

DECEMBER 2008

Lately I've been having what I call "the talk" with a number of business associates and friends that work in my industry (real estate investment and development) as well as a myriad of other fields. I've been particularly motivated to understand the forces affecting my core business, as well as our national and world economies. Since real estate was the first sector to enter into the current economic downturn, I've been afforded the ability to do a lot of reading, listening and thinking over the past year.

I believe that our current economic situation is based on a variety of forces – social and cultural changes, global demographic shifts, the increased wealth and power of newly industrialized countries, changes in our government's role in promoting borrowing and deregulating markets, new "advances" in developing financial products, and finally greed and the suspension of common sense. The forces at work today have been in process for decades, and their impact will profoundly impact our lives for years to come.

My Grandparents' Era of Low Debt and Live Within Your Means vs. Today's Era of High Debt and Deny Yourself Nothing.

My grandparents lived during the Great Depression. I remember their mindset, and the mindset of their contemporaries. They did not spend money easily. They saved before they purchased. They, and their children, measured wealth by the amount of financial assets they accumulated. Debt was to be avoided and if one had to assume debt (to buy a house) one paid it off as quickly as possible. They never borrowed against unencumbered assets. I'm not old enough to have been an adult in the 1970s, but I certainly don't remember a high percentage of people driving luxury cars, wearing the equivalent of \$10,000 Rolex watches, carrying \$1,000 handbags while walking around in \$400 shoes. Designer clothes? They came from JCPenney and Sears.

At some point along the way, a very large part of our society changed the way that we measure "wealth." Our definition changed from "how much have I saved" to "how much debt can I take on." Wealth became measured in the size of credit card spending limits, home mortgage loans and car payments.

Our Current Debt Level is 350% of GDP (\$25 Trillion Too High).

If you look at the United States' entire debt (including government, banks, corporations and consumers) and measure it as a percentage of GDP since 1900, you will see that the average ratio is 150% with two noticeable exceptions. The first exception starts in the 1920s when debt to GDP exploded to 250%. It took the Great Depression and 15 years for the country's debt level to fall back to 150%, where it stood for decades until it started to rise in the 1980s. Over the last 20 years it has soared to over 350%. If the real long-term sustainable average is 150%, this would imply that the U.S. has \$25 trillion of excess debt that it needs to deleverage.

The World Changed – Global Savings Skyrocketed and Invested in U.S. Debt.

During the last 20 years we've had major global influences shape the world's economies, most notably the successful and rapid industrialization of the emerging world markets. China and India lead the pack, but there have also been great strides made in the former Eastern Bloc countries with the end of the Cold War. Advances in technology, education, infrastructure and transportation all led to great amounts of global resources being put to productive use within a very compressed period of time. As global trade exploded, the citizens of these countries had, for the first time, the ability and necessity to become savers. Since many of these countries have little or no formal social safety net infrastructure (such as health insurance, life insurance, disability insurance, social security, etc.) these citizens are forced to maintain a high savings rate to deal with the inevitable "rainy day." Global savings rates shot up in these rapidly developing parts of the world and these countries have been transformed into large global creditors. Additionally, their mass manufacturing sparked a long-term commodity boom, further concentrating enormous amounts of capital in commodity – rich countries – most noticeably the Middle East, Brazil and Russia. This caused the build-up of huge piles of capital in need of investing. This mass of inexpensive capital needed to find a home, and the U.S. has long offered an ideal, stable market with the world's best and most creative financial system, willing and able to develop never ending investment products.

Now the U.S. is the Largest Debtor Nation – and China, India and the Middle East Are Our Lenders.

The world is now divided into huge creditor nations (China, India and the Middle East) and one super power debtor nation – the U.S. The U.S. needs to export something to finance its trade imbalance. 1975 was the last year that the U.S. exported enough physical goods or services to balance its trade with the rest of the world. From energy to consumer goods, we import much more than we export. Of course, in order to keep this trade imbalance going, the products that we have been exporting are IOUs, in the form of treasury debt, corporate debt, and consumer and housing debt.

