Stamper Capital & Investments, Inc.

"Focusing on Upside Potential with Downside Protection Since 1995."

CLARK STAMPER's
Anatomy of a Credit Contraction & Deflationary Downturn
WEBLOG

This weblog (started September 19, 2007) follows from our:

Elements of Market Tops Weblog, which we began July 18, 2004, &
Deflation Watch Weblog, which we began June 18, 2004, both can be found at: http://www.risk-adjusted.com/

This new weblog follows those weblogs and details the credit contraction which we correctly forecasted and which began in early 2007 and deflationary downturn which is accompanying it. **As in those weblogs and our Major Trend Change Indicators weblog, we are presenting the information in conjunction with a re-interpretation and/or additional interpretation of articles we see in the media.**

In Reverse Chronological Order

February 27, 2010, BUSINESS WEEK (March 8, 2010 edition), **"Why the 'D' Word is Back on the Table - Prices for core goods and services in the U.S. recently slipped to last fall's levels, while that caused some cheer on Wall Street, it could signal a bigger worry: deflation;"** We haven't written that much lately as deflation dissipated somewhat, at least as reported in the press, during the stock market rebound from the March 2009 low until recently. However, many areas were still seeing deflationary activity. We believe the markets of riskier assets has peaked (see our January 2010 Market Comment, http://www.risk-adjusted.com/) and outright deflation will be very visible over the next couple of years.

This article (and articles on these recently released statistics) could be considered the kickoff.

The article states, "...**core consumer prices.....actually fell 0.1% during the month [of January 2010]....The last time monthly core prices fell was in December 1982."**

"It's not only housing costs that are deflating. **Prices on 44% of the products and services covered by the government's personal consumption expenditure price index - everything from personal computers to parking fees - fell in December [2009]**, the latest data available at press time."

As you can imagine if you have read our stuff, we expect this deflation to become more and more obvious as credit continues to contract, prices of risky assets resume their plunge, and consumers reign in their spending to pay down debt and save for the future.

May 21, 2009, THE WALL STREET JOURNAL, **"World Economies Plummet - Fall in GDP Quickens in Mexico and Japan;"** From a table in the article:

Partners in Decline - Major Economies' GDP fell sharply in the first quarter [2009]
U.S. down 6.3%
Germany down 14.4%
Japan down 15.2%
Mexico down 21.5%

"Steep declines in the economies of three of the U.S.'s biggest trading partners - Mexico, Japan, and Germany - underscored the severity of the global recession and put pressure on major industrialized nations to revive moribund global trade talks."

Some related headlines from TIMESONLINE:

"Japanese Economy Suffers Worst Decline in 35 Years"
"Plunge in Japan's GDP takes it close to depression and raises prospect of deflation returning"

Wow - I think those headlines speak volumes.

May 15, 2009, BLOOMBERG MAGAZINE (June 2009 edition), "Earnings Distortion;" The writer explains the **concept of "comprehensive income"** - that is "the change in a company's shareholder equity during a given period, excluding the effects of new capital injections and dividends." Basically a way to measure income that takes out all the fancy and possibly questionable accounting entries. **"By this measure [of comprehensive income], through late March [2009] S&P 500 companies had combined LOSSES in their previous four quarters of about $200 billion...."** "By contrast, S&P 500 companies had about $295 billion of combined net income during the same period, which translates into a P/E ratio of about 25x earnings for the index." His point is that by traditional income measures the P/E ratio is high; and, worse, by the more straight forward, and likely more reliable "comprehensive income" method, their is no "E" in the P/E. So, for our purposes, this makes us very wary about prices of stocks in the intermediate term. As in our January 2009 Annual Forecast, http://www.risk-adjusted.com/ , we expect the current counter-trend rebound to end in a month or two, if it hasn't already, and then the rest of the year will likely be something like 2008, unfortunately.

May 14, 2009, BLOOMBERG, **"Rents Crashing In London to 1991 Prices;"** "It's another story in the City of London, where office rents in the U.K.'s main financial district are falling to 1991 levels as job losses and a mistimed building boom depress prices." "The City is reeling after the increases in building that followed the construction of more than 10 skyscrapers at the 97-acre Canary Wharf site along the Thames River." Unfortunately, we believe a similar situation is likely to hit many areas of the United States.

May 12, 2009, BLOOMBERG, **"Home Prices in U.S. Drop Most on Record in [1st] Quarter [of 2009];"** "Home prices in the U.S. dropped the most on record in the first quarter from a year earlier, led by California and Florida, as banks sold foreclosed properties. The median price fell 14% to $169,000, the National Association of Realtors said today. Prices dropped in 134 of 152 metropolitan areas, with the deepest declines in Cape Coral-Ft. Myers, Florida, and the San Francisco and San Francisco and San Jose areas." The article points out there is a difference between sales of foreclosures and short sales, and those sold in more traditional circumstances.

