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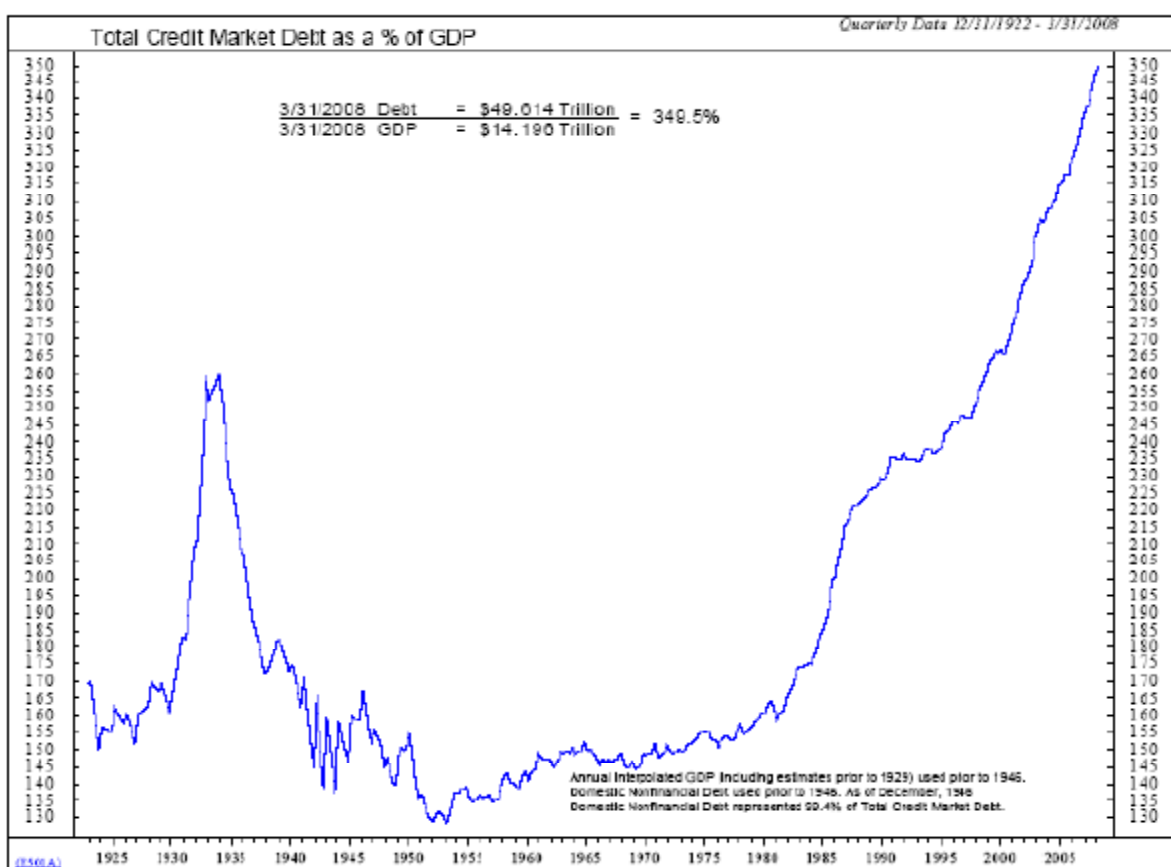
“It’s Not Over Yet”

By Matt Valentine

2009 has started where 2008 left off - with rapidly declining asset values, increasing uncertainty and stumbling policy-makers in Washington. Fortunately, our discretionary equity accounts ended 2008 with a market neutral position which has grown into a net short position as the year has progressed. You would have to live in a cave not to be aware of the global economic malaise and the reasons behind it; so I will refrain from reviewing the past. I will attempt to outline my thoughts of how the economy and market might unfold and discuss some of the reasons why we maintain such a defensive portfolio.

Just as we discussed in our letter last summer, the U.S. consumer has to retrench and begin saving again. Household debt ballooned over the last 20 years to a level that we believe is unsustainable.