The relationship worked at a level that allowed the U.S. to dramatically increase its debt load as compared to its long-term historical average. This cheap and plentiful debt also caused the largest bubble the world has ever seen – what was at first thought to be a housing bubble but is really a credit bubble. In this most recent bubble, what the U.S. invented was advanced financial engineering to increase leverage on almost any asset class through sophisticated yield enhancement financial structuring.

Oops. The Financial Models Measuring Risk Were All Wrong.

We now know that the financial models being employed to predict the likely outcomes of downside events were not modeled with robust enough focus on low probability but highly significant events. People in the financial system failed to address the impact of highly unlikely but catastrophic events that might occur at the 4th or 5th standard deviation from the mean. It turns out that the tails of the bell curve are thicker than the rating agencies, issuers and regulators dreamed.

It also turns out that sophisticated investors couldn't keep up with the sophisticated issuers on Wall Street. Derivatives and a wide array of other investment products became ever more complicated – dreamed up, structured and modeled by an army of Ph.D.s. Buyers of these complex instruments relied on the wisdom of rating agencies and failed to perform adequate due diligence on the investment products they were buying. Rating agencies were using models that didn't appropriately measure downside risk, and in one startling revelation, it turns out that many mortgage security models had no scenario dealing with the possibility of falling home prices. And in a clear conflict of interest, the system is set so that the rating agencies are paid by the issuers of the debt.

Why and How Did We Start Taking All This Risk?

One of the reasons that we became so insensitive to risk may be that our political system invaded our financial system. The Federal Reserve and banking system were permitted and encouraged to open the floodgate by the folks running the government. The bailouts started in the 1990s with the United States' willingness to rescue emerging markets such as Mexico in 1995, Russia in 1998, then East Asia including Korea, Thailand, Indonesia, as well as engineering the bailout of Long Term Credit Management in 1998. These bailouts were all engineered to "reduce systemic risk" in the global financial system and ultimately to reduce risk to U.S. economic growth. It may be that this near constant policy of bailing out markets caused a slow but long-term move to under price risk, causing moral hazard. We lost a great tool that our grandparents had – fear. The world economies lived in an unprecedented age of prosperity – no wonder we didn't consider the unlikely impact of catastrophic events. We never had the scarring of consequence.

Another big change occurred when secondary securities were created and traded outside a rigid regulatory framework. The fact that totally unregulated credit default swaps are now estimated at somewhere between \$45 trillion and \$62 trillion – four times the U.S. GDP – is the starkest measure of this outcome. This is amazing growth for a product that was developed in 1997 and legalized as an "unregulated investment" in 2000. The intrinsic value of deregulation became non-questionable, and the belief in the efficiency and inherent wisdom of the invisible hand of free markets never seemed more assured.

At the same time, we also transformed a huge part of our banking system. Twenty years ago, a bank originated a loan, serviced the loan, and then collected the repayment. The 1990s gave birth to securitization, where many loans were originated, packaged into pools and then sliced and diced into bonds to be sold off to third party investors. The occasional loan modification process changed from a meeting with your relationship banker to phone calls and emails with faceless special loan servicers, who are bound by a rigid set of choices governed by bond indentures documents. Effectively we changed our banking system from a portfolio lender model that was able to deal with change to a segmented system of originators, loan packagers, rating agencies, traders and loan servicers – each with its own separate and often conflicting role. Many of the systems used in this process have now been revealed as inadequate, wrong and fraught with special interests, self-dealing and conflict of interest.

Lastly, the U.S. government started an aggressive program of social engineering initiatives. This started in the late 1990s as the federal government pressured Fannie Mae, the nation's biggest underwriter of home mortgages, to expand mortgage loans among low and moderate income people. The financial industry was given a mandate to increase lending to a wide variety of people who were historically considered a bad credit risk. In addition, The Community Reinvestment Act that was enacted in 1977 to encourage commercial bank and savings associations to meet the needs of borrowers in low and moderate income neighborhoods went through a series of expansions in the 1990s that aggressively promoted lending to poor quality borrowers to increase home ownership rates.