April 29, 2009, BLOOMBERG, **"U.S. Economy: GDP Shrinks in Worst Slump in 50 Years;"** "The U.S. economy plunged again in the first quarter, making this the worst recession in at least half a century. Gross Domestic Product **dropped at a 6.1% annual pace**, weaker than forecast, after contracting at a 6.3% rate in the last three months of 2008, the Commerce Department said today in Washington." "The median forecast of 71 economists surveyed by Bloomberg news projected GDP, the sum of all goods and services produced, would shrink at a 4.7% pace." - so they underestimated it badly on average.

April 22, 2009, THE ORANGE COUNTY REGISTER, **"70% More Empty Stores;"** This article is about retail space in Orange County, California. **"The average lease rate in Orange County fell from nearly $2.80 per square foot to $2.61 [or by 7% unannualized] during the first three months of 2009."** "The Orange County retail market experienced a 70% increase in vacancies, rising to 7.2% of available space from 4.2% in the first three months of 2008." Part of the increase in space is from new developments that were just completed.

Industrial Rents Fall - **"The monthly asking lease rate averaged 65 cents per square foot, down almost 19% from the first quarter of 2008**, when the average was 80 cents...." "This is the largest drop in asking lease rates since 1993 when we saw a 17.95% drop."

April 20, 2009, THE ORANGE COUNTY REGISTER, **"Office Landlords Facing Bleak Prospects;"** "Three brokerages issued first-quarter reports showing that office rents in Orange County continue to fall as vacancies rise." "Average monthly lease rates...[fell] below 2006 levels." "Vacancies in the first quarter [of 2009] ranged from 15.6% to 18% - climbing to the highest levels since 2003." "At the same time, falling lease rates and increased concessions - such as free improvements or free rent - favor tenants." CB Richard Ellis stated that "rents are predicted to continue to decline until the end of 2010."

April 15, 2009, REUTERS, **"Consumer Prices Dip in March [2009], Post 1st Annual Drop Since '55;"** "A key gauge of consumer prices fell unexpectedly in March and recorded **its first annual drop since 1955**, government data showed Wednesday, as slumping demand pushed down energy and food costs." The gauge is the closely watched Consumer Price Index.

February 6, 2008, BUSINESS WEEK, **"What Falling Prices Tell Us - The World is Awash in Goods - and Government Programs to Spur Spending Won't Be Enough;"** Here is a chart that went along with this article:

UNEVEN DEFLATION

Percentage **Price Changes**, Dec. 2007 to Dec. 2008

Gasoline	-43.1%
Televisions	-19.4%
Homes	-18.2%
Toys	- 6.8%
Women's and Girls' Apparel	-3.6%
New Vehicles	-3.2%
Men's and Boys' Apparel	-1.1%
Commodities excluding food and energy	-0.6%
Furniture and bedding	-0.1%
Management and tech. consulting services	1.7%
Legal Services	5.2%
Computer Training Services	5.3%
Hospitals and Related Services	5.4%
College Tuition and Fees	5.8%

The article points out that we have deflation in many areas but that "deflation missed big chunks of the economy." Previously, we pointed out that first we would see a fall in the prices of items in areas that do not have much government involvement nor subsidies. And, we think that table has demonstrated just that. Even though we predicted it, it is still amazing to us that with all the increases in productivity from computers, software, and telecommunications and the accompanying fall in their prices and the fall in prices in most other categories that the prices of healthcare services and education are actually rising. It just shows how non-market driven those services are. However, we expect as the deflation picks up steam, pretty much everything will see price drops.

January 30, 2009, BLOOMBERG, **"U. S. Economy: GDP Fell 3.8% in Fourth Quarter, Most Since 1982;"** "The U.S. economy shrank the most in the fourth quarter since 1982 as consumer spending recorded the worst slide in the postwar era, a trajectory that's likely to continue in the coming months." This reporting goes along with our long term standing forecasts; however, we think the trajectory will last much longer than just "the coming months."

January 30, 2009, BLOOMBERG, **"Wells Fargo, Others Tighten Government-Mortgage Rules;"** "Wells Fargo, the second-largest U.S. home lender and Taylor, Bean & Whitaker Mortgage Corp., the biggest privately held mortgage company, are raising credit score requirements and other standards for government-insured loans." "...government-supported programs now account for almost all new U.S. mortgages..." These tightened credit standard go along with our call for a continuing credit contraction which is causing financial deflation.

January 22, 2009, THE ORANGE COUNTY REGISTER, **"Rents Fall for First Time in 14 Years;"** "For the first time since at least 1994, rents dropped here [Orange County, CA] from the year before, according to apartment tracker Real-Facts of Novato" - and, ..."for only the second time since 1994, Orange County rents dropped from one quarter to the next." The average change was a decline of 1.1% for the last quarter of 2008.

