Opis Advisors' Investment Letter

Opis Advisors, Inc.® **November 2009**

It's now widely understood that we've been living through a period for the financial history books.

Looking ahead, considerable economic challenges remain. The consumer is highly stressed and the job market is very weak. Housing has more shoes to drop. Commercial real estate loans sour.

Valuations have certainly been affected by the recovery in financial asset prices we have witnessed and participated in this year. Stocks are no longer undervalued unless one believes that earnings growth will be very strong over the next few years. We believe that is unlikely.

We remain underweighted to equities and have a preference given valuations and the macro backdrop for risk aversion.

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Insights About the Past, Present, and Future

Reflections on the Past Year

It's now widely understood that we've been living through a period for the financial history books. The stunning failure of major financial institutions (Fannie and Freddie, Lehman, AIG, Washington Mutual, and others) in August and September of 2008 triggered a series of events that almost resulted in the collapse of the global financial system. The lending markets may have been within days of a total shut down and only extreme government actions prevented a meltdown and probably an economic depression. But while government intervention averted an all-out economic disaster, it was not enough to prevent the worst recession since the 1930s in combined terms of its length, magnitude of GDP decline, and increase in unemployment. In the months that followed, market volatility was the highest since the 1930s, resulting in stunningly rapid shifts in investment risks and opportunities.

Challenges in the Present and Future

Evidence now strongly suggests that the recession ended sometime this summer. However, that does not mean that we are assured a lengthy period of robust growth that will quickly return the economy back to its long-term growth trend line and support a sustained bull market for stocks.

We have begun to grow again after a deep downturn. Growth is being triggered by two forces:

First, there is a slowing in the huge inventory contraction. For months businesses refused to restock inventories and instead met meager sales demand by depleting inventories. Now, we are starting to see restocking to keep pace with demand. Inventory restocking could temporarily be a powerful force in coming months.

Second, the huge government stimulus has triggered and supported economic activity. Cash for clunkers, the tax credit for new home purchases, Fed purchases of virtually all mortgages being written (which has supported the mortgage market and kept mortgage rates low), and a surge of unemployment benefits have supported and stimulated demand. However, cash for clunkers has ended, the tax credit may be extended but will expire at some point and the Fed will

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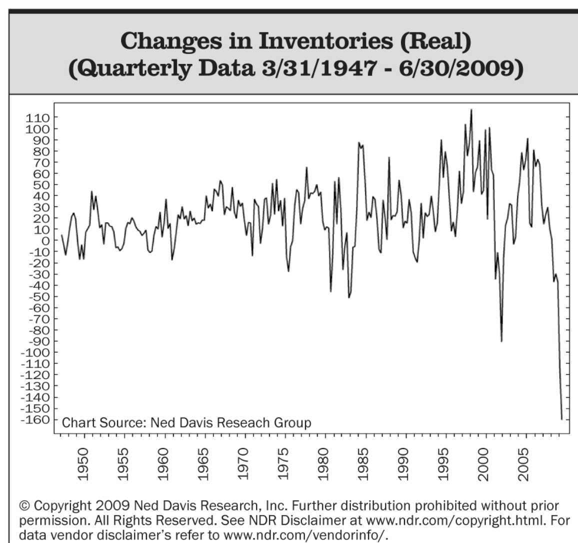
gradually withdraw its mortgage market support and unwind other measures.



We've experienced the worst inventory draw down since the 1930s. The rebound from this will contribute to a burst of growth.