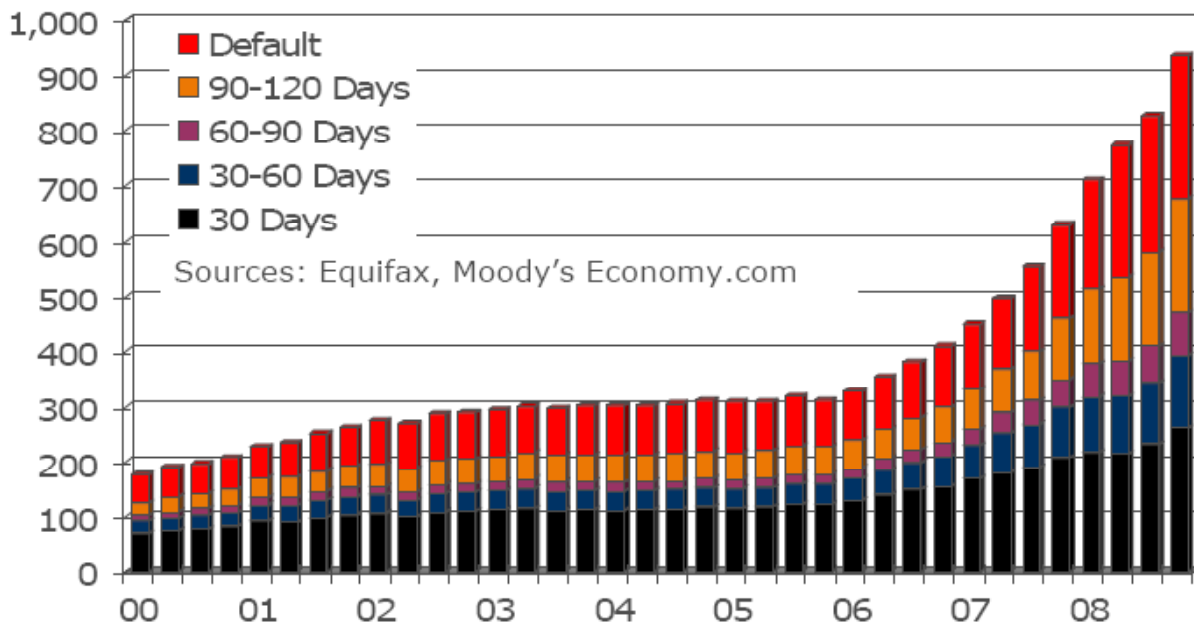
Household Debt as a % of GDP as of 3/31/2008





For more discussion on the tenuous state of the consumer, we encourage you to read our newsletter “The Material Nation Needs to Dematerialize” which you can access at our website www.valentineadvisors.com. At the peak in 2008, the U.S. personal savings rate was negative. By December, household debt in delinquency or default was over \$900 billion up from \$400 billion two years earlier (Moody’s).

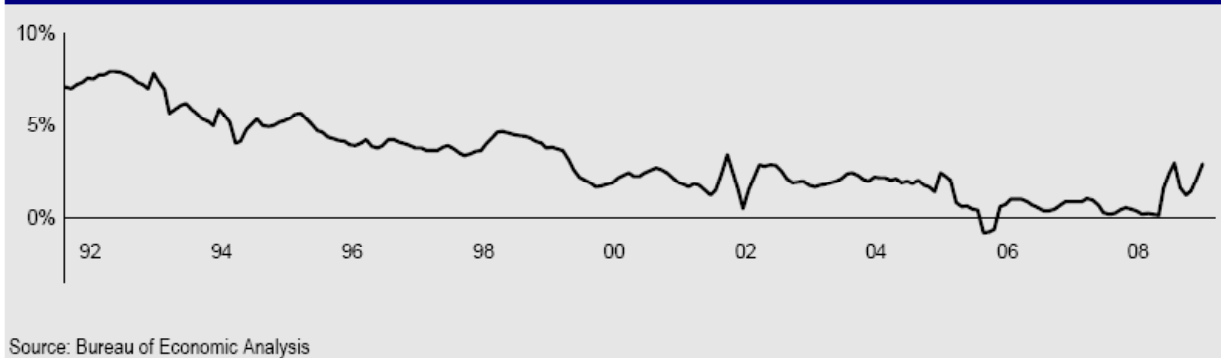
Household debt in delinquency or default, \$ bil, annualized



We believe a return to an early 1990s savings rate of roughly 8% is inevitable. An increase in the savings rate from 0% to 8% would decrease consumption by roughly \$824.6 billion which would reduce total GDP by roughly 5.8% (US Department of Commerce, Bureau of Economic Analysis 2008). For a better perspective, a reduction in spending of this magnitude would be **greater than last year's combined sales** at Wal-Mart, Home Depot, Target, Lowes, Sears, Best Buy, Macy's, McDonalds, JC Penney, Amazon, Starbucks, Nordstrom, Whole Foods, and Abercrombie & Fitch (based on 2007 revenues, Reuters). The data even surprises us! It is impossible in our opinion that an increase of the savings rate to 8% won't cause massive retail store closures and eventual bankruptcies. Keep in mind that it took years for consumers to increase their standard of living on borrowed money and it will take a few years to readjust to the new reality of saving instead of spending. But given enough time, the savings rate should increase substantially from the current 3.6%.

