401KVentures

OVERVIEW

Economic Analysis and Market Review Q3 — 2010

A Time to Grow Grapes

AN OLD ITALIAN SAYING GOES, "There's a time to grow grapes and a there's a time to make wine." From an economic perspective, I suspect that this is one of those times we grow grapes. It doesn't look like this economy is going to go anywhere fast. Officially, the Great Recession is over and we're in the recovery stage now, but I'd be hard pressed to find anyone that I know that would agree with the Administration's view.

A year ago, we were told that for the recovery to begin, we had to get the housing mess in order. Well, single family home sales, both new and existing, are still sliding, home builders aren't doing well, lending is much tighter (as it should be) and foreclosures are still rising. The latest figures show that 4 years ago, 1 in 100 mortgages were in foreclosure, now it's 1 in 21 and 10% of all mortgages are 90 days past due. At the time of this writing, the whole foreclosure process is in complete disarray and banks are holding up their foreclosures until things get straightened out. In short, it appears that a legal issue involving the "chain of title" is at the root of the problem. When the mortgage notes were packaged and securitized into Real Estate Mortgage Investment Conduits (REMICs) a system was set up with Fannie Mae and Freddie Mac to facilitate this called the Mortgage Electronic Registration System (MERS). According to the law, only the note holder has the legal standing to foreclose and evict; however, at the moment, it's not clear who the holders of the notes are. If a note is sold to Larry and he sells it to Moe and he sells it to Curly, that is the chain of title and their notarized signatures are on the note. If that gets broken, the note is invalid. When these notes went into REMICs and then to MERS, and neither of them owns the note, the chain of title was broken. This could be a huge problem for the banks and the housing industry. No one can buy a house without title insurance and no title company will insure a title if there's a cloud over it.

In addition to this aspect, there's the issue of the foreclosure paperwork not being handled properly. The paperwork should be reviewed, signed and notarized and it appears that hasn't been done. One agent for GMAC in the Palm Beach office is said to have processed 10,000 foreclosures a month. One can imagine the increasing volume of foreclosures required that kind of productivity, but it doesn't allow much time for anything other than signing without reviewing and notarizing. Then there appears to be some fraud involved in this process as well. If documents weren't found, some law firms would simply create them and even forge signatures. There's more to come on this topic and it's sure to have an impact on the markets' performance in the future.

The Federal Reserve may say we're in recovery but they continue to believe that there's a sizable risk of deflation. The slow pace of this recovery at this stage leads them to believe that the economy still needs more stimulus hence we move to quantitative easing phase 2 or QE2.

Ben Bernanke has stated that the Fed will buy more debt to help keep interest rates low and promote economic activity. The Fed bought more than $300 Billion of Treasurys in 2009 and yields on Treasury bonds have remained at extremely low levels on account of it. A 2-year Treasury note now yields 0.35%! These low yields have helped keep mortgage rates at levels not seen since the '70s. A 30-year fixed rate mortgage is currently 4.2%. But quantitative easing is simply a euphemism for printing money and that has its side effects: it devalues the dollar and raises the price of commodities priced in dollars. The price of gold is now at historic highs, silver has appreciated 41% in price this year and oil is now over $80 per barrel. From January, 2009 to January, 2010, the price of oil has risen 111% and another 17% since then.

It's apparent that the Fed's quantitative easing has helped maintain low interest rates but what is less well understood is if some of this printed money is finding its way into the stock market. The stock market's stellar rise since the spring of 2009 is difficult to explain and this might be one of the causes. There's statistical evidence to support this idea. With the individual investor pulling money from equity funds for three-plus years, there's little room for traditional fund managers to accumulate stocks so a simple explanation is elusive. Now however, though just a third of companies in the S&P 500 have reported quarterly earnings results, the picture is impressive. Profits are soaring. Eight out of ten companies have beat earnings expectations, according to Thomson Reuters. The average jump in profits is 33%. Perhaps it's hedge funds and high frequency traders keeping the market in high gear. More on this later. Stay tuned.

INDEX	Q3'10	YTD	12 MO. CHANGE
S&P 500	11.3%	3.9%	10.2%
Russell 2000	11.3%	9.1%	13.4%
Europe, Aust., Far East	16.5%	1.1%	3.3%
Barclays Agg. Bond	2.5%	7.9%	8.2%
Wilshire Real Estate	13.2%	19.2%	30.1%
Treasury Bills	0.03%	0.08%	0.11%

- The S&P 500 is an index of 500 large, well-established companies
- The Russell 2000 is an index of 2000 small companies
- The Europe, Australasia, Far East Index (EAFE) is an index of the developed countries around the world
- Barclays Aggregate Bond Index is an index composed of investment grade bonds
- Wilshire Real Estate Index is an index of commercial real estate properties