So, the economy is now very likely growing but it is off of a very depressed level, and it is still fragile:

Housing: Home sales have strengthened thanks to low mortgage rates, depressed home prices, and tax credits for home buyers. However, there is no "all clear" yet with respect to prices and foreclosures. The risk looking ahead is that the level of foreclosures will continue to run at very high levels as a result of the combination of high unemployment, a sizable percentage of homeowners who owe more than their home is worth (about a third of mortgaged properties), and a huge wave of Alt-A and Option ARM mortgage payment resets that will occur over the next three years (in most cases there will be a large percentage increase in monthly payments). A high foreclosure volume will dump more homes on the market, which will put more downward pressure on home prices. Some experts we follow believe that prices could decline into the first half of 2010. If they are right, there will be further damage to household wealth.
Employment: The labor market remains extremely weak and while it is getting worse at a slower rate, the fact remains that it is still deteriorating from an already weak level. Overall, over 16% of workers are "underemployed." Moreover, the duration of unemployment is at 25 weeks, a record high (the record goes back to 1948), and job seekers outnumber openings by six to one. In the last recession the jobs-to-job-seeker ratio was just over two to one (this measure did not exist prior to the last recession). Still, the rate of decline in the labor markets is slowing and we may be within months of a bottom in unemployment. If so, the new debate will focus on the strength of the labor market rebound.

The Consumer: The strength of the consumer rests on several factors:

Assets—By this measure consumers have taken a huge hit. Though financial markets have rebounded this year, they have not come close to recouping prior losses and the loss of home equity has been enormous. Dual severe bear markets in stocks and housing have not occurred since the 1930s.

Debt—Debt levels are declining for the first time in years. In fact, consumer credit has just experienced the largest two-month decline on record. However, we believe it will take years for the consumer to reduce debt to a sustainable level. Debt levels still remain very high compared to assets, income, and GDP, and debt service (interest payments) relative to income is also historically high. The combined impact of high debt and asset price declines triggered a drop in household wealth of close to 20% from its peak in 2007.

Access to Credit—The book is closed on the great American credit expansion. The days of liar loans and a pyramid of credit card debt are over. Lending standards may have even overshot a return to prudency. Credit cards are cancelling customers and lowering limits. Homeowners must make larger down payments and meet more demanding documenta-

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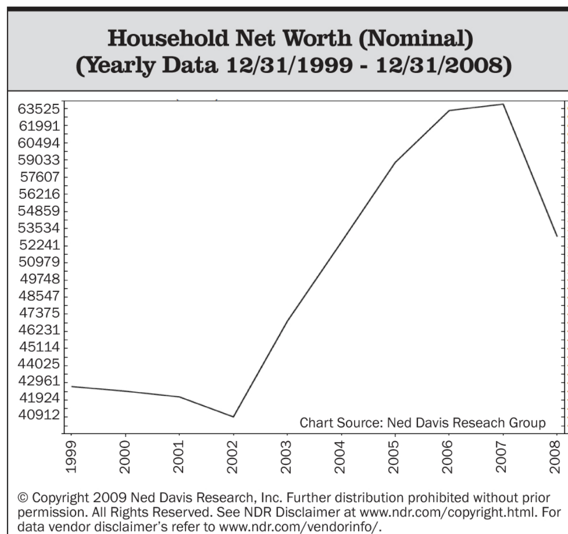
tion and income standards. Generally, banks remain cautious with respect to their lending partly due to the weak condition of potential borrowers, but more importantly, because of expectations of many more losses to come from loans on their books (not only from residential mortgages but also a big hit from commercial mortgages as well as more from credit cards and other types of loans). A recent International Monetary Fund (IMF) forecast predicts that globally, total bank losses between 2007 and 2010 will be more than double what has been written off to date. In the United States the outlook is only slightly better with banks having recognized 60% of expected losses per the IMF calculations.

Employment and Income—As discussed, the employment market is on the ground and trying to get to its knees. Income growth is minimal. Disposable income grew at 2% in the first half of this year, but according to Moody's it would have declined by 7% without government transfer payments (such as unemployment insurance benefits).



Household net worth was down close to 20% from its peak through the end of 2008. (It declined further in the first quarter of 2009 before rebounding.) The decline was driven by the simultaneous major bear markets in stocks and home values–something not experienced in any cycle since the 1930s. Debt levels compared to net worth remain around all-time highs and almost twice the average level since 1950 and about 40% higher than at the beginning of the decade.