Turns Out It Was a Credit Bubble, Not Just a Housing Bubble.

We've had a bubble in the U.S., but it wasn't just a housing bubble. Commercial real estate values are a bubble, fueled in large part by the enormous leverage levels that were employed in the \$230 billion per year CMBS market, where so called "B piece" buyers (the only true "real estate" lender in the CMBS market) were operating at 80+ times leverage. Consumer debt loads are a bubble, and our general consumption levels are a bubble as well. The bubble has been going on for the last 20 years due to the dramatic increase in consumerism spread by the availability of credit that has been too easy to access, too poorly underwritten and inappropriately priced. The housing bubble was the first to collapse, but surely not the last of this cycle.

The scope of the bubble is enormous. For U.S. residential real estate alone, there is \$10 trillion of prime mortgage debt, \$1.5 trillion of Alt – A mortgage debt, and \$1.2 trillion of subprime mortgage debt. Shockingly, 45% of all homes sold in the U.S. last month had no equity – they were either REO or short sales. Estimated default rates and losses vary, but we believe we will see real losses of at least \$1.3 trillion. JP Morgan recently released their estimates that the losses in the commercial real estate market will equal or exceed the losses in the residential market. There is approximately \$7 trillion of total corporate debt in the U.S. and Standard and Poor's recently estimated that we will see up to 23% cumulative corporate debt defaults by 2010, meaning that we could see \$1.6 trillion of corporate defaults over the next two years. And we haven't even taken into consideration the mounting losses in credit card and auto loans.

But at Least We Were Investing in Good Assets, Right?

It turns out a lot of the debt we were issuing and selling to the world market was not for assets that generate returns where the debt is serviced from the “benefits” of the loan – such as debt used to finance a manufacturing plant to produce goods to be sold at a profit, which in turn will generate cash to service the loan. Instead, the American consumer has been leveraging up personal debt in order to spend on perishable consumer goods (vacations, cars, wine, parties, electronics, etc.), in large part due to their newfound wealth caused by rapid home appreciation, and in others due to their oblivion to the trap of borrowing. Much of the debt was used to finance assets whose value was inflated due to the availability of inexpensive debt leading to a house of cards now currently collapsing.

In addition, most corporate debt rated BB or lower was for leverage buyouts. These LBOs were primarily done not due to the brilliance of private equity and their ability to remake corporate America more efficient and create world-leading companies, but to take advantage of pricing disorders in the capital markets, due to cheap debt!

Change is Coming to the Creditor Nations – And It's Not Going to Help.

Long-term global economic trends were designed to move against this system, even before the system started to collapse. Rapidly industrializing countries go through a natural process where their focus shifts from investing their savings reserves in debtor nations' financial instruments to one where they increase their investment in building their own domestic infrastructure. This includes building better transportation systems, housing, education and health services for their rapidly growing upper and middle classes. The investment is needed to build a more robust national consumer base, and ultimately these countries build their own domestic markets that will increasingly consume a higher percentage of their domestically produced goods. The U.S. economy cannot hope to run its trade imbalance at ever-increasing rates, particularly after the realization by many of the global investors that the financial products that they have been buying were based on faulty underlying assumptions.

Everyone's Deleveraging - What Does it Mean?

The deleveraging that is taking place now will take many years to complete. The days of easy credit are gone for the foreseeable future. The collapse in asset values that has occurred has wiped out \$29 trillion – or half of the world's equity value – since October with \$9 trillion of these losses in the U.S. equity market alone. Oil and commodity prices have crashed which will greatly reduce the cash flow to the commodity producing nations so recently awash in cash. All of the world's lenders have to build cash balances to absorb the declining asset values that are the collateral for their faulty loans. Creditor nations are naturally going to move to investing a greater amount in their own domestic economies. No amount of pumping money from the world's government treasuries is going to get the banks back into the lending business at the levels we've seen in the past 15 years. Furthermore, a large amount of the deleveraging will be accomplished by debt default, not debt repayment.