"Southern California rents declined from the fourth quarter of 2007 as well, pulled down by a 2.3% decline in Riverside County, a 3.7% decline in San Bernardino County and a 2.6% decline in Ventura County. Statewide; however, the rents still inched up - by just 0.6%.

Our view is that when people started losing there houses to foreclosure, at first rents went up as these "home owners" now had to rent somewhere. But, now the banks are selling those foreclosed on homes, putting more rental supply out there just as more people are getting laid off - with the result being a drop in rents that has just started. Of course, the same pattern is happening not only nationally but globally.

September 25, 2008 - We haven't written in a while, simply because most of what we have forecasted is now obviously coming true. We are at, what we have explained in our **Major Trend Change Indicators weblog,** at http://www.risk-adjusted.com/, is at a "point of recognition" or "reality recognition" when investors realize what the real deal is - that risky assets are worth a lot less now than they were - a point where people come out of states of denial.

Looking forward, we believe with or without a "bailout," the credit contraction will continue and it will become more and more obvious to everyone that we are in a deflation. Right now, Stocks are off their October highs by around 25%, low quality junk bonds have seen their prices drop substantially and Gold and Silver are down substantially but somewhat above their more recent lows, Oil has dropped precipitously from $150 per barrel to under $100 per barrel (although somewhat higher now), prices of almost all commodities are in downtrends - the CRB is down 22% from 7-2-08 which we labeled as a possible top when it was down only 5% (see July 9th, below). To us, the trends are all down for risky investments. As credit for risky assets continues to contract, those owning those investments will have to sell them to fewer and fewer buyers, causing their prices to continue to drop. Sooner or later (probably several years at a minimum unless we experience a huge crash), we will reach a bottom - after much of that financing/debt has been liquidated and most of those risky assets have been sold. Be careful out there.

August 3, 2008, THE ORANGE COUNTY REGISTER, **"Tenant Shortage Plagues Office Space - A quarter of Orange County's market was up for rent in the second**

quarter [of 2008];" "Studley Inc. reports that 25.1% of the office space in O.C.'s most prized buildings was available for rent during the second quarter - a rate not seen since the second quarter of 2002 in the last recession. A year ago, it was 18%.

August 3, 2008, BLOOMBERG, **"CRB Index Drops Most in 28 Years as Gas, Nickel Fall;"** "The CRB Index of 19 commodities fell 10% since June 30th [to July 31], the biggest monthly decline since a 10.5% drop in March 1980, when the U.S. economy was in a recession. Natural gas plunged 32% to lead July [2008]'s biggest losers. Corn dropped 20% and nickel sank 16%."

We also point out that oil has broken its parabolic uptrend line and has fallen over 16% from that recent top. We believe that downward direction is the new long term trend, and that oil and energy related prices will continue to drop, joining real estate, stocks, low quality bonds, and other commodities like gold and silver.

July 11, 2008, BLOOMBERG, **"Fannie, Freddie Turmoil May Hike Rates, Delay Housing Recovery;"** "A failure or government bailout of Fannie Mae and Freddie Mac could push mortgage rates above 7 percent for the first time in six years and delay a recovery in the U.S. housing market." We note that market participants and borrowers and politicians were already complaining that mortgage rates were too high versus U.S. Treasury yields; however, given what is going on, looking back, the market seems to have been correct.

July 11, 2008, MIAMI HERALD, **"Small Businesses Squeezed Out of Loans** - Amid the subprime fiasco and a tanking economy, entrepreneurs are finding bank loans harder to come by." This article goes along with our forecast for an increasingly difficult credit crunch. "Buckling under the subprime crisis and a limping economy, many banks are turning off the money taps to local entrepreneurs..."

July 11, 2008, BLOOMBERG, **"Deflation May Return to World Economy, Say SocGen, Deutsche;"** Well, here are the first analysts from big sell-side shops who I have seen talking about deflation in quite a while (there was a little talk about it back in 2003/2003) - basically, the first to agree with us: "Inflation fears are overdone and the deflation threat could reappear, prompted by a global recession and collapse in the commodity bubble." We believe this is the beginning of widespread recognition of the possibility and probability of deflation. As we have said before, once oil and oil/energy related products start downwards, we will likely be in an outright deflation. If the believe in deflation becomes widespread, it will likely spark "deflationary psychology" whereby people postpone purchases because they are expecting prices to drop.