Inflation: Inflation has been nonexistent recently, in fact we have experienced mild deflation of -1.5% over the past year. In the near term we don't believe higher prices (in general) are a risk. This is because there is an enormous amount of excess manufacturing and labor capacity which is inconsistent with strong inflationary pressure. Moreover, consumer demand is weak. All of this suggests, in the near term, that deflation could be more of a risk than inflation—and that is an element in our most pessimistic scenario. The Fed is clearly aware of and concerned about this risk and we believe it is likely they will eventually be successful in reflating the economy. Longer term the trick will be to get it just right, without igniting a period of too-high inflation. Several of our scenarios assume that inflation is materially higher towards the end of our five-year horizon.

So where does the economy stand? We are still facing bank failures—mostly small and perhaps some regional banks—as real estate-related loan losses (residential and commercial) are not done. But, financial-system meltdown risk is behind us. The government has eliminated that risk. The economy is recovering. But there remains the important question of how strong the recovery will be and whether it will be sustained, or whether there will be another leg down for the economy and the markets (which is commonly described as a "W").

With drops in household net worth erasing years of gains; debt levels far too high; access to credit more limited than it has been in years; and labor markets feeble, the consumer is in a weakened state. We continue to believe it is highly probable that households will want and need to rebuild their balance sheets, especially the 78 million baby boomers depending on their net worth to help fund retirement. The end of the home equity ATM, and generally less available credit as financial institutions repair their balance sheets, will reinforce this

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trend. The consumer is 70% of the economy, so clearly consumption growth is of critical importance to economic growth. It is the expectation of slow consumer spending growth coupled with increasing regulation and likely reduced risk taking on the part of businesses and investors (relative to much of the past 20 years) that suggests to us that any near-term burst of economic activity is unlikely to be sustained at a robust level.

Several scenarios are possible, including a possibility that we could slip back into a recession in 2010 or 2011 as government stimulus is gradually removed and inventory restocking is spent. This would be similar to what happened in the 1930s in the United States and in the 1990s in Japan as government efforts were phased out. However, an optimistic case is possible if the initial economic rebound from depressed levels, coupled with more robust growth from China and some emerging markets, significantly improves business and consumer confidence resulting in a reasonably strong recovery that could get us back to the long-term economic and earnings trend lines. We believe this is an optimistic view that is improbable but not so much so that it should be totally dismissed. Our decision making continues to more heavily weight scenarios characterized by subpar economic growth over the next five years, even if we temporarily get more robust growth as the economy bounces off a depressed bottom.

Opportunities and Risks

We are always assessing opportunities and risks. Do asset-class fundamentals and valuations justify significant risk taking, risk aversion, or something in between? Our weighing of risk versus opportunity is always driven by scenario analysis that combines our fundamental and valuation analysis. Valuations have certainly been affected by the recovery in financial asset prices we have witnessed and participated in this year. Stocks are no longer undervalued unless one believes that earnings growth will be very strong over the next few years. We believe that is unlikely. Both fundamentals (such as the weakened consumer) and valuations are pushing us toward a risk-aversion preference.

If we believed the recovery from this recession to be in the range of all the other post-WWII recoveries, then we would expect much more upside from stocks. But if the housing and debt bust triggered a transition to an economic re-set at a lower level, then economic history clearly suggests a period of subpar growth and lower returns.

We know that no one has a crystal ball and there are experienced and very savvy investors on both sides of the argument. We periodically examine the bullish case as we attempt to understand what could make us wrong. As we continue to process all the factors we've discussed here (as well as others), it will impact the degree of risk we take and the opportunities we pursue.

Please feel free to contact us if you have any questions or seek assistance in your investment and wealth planning for you, your trusts, estates, retirement plans, IRAs or business accounts.

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