The U.S. government has so far committed to spend \$7.8 trillion on the financial rescue, which includes \$2.4 trillion for U.S. commercial paper and certificates of deposit; \$900 billion in Fed Term Auction Facility loans, \$700 billion for TARP, \$250 billion to backstop Citigroup, \$153 billion for AIG, and the list goes on. In 2009 the treasury is going to have to sell at least an additional \$1.5 trillion in notes and bonds, with \$2 trillion to \$4 trillion more to come in 2010. Who will buy this debt? A significant amount of this debt that would have been bought by foreign investors will instead be bought by U.S. financial institutions that have been massively de-capitalized and have now had their balance sheets captured by the U.S. government. This will crowd out private borrowing for many years to come, and will likely lead to years of inflation. The biggest irony is how long we all have listened to the Fed measure and talk about inflation being controlled when all the while we have been living with the largest run up in asset-value inflation in the history of man.

A View of The Future Through Our Crystal Ball.

When lending does resume, it will be based on significantly more conservative underwriting and dramatically lower leverage levels. It will affect all U.S. spending, including credit card debt, home loans (both purchase and home equity lines) and auto loans. With reduced debt levels available to the consumer for a protracted period of time, it is entirely possible that our society will revert to the times of my grandparents and parents, where wealth was measured by having money in the bank and debt held at moderate levels.

In the near-term, the dollar is likely to rally as a safe haven relative to other currencies and the deflationary pressure caused by falling commodity prices, but over time this is likely to reverse. This reversal will be brought on due to the dollar's limited purchasing power as reduced credit is extended to the U.S. from foreign investors and via inflation as the government chases more debt by increasing interest rates and printing money to attract credit. The result of this is that U.S. dollar-denominated values are most likely going to be dramatically lower until capital flows to classic investment categories that yield intrinsic return on investments. These assets would include real assets, innovation (technology) assets and growth companies.

After falling significantly from their debt fueled values, income earning real estate assets will begin their road to value recovery due to their inherent inflation hedge. Other real estate assets that are bought at a significant discount to improvement costs will appreciate as the markets recover, once again with their value driven up due to the inflationary impact of rising construction/replacement cost.

What Does All This Mean for Capstone Advisors?

Capstone Advisors moved into an increasingly defensive investment position over the last two and a half years. By March 2006, we realized that we were in the middle of something much greater than a typical residential real estate downturn, and we worked aggressively to sell or restructure all of our real estate assets. We were successful in liquidating the vast majority of our investments. Select assets that required additional equity infusions and couldn't be sold due to their existing bank financing levels and illiquid nature were allowed to fail. Current market conditions have proven that walking away from the original equity investments was more prudent than spending large amounts of additional capital in an attempt to deleverage while asset values were in free fall. On a portfolio basis, we did very well with our residential investments.

We've emerged with a clean balance sheet, no contingent liabilities, and an operating platform ideally structured to handle today's illiquid real estate market. Most, if not all, of our focus for the next few years will be on buying defaulted loans originated by national, regional and local banks and secured by quality real estate in our local market areas. We've already bid (so far overwhelmingly "unsuccessful") on over \$2 billion of defaulted debt. Much of this debt has not traded due to bid/ask gaps, but we have recently started to buy limited assets at very attractive levels due to the sellers final capitulation in the face of overwhelming losses, their inability to hold until market recovery, and forced liquidation due to regulatory pressures.

We are investing primarily in Southern California, which traditionally has led the nation in population and job growth, has increasing difficult land entitlement and development regulations, and now has homes that are priced at significantly more affordable levels. We believe that these factors will help Southern California lead the nation in recovery.

Capstone Advisors is poised to be a market leader in the distressed debt arena, buying quality real estate at attractive values, holding and managing the assets through the long road to recovery and then selling as the U.S. economy inflates – which it will due to the massive amount of stimulus being pumped into the world's economy.

We cautiously look forward to the opportunities ahead.

Sincerely,

A handwritten signature in black ink that reads "Alex Zikakis". The signature is written in a cursive, flowing style.

Alex Zikakis
President, Capstone Advisors