July 9, 2008 - Doing some of our own primary research here. Recently, several of the stock indices dropped to levels more than 20% lower than their October 2007 highs. In our January 2008 Annual Forecast http://www.risk-adjusted.com/ , we used drops from that top to forecast that we were already in a recession. Here I am updating what has transpired from those tops:

	Oct. '07 Top to Mar '08 Bottom	**Retracement of drop to May '08 top**	**Oct. '07 Top to July 9th, 2008**
Dow Jones Indu.	- 17%	53%	- 21%
S&P 500	- 19%	53%	- 20%
NASDAQ	- 24%	55%	- 22%
Russell 2000	- 24%	59%	- 22%
BKY Bank Index (BKY from 2-2-07 top)	- 35%	Not applicable	- 55%

So you can see we had fairly large retracements of the initial drops from October 2007 tops down into the March 2008 bottom of around 55%. Also, since then, the Dow Jones Industrial Average and the S&P 500 have gone below their March 2008 lows. The NASDAQ and Russell 2000 are [still] above their March 2008 lows but have fallen more from the tops than the Dow or the S&P. We expect over the next few days almost all major equity indices will take out their March lows, put in some sort of intermediate bottom and then experience sharp retracements due, in large part, to short covering. (However, these bottoms could be substantially lower than today.)

Note the BKY Bank Index has fallen 55% from its 2-20-07 top. Importantly this index has fallen below its 10-2-2002 low!!!!

Besides the BKY Bank Index drop, other good indicators of the credit crunch are the equity prices of Fannie Mae and Freddie Mac. Fannie and Freddie and FHA are currently accounting for around 90% of all new residential loan volume -so they should be watched closely.

Fannie has fallen 82% from its high back in late 2000
Freddie has fallen 85% from its high at then end of 2004

We have written about Fannie & Freddie on several occasions in the past - in similar veins to what is in the press currently. Right now, there is lots of talk in the press about how new accounting regulations to be phased in in January 2009 will require them to raise very large amounts of capital and/or to shrink their balance sheets which means selling off loans and/or not making as many new ones. Below, several times we have documented increasing requirements to get loans and that, also, has recently been a prominent theme in the press. **All of this goes along with our long term forecasts for a credit crunch that pushes the prices of risky assets downwards, essentially because people can no longer get as much financing to purchase them as they used to be able to get - that, in conjunction with the unrealistic valuation levels that were not supported (according to us) by the income the assets were throwing off or were expected to throw off.**

We don't like to get too negative in these blogs; however, we think we should point out that now up to $1.6 trillion of sub-prime related losses are being forecast (from $1 billion and, later, $1.2 billion) and only around $400 billion have been owned up to and written down. The equity prices of the banks (see BKY index above) have fallen precipitously, somewhat to us, in advance of asset writedowns and the raising of new equity capital. If equity capital becomes more difficult to raise, these banks, similarly to Fannie and Freddie will likely have to shrink their balance sheets by making fewer loans; thus, we expect further large contractions in credit, which, to us, is deflationary.

Commodities - Gold and Silver's mid-March 2008 tops are still intact. Since then they dropped to bottoms on 5-1-08 down 22% for Silver and 16% for gold. Retracements of those drops have been 46% for silver and 59% for gold. Since the recent rebound highs on 7-2-08, silver and gold have dropped marginally. However, from around that time other important commodity indices may have put in their final tops:

	Possible Top	**Drop** from Possible Top to July 9th, 2008
ABN Amro Coal Index	6-18-08	13.9%
CRB index	7-02-08	5.5%
Oil (CLA)	7-03-08	6.4%

Note that some have been watching the coal index as possibly tipping its hat to the top in oil. You can see that coal has topped somewhat earlier and has fallen quite a bit further. Also, coal seems to have broken out of its parabolic uptrend. **Time will tell, but we would not be surprised if that were it for the commodities' bull run. If oil and oil-related/energy products join everything else that is already dropping, we should be in a full deflation, which is what we have forecast and which is what we are expecting.**

May 15, 2008, BUSINESS WEEK (May 26, 2008), **"The Brewing Credit-Card Storm - Regulators plan to limit rate hikes and curtail fees. But do reforms go far enough?"** Wow, that title really doesn't match the article. "In early May [2008] the Federal Reserve Board unveiled a proposal that would limit interest rate hikes, abolish certain fees, and modify controversial billing practices - targeting what officials consider to be abuses." These new regulations are to go into effect by the end of the year. The article points out that such moves will likely lessen banks' profits and the costs will likely be passed on to other consumers. Basically, what is going on is they are now trying to limit egregious practices; however, they should have eliminated them before the bubbles - during the bubbles, and now, people at the lower end of the financial spectrum have been relying on these sources of credit to stay afloat, even as high as the interest rates, fees, and penalties are for credit cards of lower quality borrowers. Now, "borrowers with bad credit may see limits cut or be denied cards altogether....and Citigroup [and others] have indicated it probably will reduce the number of teaser rates..." An analyst comments, "We are going to see a further tightening of credit" - which, if you read our Blog often, you know is our point here. This new legislation is credit contractionary!!! We forecasted regulation such as this, patching over problems, but after the fact, that end up being contractionary with the result of less credit causing a decline in the prices of assets that were previously financed with these sources before the regulation change.

