1979 hostage ordeal.

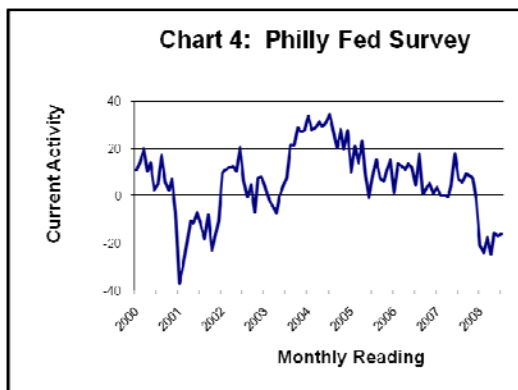


The U of M sentiment index exhibited similar characteristics during Q2 but has recovered slightly near 62 after bottoming in Jun08 at 56.4. Recent declines in gasoline prices combined with better stock market performance have likely contributed to recent improvements. Clearly sentiment needs to improve for the economy to regain upward momentum. **Expectations are much weaker today than in April with the election process likely to create more uncertainty in the next few months.**

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Business sentiment improved slightly during Q2 with the Institute of Supply Management's (ISM) purchasing manager index averaging 49.5 up from 49.2 in Q1. The index has remained above 50 (expansion) for two consecutive months and has held above its cycle low of 47.7 reached in Dec07. The Philly Fed index of regional manufacturing growth remains well below zero but has also improved during the last few months. The index has averaged -16 during the last three months (May-July) and appears to be holding its cycle low of -24.9 in April.

Chart 4 depicts the recent sideways activity in business sentiment suggesting perhaps some stabilization of output and investment in the coming quarters. Also note that unlike the consumer, business sentiment has not dropped below its 2001 bottom and while business lending standards have tightened, the decline in Fed funds has lowered interest costs for credit worthy borrowers.

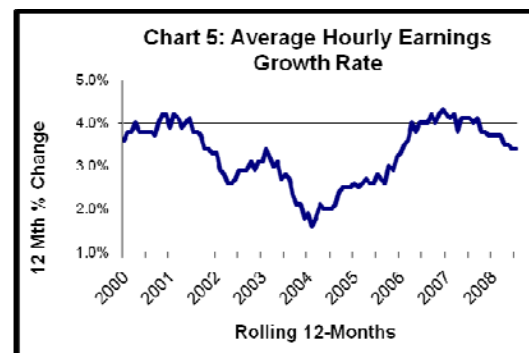


Capacity utilization has also begun to stabilize after reaching a three-year low of 79.6% in May. Average monthly utilization dropped to 79.7% in Q2 from 80.2% in Q1 and is over 200bp below 2007 readings. **Industrial production** remained in negative territory for a second consecutive quarter with an average Q2 monthly decline of -0.2%

although June and July were much stronger than April and May.

Non-farm payroll employment continued to contract in Q2 but at a slower pace than Q1 dropping at an average monthly rate of 55k jobs as compared to -82k during Q1. **Total non-farm payrolls have contracted by 463k thus far in 2008** with many economists expecting more job losses during the balance of the year. The unemployment rate continues to drift upward reaching 5.7% in July while the average hourly earnings growth rate has softened further and on a rolling 12-month basis is 210bp below the CPI inflation rate.

Weekly jobless claims are trending higher with early August readings above 450k and the most recent four-week average reaching a cycle high of 441k, up sharply from just over 300k at the start of 2008. **Chart 5** depicts the rolling twelve month change in hourly earnings growth from 1997 to 2007 with a clear downward trend during the last twelve months.

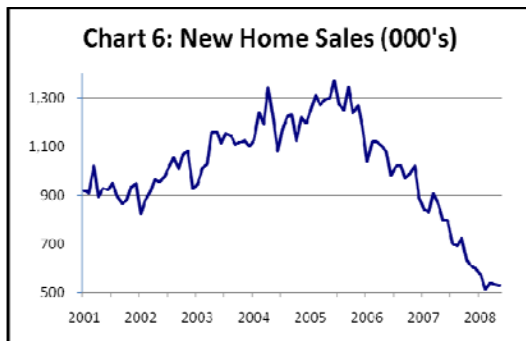


New home sales and housing starts have stopped falling on a month-by-month basis with new sales holding around 525k and housing start just below one million annual units. Jul08 marks the third anniversary with new homes sales dropping almost 63% from the Jul05 peak to the Feb08 assumed bottom at

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513k annual units. Inventory of unsold new homes contracted further during Q2 with **426k unsold homes** at the end of Jun08, down sharply from 543k in Jun07. The supply of new homes for sale remains elevated at 10 months but is trending lower after peaking at 11.3 in Mar08. The Jun08 median home price was up slightly to \$231k from \$227k in Mar08 with average selling price up almost \$7k from March at \$298.6k but still about 3% below Jun07.