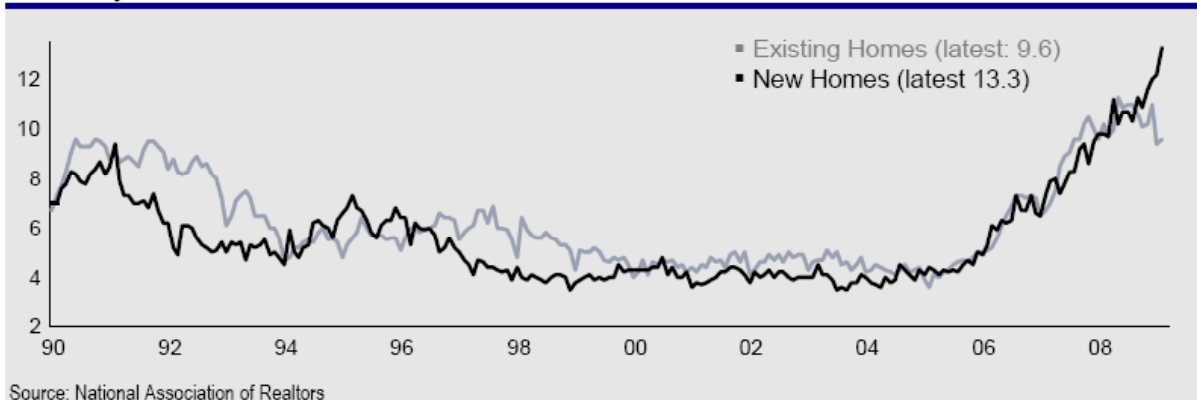


Savings Rate — Likely Rise Will Be Headwind For Recovery



This leads us to residential real estate which served as the “piggy bank” to allow many Americans to increase their consumption through home equity withdrawals. The real estate slowdown (or meltdown depending where you live) will continue to drag on for some time; though there are some signs of stabilization. However, we believe the “positive” data points are more a function of massive foreclosures being sold at discounted prices than an increase in fundamental demand. In California, there are currently estimated to be 725,000 homeowners with loans 125% greater than the current value of the homes. With average prices down 41% and unemployment continuing to rise, the likelihood of elevated foreclosures seems unavoidable. This will only add to homes already on the market. In January, California housing inventory for sale was 348,000 units, **up 37%** from December. Obviously, California is just one specific case with a very deep housing problem but one that has been going on for at least 15 months with still no end in sight. I believe you will see the real estate situation deteriorate further as foreclosed homes continue to come on the market.

Inventory Of Unsold Homes — Must Decline Before Home Values Can Stabilize





The average sales price of a home is \$170,000 down from a peak of \$225,000. If you were to take the \$100,000 average price of a home in 1992 and inflate it at 3% until today, it would be worth \$170,000. In other words, home prices today are about where they should be based on normal growth. Typically in significant declines like today, past excesses usually overcorrect. With the absolute number of homes on the market continuing to rise, it will take more time and price declines for housing to find a bottom. Most importantly, we believe average future home price increases won't exceed much more than 3% growth for quite a while. We do realize real estate differs drastically from market to market and potential returns are possible in the right areas if the purchase price is distressed enough. But in totality, we believe future growth is somewhat limited to long-term historical averages.

Real estate leads us to the banking sector which invariably leads us to Washington. The majority of bank lending is backed by real estate. When real estate values fall, banks are less able to make loans. Lack of available bank credit makes it harder for businesses to make payroll. Cash strapped companies will then be forced to lay off workers. Unemployed homeowners will be unable to make mortgage payments. Foreclosures will erode real estate values...and the cycle continues. Washington policy makers have attempted to break this cycle by continued creation of various stimulus plans. The Bush Administration, hampered by incredibly low approval ratings and lame-duck status, weakly attempted several strategies to try to improve the capitalization of the banks and stop the downward spiral of financial assets but it all fell on deaf ears. The Obama Administration came into power bringing with them a message of hope and fresh ideas. The initial fiscal stimulus plan outlined \$787 billion of spending to create jobs and restore confidence. It is often dubbed the "infrastructure package", yet less than 10% of the new spending is directly aimed at infrastructure outlays. Of the \$282 billion in tax cuts, 25% is a provision to keep people from being ensnared by the AMT (Alternative Minimum Tax). The largest part of the tax relief is in tax credits via lower withholding taxes on one's paycheck. We are curious how an extra \$8 per paycheck is going to end the recession. Once again, the market wasn't listening as the downward spiral intensified.