April 22, 2008, BLOOMBERG, "California's Home-Mortgage Defaults More than Double;" This article has a large number of interesting facts, of which I will list some:

Home sales volumes plunged by 41% in So.Cal and the Bay Area.
Prices have dropped 24% in So.Cal the biggest year-over-year drop since 1988
Mortgage Defaults more than doubled in the first quarter to the highest in 15 years
Default notices are the first step in foreclosing on a home
Recently about 32% of homeowners have been able to stop the foreclosure process
Last year about 52% were able to stop the foreclosure process by catching up on payments
Multiple loans used to finance a property makes it more difficult to seek forebearance
The 4th quarter of 2006 saw 61% of all home purchases financed with multiple loans
1st qtr of 2008 Calif. homeowners were a median 5 months behind when foreclosure began
Merced, San Joaquin and Stanislaus Counties were the most likely to go into default 1st qtr
Sales of foreclosed homes accounted for 1/3rd of all California resales in the 1st qtr
67% of sales in San Joaquin county were of foreclosed properties

April 20, 2008, BOSTONHEARLD.COM, "Condo Loans Could Be tougher To Get;" "AS a result of underwriting changes by giant investors Fannie Mae and Freddy Mac, plus severe new restrictions by private mortgage insurers, getting a loan on a condo unit - or even refinancing one you already own - could prove tougher than you imagined." To us this is further evidence of the credit contraction we have forecasted and are now chronicling. For example, "the ban is irrespective of applicants' credit scores, assets or equity stakes. Even in the healthiest real estate markets, United Guaranty [,a major private mortgage insurer,] will require buyers to put at least a 10% down payment into the deal, and will reject applications on units in condo projects where more than 30% of the owners are investors." Thus, in the last situation, they will not issue PMI insurance no matter what! Also, United Guaranty...."no longer will write coverage on condominiums in hundreds of zip codes across the country that it designates as having 'declining' market conditions."

Increased due diligence - Now, Fannie Mae is requiring upfront due diligence by loan officers of: "a projects legal documentation, the adequacy of the condo association operating budget, percent of unit owners who are late on association-fee payments, percentage of space allocated to commercial use, and percentage of units owned by investors."

Related to all of this, an analyst comments, " 'Even if you had an 800 FICO score and 50% equity, you still might not be able to get a condo loan' under certain circumstances."

To us, this definitely is a credit crunch.

April 9, 2008, BLOOMBERG, **"Goldman Sachs Level 3 Assets Jump, Exceeding Rival's;"** "Goldman Sach's so-called Level 3 assets surged 39% to $96.4 billion at the end of February from $69.2 billion in November [2007], according to a filing with the U.S. Securities and Exchange Commission." Level 3 assets are those which are "hard to value;" assets can be categorized as Level 3 when "there are hardly any observable inputs, and the firm has to rely on in-house models to calculate potential gains or losses." Investment banks, Morgan Stanley and Lehman Brothers also reported large increases in Level 3 assets. **The key for us here is that this stuff keeps dribbling out in size, it seems every month or so at various financial institutions and even for investments that other corporations have made.** According to the following article there could be up to another $745 billion to be disclosed. Thus, we think there is potentially a long way to go with this credit crunch & that the swift contraction of debt as we most recently witnessed at Bear Stearns, will continue and will result in a broad deflationary recession - hopefully not worse. For these reasons, we at Stamper Capital are potentially going to be naming 2008, "The Year of the Margin Call," unfortunately.

April 8, 2008, MARKETWATCH, **"IMF: Credit crunch losses could approach $1 trillion - Effects of current crises likely to be broad, deep and protracted;"** The title says most of it, and is in opposition to most of what you read elsewhere. "The total potential global losses from the credit crunch could top $945 billion over the next two years, the International Monetary Fund estimated on Tuesday, suggesting more pain for the financial sector and more headaches for governments struggling to contain the crisis." It points out that "banks and investment banks have so far written off just over $200 billion from the subprime mortgage sector." We saw a comment on this story pointing out that $1 trillion is $1,000,000,000,000.00 - so it is a lot. We take the amount of likely downside problems that have yet to be exposed to affirm our opinion that we have quite a ways to go in this credit contraction & that the swift contraction of debt as we most recently witnessed at Bear Sterns, will continue and will result in broad deflationary recession - hopefully not worse.

March 19, 2008: Here we are doing a little bit of our own independent reporting. To us it looks like there is a good possibility that deflation has stepped up - that **the flight to "inflation protection" is over.** We put together this little table of inflation/deflation indicators/vehicles:

	Recent Top	**Percent Drop**
Silver	**3-17-08**	**14.3%**
Gold	**3-17-08**	**9.0**
Copper	**3-06-08**	**10.5**
CRB Index	**3-03-08**	**9.7**
Oil	**3-17-08**	**7.8%**

These are huge drops and likely a change in trend and an acceleration downward. The drop in gold was $91 per ounce. Silver dropped over 14% in three days.