The below **Chart 6** illustrates that **the steady three year decline has at least stopped in recent months** with annualized new home sales holding just above 500k.

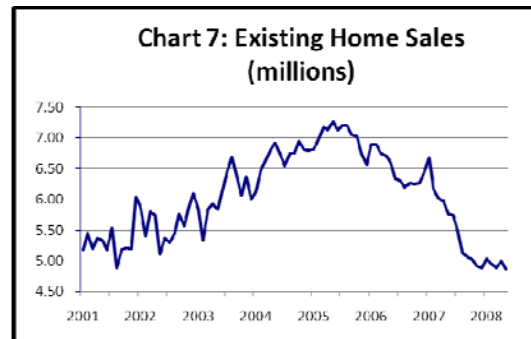


Housing starts dropped below one million annualized units in March and again in May but are also exhibiting some stabilization after reaching a multi-decade low which is likely the best scenario we can expect given very tight credit conditions.

Existing home sales are showing more weakness and have yet to make a clear bottom (**Chart 7**) as inventory levels remain near record levels. The number of existing **homes for sale** remains quite high at **4.49m** units and is holding near the cycle high at 11.1 months of supply. Inventory levels are not adjusting downward as might be expected given substantial price reversals in many of the

formerly-hot east and west coast property markets. Much tighter credit standards and high foreclosure rates are clearly having a greater impact on existing home sales relative to new homes.

The national median selling price has drifted higher in recent months to \$215k, down 6% from 2007 while the national average selling price improved to \$257.5k up from \$247.7k in Mar08 but still down 6.8% from last year. Recent declines in the ten-year Treasury bond yield have not filtered through to lower mortgage rates in part reflecting much wider credit spreads and more conservative risk management assumptions.

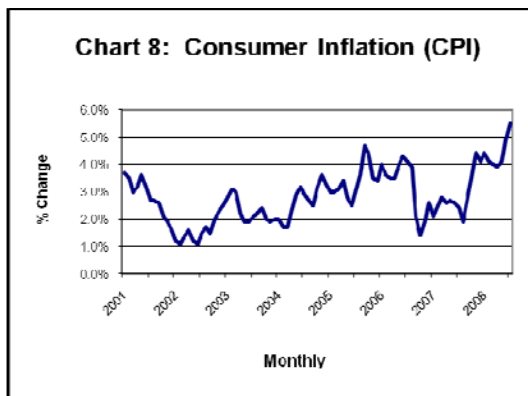


Inflation remains elevated despite a slowing economy with CPI breaking above 5% in July after briefly dipping below 4% in April before the summer run in energy price. The core CPI inflation rate increased slightly and remains above the upper-end of the Fed's comfort zone. Recent declines in commodity prices are helping to reduce headline inflation in August as the dollar continues to recover. Regular unleaded gasoline should drop to \$3.50 per gallon once recent crude oil price declines work through the refining and distribution system. The producer inflation (PPI) also jumped sharply in recent months as has

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the input price sub-components of the ISM and Philly Fed surveys.

The below **Chart 8** illustrates the sharp move higher thus far in 2008 using the CPI rolling 12-month price change. Also note that the inflation increase from around 2% in 2003 to above 4% by 2006 reflects the housing boom while the dip below 3% in 2007 the bust. The most recent sharp move higher occurred concurrent with the Fed's second substantial easing of monetary policy beginning in Sep07 with a 50bp cut to 4.75% and ending in Apr08 with 25bp cut to 2% then holding during the summer.



In sum, U.S. **economic fundamentals remain weak** as falling durable-goods sales and industrial production were offset by a jump in retail sales due to the \$78b tax rebate program. Consumer and business sentiment are indicating much

more weakness than is evident thus far in other important metrics like GDP which might suggest additional downside risk for the balance of 2008.

Many economists have concluded that a meaningful recovery will take much longer because so many financial institutions are deleveraging their balance sheet and reassessing risk-taking. Accessing consumer credit is clearly much tougher despite very aggressive monetary policy. Consumers who are able to obtain credit will face a large down payment and more costly repayment terms including higher interest rates and much lower lease residual values.

A continuing unwinding of the current commodity bubble will likely help to accelerate the recovery process although a growing consensus suggests mid-2009 or possibly early 2010. The election process will add additional uncertainty for both the stock market and economy in the coming months.

1) Form ADV II, as filed with the SEC, is available upon request. Also, quarterly client letters are available on our web site (www.yswm.biz).

2) Our privacy policy, as per regulatory requirements, is mailed annually and is available in PDF on our web site.