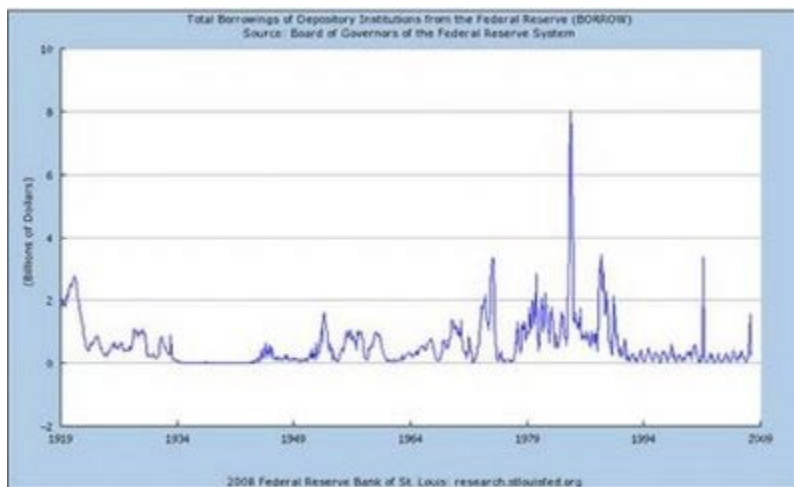
Next, President Obama outlined his initial 2010 budget. In his defense, he begins in a large fiscal hole mostly due to plans put in place by President Bush, Hank Paulson and last year's Congress. President Obama's budget fails to achieve balance at anytime in the next decade. Despite some of the highest economic growth projections and one of the largest tax hikes in history, the smallest deficit still will be \$533 billion in 2013. As Brian Wesbury, the Chief Economist at First Trust wisely points out, "The budget forecasters assumed that the economy would grow at a 3% annual rate starting in April, and that real GDP would fall just 1.2% in 2009 from 2008. Then, from 2010 through 2013, the administration assumes that real GDP will grow at a 4.0% annual rate. To put this in perspective, it is twice as fast as the economy's 2.0% annual growth rate between 2004 and 2008. This is not impossible, but the only other periods that came close to this 4% growth rate for such a prolonged period of time were the late 1990s and mid-1980s. Both of these periods followed major shifts toward freer markets, and tax cuts, not bigger government and tax hikes. There is no period in U.S. history where tax hikes and the size of government both increased, and yet real GDP growth accelerated as sharply as the Obama team forecasts."

Further, the government believes that part of the solution lies in policies designed to increase the value of troubled assets. The problem with this approach is that it is based on incurring trillions of dollars of additional debt to create the demand to purchase these assets. At best the government may be able to provide a short-term boost to the economy, but it isn't a prescription for long-term success. Debt-financed government demand can't be sustained indefinitely which is why I believe these policies are doomed to fail in the long run.



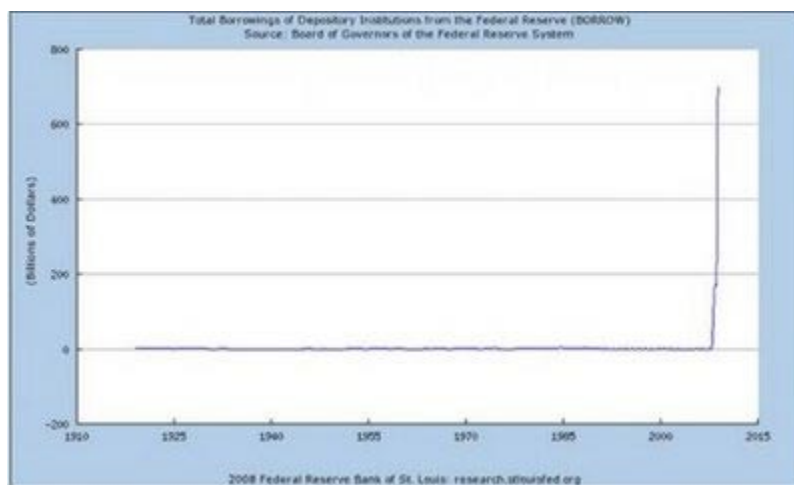
The U.S. balance sheet is not a bottomless pit, although I believe it is beginning to resemble a Black Hole. At some point, the economy will have to generate sufficient tax revenue to pay for this government spending or the country could lose its AAA rating. Economic demand will ultimately have to become savings-driven and not debt-driven or it will again collapse. We are by no means suggesting that there will be no winners – education, health care, energy, the environment and technology – but it does mean that enhancing the social safety net does not necessarily translate into sustained growth in economic activity or wealth creation. The markets response to his efforts speaks loud and clear. The strain on the income statement and balance sheet of the U.S. government will be a matter to watch very closely.

