



Buyer Shortage II

In the years 2000 and 2001, investors thought they were better off, only to find that the stocks of dot.com and new age companies were worth less than imagined. The cry from those who suffered was that they had been wronged. It couldn't have been their responsibility. They must have been misled. Recall the stockholders of ENRON, who were enraged to find that reported assets were bogus. If only they had been supplied with proper financial reporting, they would have been able to sell their securities (while they had quotes) to someone less informed. These revelations did not manifest themselves from fire, drought or pestilence, but merely from the fact that stock prices had been bid up to the point where there just weren't enough buyers to keep the bids coming and prices afloat. The stocks of the dot.com companies fell merely from a shortage of buyers willing to pay for publicly traded business plans masquerading as companies. There were plenty of warnings such as insufficient revenue, or lack of tangible book value. Yet, these investors were too smart--they were going to get out before the prices fell. If only they had known the truth, they could have sold to someone less informed.

After the dot.com bubble, the Federal Reserve came to the rescue. Interest on overnight loans among member banks, the Federal Funds Rate, was lowered to a mere 1%. People were encouraged to borrow money to purchase homes. Ah yes, the only investment that hadn't declined in four generations, residential real estate. There is a significant impediment to purchasing stock: you must have cash! The need for cash to purchase residential real estate was eliminated in the 21st Century with the advent of piggyback loans and no-doc mortgages. Eliminating the need for down payments and income documentation allowed more marginal homebuyers to inflate the economy, and this time they could do it with leverage. Incremental buyers of residential real estate were found by sucking in a more marginal investor than those who participated in the dot.com bubble. Little opportunity is left for new market entrants if the only impediment to home ownership is signing loan documents unsupported by income and net worth information. Similar to the issue faced at the end of 2000, buyers of residential real estate have bid up prices to a point where once again, the sellers have run out of buyers.

Fred Hickey, publisher of The HiTech Strategist wrote in his 12/6/07 letter:

After all, who knew that California housing prices could fall by 10% in just one year? Who knew that almost all the people taking out no-doc "liar loans" would lie about their incomes? Who knew that appraisers would inflate appraisals when there were riches to be had? Who knew that subprime borrowers (mostly those who had defaulted before) might default again? Who knew that it was not a good idea to stretch out auto loans to 9 years? Who knew that prices of commercial property should be somewhat related

to rental income? Who knew that mortgage insurers did not have the wherewithal (billions of dollars in equity) to insure risk (in the trillions)? Who knew?¹

It is disturbing that the Chairman of the Federal Reserve Board (The “Fed”) said at the time of the dot.com bubble, that he “wouldn’t be able to identify a bubble if it occurred, and wouldn’t prick it if he could.” The fact that he made this statement isn’t as disturbing as the fact that no one asked him: “If that is the case what is your job?” Or more appropriately: “Why are we talking to you?” Congressmen sat around stroking their chins and asking questions with erudite sounding words, reminiscent of teenage boys discussing video games, or preteens talking of Mozuls and Hogwarts. Through hearings attended by the Fed Chairman, Congress once again pretended to oversee the situation. What Congress oversaw this time was the Fed flooding the system with cheap money thereby assisting with the migration from the dot.com bubble to the real estate bubble. Investors as a whole were bailed out from their mistakes, and politicians reelected.

We could be at the point where the Federal Reserve has out done itself. The Fed must flood the system with money to keep the residential real estate bids coming. The Fed is faced with the impossible task of inflating the value of homes without devaluing the dollar and inflating commodities and interest rates. Unlike the imaginary stock profits of 2000 and 2001, the primary difference this time is that the loans on real estate need to be paid back on property that isn’t worth the value of the loans. The Fed must inflate the economy so that borrowers will continue to pay on their loans. In order to do this, borrowers must believe that the equity in their homes will increase at least as fast as the loans are paid down. This will require the value of the dollar to fall so that wage earners can receive dollar based wage increases, allowing them to pay down their loans and feel good about it. If inflation does not allow homeowners to live in a more expensive neighborhood without the inconvenience of having to move, they get restless and vote against incumbents.

The Fed may have met its match this time because many of the borrowers have floating rate loans. Interest rates on floating rate loans increase and decrease based primarily on two key benchmarks: the London Interbank Offered Rate (“LIBOR”), or the going rate on the 10 year Treasury bond. The predicament here is that the rates on these two benchmarks will increase to stay ahead of the Fed’s ability to flood the economy with cheaper dollars. This problem is much greater than the fact that lesser informed borrowers signed floating rate loans with below market (“teaser”) rates applicable to the initial years. As the Fed inflates the economy, and thus devalues the dollar, LIBOR and Treasury lenders will raise rates to compensate for the devalued dollar. Eventually the Fed will meet Adam Smith’s invisible hand of the free market. As the dollar falls in value, the invisible hand will move the cheese further out to compensate lenders.

As the Fed floods the market with dollars, the dollars will, as they always do, move on to the next bubble. Unless Liar Loans can be sold in China and India, the next bubble will be in commodities. The mantra will change from “Buy real estate, the value never goes down.” to

¹ Mountebank has been short and writing about Countrywide Financial since 2005.

Quarter Ended December 31, 2007

3 of 3

“People have to stay warm and eat.” Sellers will not stand by and sell oil and other commodities without being compensated for receiving deflated dollars.

It is ironic that this situation arose in the same year that the first baby boomer applied for social security. The vaunted baby boom generation now heads toward retirement with their largest asset, their home, falling in value, the cost of commodities increasing in dollar terms, while incomes remain under pressure from third world wages. What is missing again is the right question: “What do markets do when large numbers of sellers approach?” When the right question is asked, the answer is usually easy: “When buyers see an increasing number of sellers approaching, they mark down the bids.”

Portfolio Changes in the Quarter

Additions and New Positions:

Proshares Ultra Short Zinhua China 25 (FXP) This Exchange Traded Fund was purchased to give clients protection from a fall of the top 25 Chinese shares. These shares trade at price earnings multiples averaging 60 times earnings. History has proven that when shares trade at such lofty premiums, they usually revert to an average P/E ratio by falling in price rather than from a dramatic increase in earnings. One day, the central planners will drop their free marketeer masks, just in time to catch the backside of the invisible hand.

Proshares Ultra Short 100 FD (QID) This Exchange Traded Fund is designed to be 200% negatively correlated to the Nasdaq 100. This fund was purchased to replace the Rydex Arktos Fund intended to protect investors from a fall in the Nasdaq 100. QID gives the investor twice the protection as the Rydex offering for the same investment. Exchange Traded Funds such as FXP and QID have the added advantage of being able to be bought or sold during the day since the shares effectively trade like stock on the exchanges.

Plains Exploration & Production Co. (PXP) Plains acquired the stock of our previous holding, Pogo Producing (PPP) at a premium to our position. We are going to hold on for now even though Plains is not the same takeover potential that Pogo was.

Reductions and Eliminated Positions:

Rydex Arktos and **Pogo** explained above.

I will write to you again at the close of the next quarter. As always, please feel free to call or email if you have any questions.

Sincerely,



Martin C. Kendall
Managing Member
January 1, 2008