Also, we did not report on it but for about a month now **U.S. Government Treasury Inflation Protection Securities (TIPS) have traded at a negative yield,** the first time since their existence. People were willing to buy these securities as such high prices (low yields, in this case negative) because they were so sure that a large amount of inflation was going to show up on the horizon. With these securities you get a boost in principal if inflation rears its head, based on an index. **The important thing to us was that people were so sure of inflation ahead that they were willing to take a negative yield if everything were to go sideways.** Thus, this to us was part of the flight to inflation protection that had been happening over the past several months, which to us was somewhat incredible since it was totally obvious that the economy is sputtering, including seeing obvious in deflation in several areas including housing and real estate which is one of the largest parts of the economy. Another interesting item, is the parabolic nature of the price charts of these commodities. It appears that the parabolic rises are over and, usually after a parabolic rise, you have a swift deep drop.

Another point is what is going on with Bear Sterns - previously a premier investment banking house on Wall Street. It is all over the press. They are being bought out by JPM at $2 per share. Their share price was above $170 just over a year ago. It is incredible to us that the U.S. equity market is still above 12,000 with **Bear Sterns basically being vaporized due to a margin call.**

Bear Sterns vaporizing is not an isolated event. Mortgage lenders and brokers have also vaporized recently as have several hedge funds including a couple in the municipal bond market that liquidated around $2 billion of municipal bonds during February 2008, in what experts are calling **the largest rout in the municipal bond market for a month in thirty years - long and intermediate high grade municipal bond and municipal bond funds were down nearly 5% for the month, yet the stock market is still above 12,000.** We think it is important to realize that these companies and hedge funds that have vaporized have **leverage of up to 30 to 1.** At those leverage levels, just a little down turn and a margin call, and apparently they are gone in as short as a week. There were **several other, what we are calling "illiquidity events," that have occurred since around March 2007,** when the commercial paper market first seized. Following that it was sub-prime mortgage backs, CDO's, junk taxable bonds, leveraged loans, Auction Rate Securities (ARS) and Auction Rate Preferred Stocks (ARPS) and high grade municipal bonds that have suffered illiquidity events. We believe, sooner or later, the next shoe will likely be equities.

March 10, 2008, MARKETWATCH, **"Derivatives the new 'ticking bomb;'"** This article has some fascinating information. According to the Bureau of International Settlements (BIS) derivatives grew from about $100 trillion to $516 trillion over the five years ending in 2007. The article then puts the $516 trillion in perspective:

- U.S. annual gross domestic product is about $15 trillion
- U.S. money supply is also about $15 trillion
- Current proposed U.S. federal budget is $3 trillion
- U.S. government's maximum legal debt is $9 trillion
- U.S. mutual fund companies manage about $12 trillion
- World's GDPs for all nations is approximately $50 trillion

- Unfunded Social Security and Medicare benefits $50 trillion to $65 trillion
- Total value of the world's real estate is estimated at about $75 trillion
- Total value of world's stock and bond markets is more than $100 trillion
- BIS valuation of world's derivatives back in 2002 was about $100 trillion
- BIS 2007 valuation of the world's derivatives is now a whopping $516 trillion

Now, theoretically a lot of these derivative contracts are "netted" against each other with a theoretical net exposure, which they are calling "gross market value" of $11 trillion, which, of course, is dramatically less than $516 trillion. **We point out, and the article points out, that this "netting of liabilities" works fine as long as the counter parties hold up.** The counter party being the entity that is guaranteeing the other side of the trade. If a few counter parties go belly up, all bets are off. The article talks about a 2% problem which causes a "domino effect" with which we are in agreement as to the potential downside risks, unfortunately. The key, as they point out, is that **these promises to pay the derivatives are unsecured** - they, are only backed by a promise, not real collateral. We point out that even if they were backed by real collateral, the collateral could fall in value and more collateral would have to be posted in the event of a margin call - this is pretty much what happened to the several hedge funds that have imploded over the past year and to Bear Stearns. Only if they were collateralized at very healthy loan to value ratios would this not be a problem - and it isn't even close to that - as far as we have learned, they are all unsecured!!!

Thus, we at Stamper Capital are potentially naming this year, "The Year of the Margin Call," unfortunately.