TOTAL BORROWINGS FROM THE U.S. FEDERAL RESERVE (1919-2007)



Source: Board of Governors of the Federal Reserve System

TOTAL BORROWINGS FROM THE U.S. FEDERAL RESERVE (1920-2009)



Source: Board of Governors of the Federal Reserve System

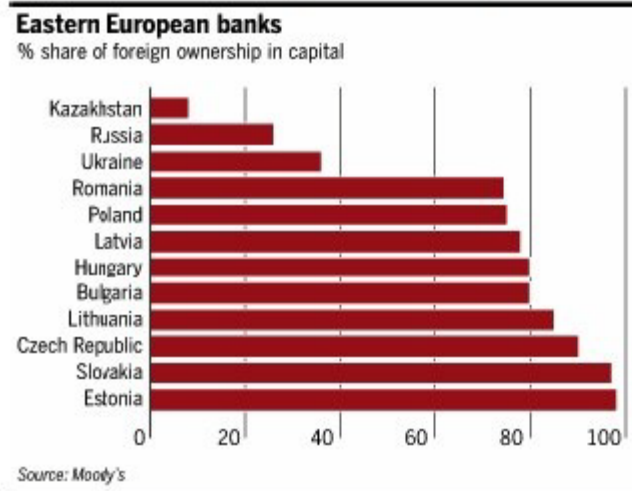
Despite the seemingly immense negative possibilities for the U.S. due to slowing consumption, further declines in real estate and reckless government spending policies, the U.S. looks to be better positioned in the short-term than many of its peers. The current weakness permeating the rest of the world and potential pockets of social unrest lead us to believe that the U.S. dollar will maintain its strength.



The U.S. economy as a whole has less leverage and less exposure to radical economic deterioration than Western Europe. Provided European banks loaded their balance sheets with very high-rated assets, regulators allowed them to apply much more leverage than the U.S. banks. In a normal economic environment, more leverage generally allowed banks to make more money; and thus banks in Europe bought as much AAA-rated assets as they could. But AAA is not always AAA as we have learned over the past 18 months.

Many asset-backed securities (CLOs, CDOs, MBSs, etc.) proved very popular among these banks partly because they offered very attractive returns and partly because S&P and Moodys rated them AAA despite the dubious quality of the underlying assets. According to the International Monetary Fund (“IMF”), European banks have 75% as much exposure to U.S. “toxic debt” as American banks. Citigroup calculated that it only would take a cumulative increase in bad debts of 3.8% in 2009/10 to take the core equity tier 1 ratio of the European banking industry down to the bare minimum of 4.5%. To compound the problems, when the iron curtain came down Western European banks acquired many Eastern European banks in order to profit from the potential growth opportunities.

Chart 1: Western European Ownership of Eastern European Banks



Source: FT.com

Based on a Credit Suisse research study assessing the credit quality of sovereign debt, 8 of the 15 highest-risk countries are in Eastern Europe. According to the IMF, 90% of all cross border loans to Eastern Europe originate from Western European banks. Now, with many Eastern European economies in free fall, this ownership could prove disastrous for an already weakening banking industry.



Lastly, European banks have been far slower to realize losses on their books and raise capital. To date, 75% of all recognized bank losses globally have been taken in the U.S. Yet, the liabilities of European banks are still quite large when compared to the U.S. banks.

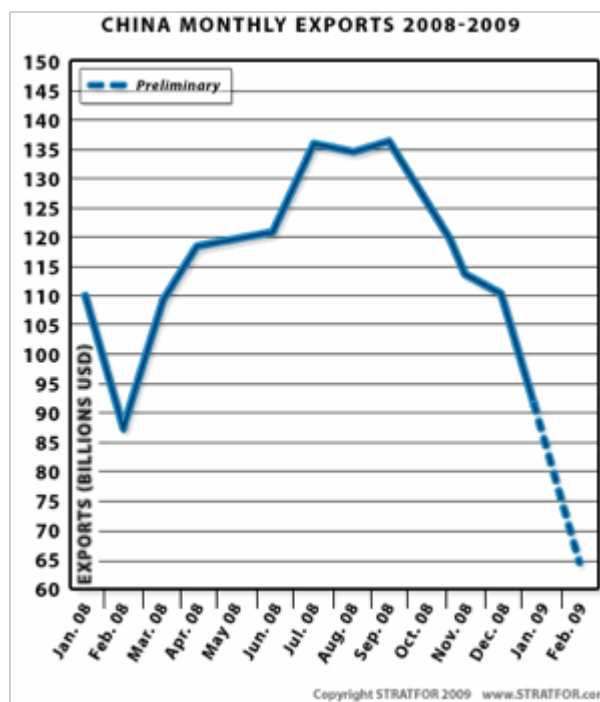
Short-Term Bank Liabilities to GDP

Belgium	285%
Switzerland	260%
Britain	156%
France	60%
Germany	60%
Austria	42%
United States	15%

Source: Bridgewater Associates, NY Times

We believe these problems will continue to pressure the Euro and a discussion of European Union dissolution could occur at some point this year which would slow down world trade further and cause more panic in financial markets.

A further slowdown in world trade would cause much more harm to Europe and East Asia than the U.S. since we are much less dependent on manufacturing goods. Slowing consumption around the world has hurt the European and Asian manufacturing-based economies. European industrial production has declined rapidly in the last year with the entire Eurozone down 12%, Sweden down 20% and Germany down 12%. Exports from Asia have fallen even more drastically with South Korea down 34%, Taiwan down 44%, Japan down 46% and China down 18% in January. Exports are vital to the East Asian economies particularly China, with it comprising about 40% of GDP. China manages its day-to-day expenditures and puts away foreign currency reserves from its robust trade surpluses. China's surplus has recently cratered from \$39.1 billion in January to a mere \$4.8 billion in February with a 26% decline in exports.





The slowdown clearly knows no boundaries and previously unthinkable deflation has reared its ugly head. Chinese consumer prices fell 1.6% in February. This was the first decline in consumer prices since 2002. The drop in prices raises the risk that deflation will become prevalent, squeezing company profits, prompting more wage/job cuts and eroding consumer demand. Bloomberg recently noted that at least 67,000 factories across China have closed down and more than 10 million workers have lost their jobs in the last year. Ultimately, the pain in China's export sector will contribute to deflation and social problems that are already emanating from rising unemployment. We believe that some form of social uprising in China could be another potential threat to restoring global confidence.

Taking the various risks of 1) slowing U.S. consumer spending 2) continued real estate foreclosures 3) unprecedented U.S. government debt 4) European Union problems and 5) potential Chinese social unrest, it is no surprise that U.S. equity markets are down almost 50% in the last 18 months. That being said, equity valuations for many world-class companies are trading at very depressed levels with dividend yields higher than long-term U.S. Treasury bonds. In general, valuations such as we see now should lead to longer-term positive returns and at some point in the future aggressively investing in equities will be the appropriate strategy. We just don't believe it is time yet. We continue to maintain the defensive posture that we have had through most of the last 18 months with large cash positions and intermittent short investments. We don't foresee removing our defensive positions until we have conviction that things aren't going to get worse. Initial signs of stabilization in the economy could cause us to rethink our overall portfolio posture. As always, we continue to work diligently to help protect and grow our clients' capital as we search for signs of the inevitable economic recovery.

Matt Valentine
Valentine Capital

	<u>March</u>	<u>YTD</u>
Dow:	7.94%	-12.48%
S&P 500:	8.76%	-11.01%
Nasdaq:	11.02%	-2.79%

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International investing involves additional risks such as currency fluctuations, differing financial accounting standards, and possible political and economic instability. These risks are greater in emerging markets. Companies engaged in business related to the technology sector are subject to fierce competition and their products and services may be subject to rapid obsolescence. Past performance does not guarantee future results.

Gross Domestic Product (GDP) is the annual total market value of all final goods and services produced domestically by the U.S.

Real estate securities are susceptible to the many risks associated with the direct ownership of real estate, including but not limited to:

Declines in property values, due to changes in the economy or the surrounding area or because a particular region has become less appealing to tenants

Increases in property taxes, operating expenses, interest rates or competition

Overbuilding

Changes in zoning laws

Losses from casualty or condemnation