February 27, 2008: We did some primary research looking at the money supply. We hadn't looked at it in quite a while and were surprised by what we saw. We graphed the M1 money supply back to January 2000. Basically, other than a couple short-lived peaks, **the M1 money supply peaked in early 2006 and has been trending downward since then.** We feel this is very important because this money supply (M1) measures the "high test" money that is later multiplied as it is loaned and re-invested and re-loaned throughout the monetary system. We speculate that while the FED is lowering interest rates to fight recessionary forces, it is constricting the money supply, most likely, to buoy the U.S. dollar. Also, the lowering of Fed Funds by the Fed has been lagging the lowering of yields of U.S. T-bills by the market - the gap is around 100 basis points currently. So, not only is there room "to lower" but having the Fed Funds rate that much higher than T-Bills, is, to us, some what restrictive and, again, we believe that is to help buoy the U.S. dollar. Important to the discussion on this weblog, we believe restricting the M1 money supply is not only an anti-stimulus but it likely could be hastening the credit contraction.

February 27, 2008, ORANGE COUNTY REGISTER, **"Auto Sales in Orange County [CA] Take a Fall;"** "**Decline of 28.5%** in new-car registrations over last January points to more economic trouble - locally and nationally." We point out this is more of the ripple that we were one of the few to forecast a couple of years ago. We also add, that car salesmen are usually on 100% commission; so their incomes are dropping rather precipitously. We expect the reductions in their compensation to ripple through the rest of the economy, unfortunately.

February 24, 2008, NEW YORK POST, **"Strapped Americans Turn to Retirement Accounts;"** "....we are witnessing a quiet run on the nest eggs of millions of Americans." Another article demonstrating how Americans are getting squeezed, unfortunately.

February 23, 2008, USA TODAY, **"Housing Crash Fuels Rise in [Credit] Card Debt;"** "As more homeowners struggle with skyrocketing house payments, several experts expect many of them to start using their credit cards as a means to get by." "Nationwide, the use of revolving credit - fueled largely by credit cards - kept increasing throughout 2007.....Use of revolving credit rose 11.3% in November [2007]." Not mentioned in this article is that credit card companies have been raising their rates.

February 20, 2008, REUTERS, **"One in 10 U.S. Home Loans Now Underwater;"** "One-tenth of U.S. homeowners holds mortgages that are larger than the worth of their homes...." Wow, that is astounding and could never have happened without lenders letting the loan to value ratios be so low. Of course, as the real estate market continues to drop, this percentage will grow.

February 20, 2008, MONTEREYHEARLD.COM, **"Recent Retailers to Declare Bankruptcy;"** This article lists retailers to declare bankruptcy recently. We make the comment that this is part of the "ripple" we were pretty much alone in forecasting a couple of years ago. The list includes:
Sharper Image, Lillian Vernon Corp, Tweeter Home Entertainment Group, The Bombay Co., Levitz Furniture, Harvey Electronics, Wickes Furniture Co., and Fortunoff.

February 17, 2008, BOSTONHEARLD.COM, **"Insurer Balks at Exotic Home Loans;"** "First it was the lenders. Now it is the mortgage insurance industry: Entire product lines are being yanked off the real estate financing shelf, potentially squeezing large numbers of buyers and refinancers out of the market." Sounds like a credit crunch to us. The article is talking about MGIC, the oldest and largest private insurer of home loans. It is tightening eligibility standards beginning March 3rd, 2008 and it covers "....four states in their entirety, the District of Columbia, plus 25 other major real estate markets."

February 10, 2008, FORBES (February 25th edition), **"Un-Real Estate;"** This article is on the commercial real estate market. It is an update on our review on November 6, 2007 (see below) on INSTITUTIONAL INVESTOR (October 2007 Issue), "Commercial Contagion: Residential Mortgage Woes Are Hurting Commercial Real Estate, Despite Strong Fundamentals;" In our review back in November 2007, we pointed out that around $30 billion to $40 billion of CDO's (collateralized debt obligations - similar to the ones that contain sub-prime residential real estate mortgages) had been issued per year over the last several years that contain commercial real estate loans. We pointed out that liquidity for these Commerical Mortgaged Backed Securities (CMBS) was drying up.

This current article points out that **"No U.S. bank [has] completed even one CMBS deal in all of January [2008]. That's a phenomenon not seen since October 1990,**

when the U.S. economy was just about to enter a recession...." Wow, from around $3 billion per month on average to zero. To us, that indicates a severe contraction of credit at least in this sector.

February 9, 2008, PITTSBURG POST GAZETTE, **"Many Tax Rebates Will go to Creditors;" "....surveys show that most people plan to use their windfall to pay off debt."** We see this "paying down debt" as an indicator of classic credit contraction. Rather than spend, people will use the supposed tax stimulus tax rebates to pay down debt! Really, that is the bottom line - we are in a credit contraction - people don't want to borrow, they want to pay down debt.

February 6, 2008, THE WALL STREET JOURNAL, "Recession Fears Intensify - **Service Sector Index Hits Six-Year Low;"** Today in the WSJ was a graph of the Institute for Supply Management Index of non-manufacturing business activity (ISM Index) - a key barometer of the strength of the service sector. **Remember the service sector currently represents a huge amount of the U.S. economy.** In a huge, record one month drop & swing from December 07 to January 08, it fell to its lowest level since October 2001, **swinging from an indication of expansion in December 2007 to an indication of contraction in January 2008 - in one month! "This was the sharpest decline in the survey's 10-year history."** Also, in Europe, a similar indicator fell to a four-year low - indicating this is a global economic downturn. Also, **know that the ISM Index after this recent plunge is lower than it was at all times except the final low in the last recession.**

Similarly to this sharp business cycle index turn down, On January 24, 2008 we reported in our 2008 Forecast http://www.risk-adjusted.com/ on the Baltic Dry Index. We said, **"Here is another indicator that makes us believe the "top is in" - The Baltic Dry Index, which tracks global shipping rates, is down 47% from its late October 2007 all-time high peak to January 24, 2007.** According to Marketwatch.com, 'That sharp decline suggests that the demand for basic goods is slowing and that U.S. weakness is spreading overseas.' (Note, we have spent considerable time in our prior forecasts and weblogs detailing why we think the bubbles were global and the decline is/will be global.)"

February 4, 2008, THE ORANGE COUNTY REGISTER, **"As rich tighten belts, others feel a squeeze;" "Those making more than $150,000 per year account for 40% of consumer spending, and their frugality is having broad ripple effects."** People probably don't remember at this point, but most financial forecasters (other than us) said they did not believe there would be much of a ripple if any from the housing slowdown. Of course, now things are different as this article indicates. The article details several examples of how the wealthy cutting back on spending is affecting other workers who provide services for them. Now analysts are saying things like, **"cutbacks by the wealthy have a ripple effect across all consumer spending."** We expect to see more and more examples of "rippling" as we forecasted earlier.

January 29, 2008, CNNMONEY, **"Foreclosures up 75% in 2007 - Defaults are way up for the year, with once red-hot Sun-Belt markets reporting the worst losses;"** Basically the article says, foreclosures increased by 51% for 2007 compared to 2006 and total filings, which includes foreclosures, default notices, auction sale notices and bank repossessions grew 75% year over year.

January 29, 2008, BLOOMBERG, **"Junk Bond Rising Spreads Signal Worst Bust Since 2001;"** "Junk bonds are off to their worst start since 1990, falling 1.8% and triggering $18 billion in losses this month.....**Yields relative to Treasuries are rising at the fastest pace in at least 11 years as prices drop"** - that according to data compiled by Merrill Lynch.

According to the article, analysts now think, **"The market for high-yield bonds shows that a U.S. recession is a foregone conclusion."** Of course, we at Stamper Capital concur as we said we thought we were in a recession months ago.

January 18, 2008, THE ORANGE COUNTY REGISTER, "Reports Confirm O.C.'s Gloomy Economy - **Rental vacancies at 12-year high**, while 16,000 jobs lost in 2nd quarter of '07;" This article is talking about apartment rental vacancies. Interesting to us is how everyone said there was a "housing shortage" even up to a year ago and now vacancies are at 12-year highs - how quickly things change - or rather, how quickly perceptions change.

January 15, 2008, THE WALL STREET JOURNAL, "Home Sellers' Pain Is Renters' Gain;" This article points out how the decline in the housing market is increasing vacancies and decreasing rents is many markets - we would say the weakest markets; however, we believe this situation is very likely to continue spreading, unfortunately. We think all markets across the U.S. and likely globally as well (as we have forecast previously in these pages) will see prices and rental rates drop more than hardly anyone right now is expecting. We shall see.

January 8, 2008 - Our short comment:
Unfortunately, with the Dow Jones Industrial Average's drop today, essentially all stock averages have taken out their August 2007 and November 2007 lows. Look out below - ugh. [Editor's note: from the low on January 8, 2008, the market rebounded for a couple of days and then plunged - 7% from the January 8th low of "Our Short Comment" to the low on 1-22-08.]

January 3, 2008, BLOOMBERG, "GM, Ford, Toyota December Sales Fall; Honda's rise;" "GM, Ford, and Toyota said **U.S. auto sales fell in December [2007], capping the worst year in a decade, and predicted that 2008 probably won't be any better." "Industrywide U.S. sales fell 2.9% in December to 1.4 million, and the annual total was down 2.5% from 2006,** according to data compiled by Bloomberg."

January 3, 2008, CNNMONEY, "Bankruptcies jump 40 percent in 2007;" **"The roughly 40% spike in consumer bankruptcies during 2007 presages an even higher number**

of filings this year [2008], as the heavy consumer debt load is made worse by the home mortgage crisis,...."

January 3, 2008, ABC NEWS, "Deadbeat America: **Late Payments Soar - Delinquencies on Car and Home Equity Loans Hit the Highest Point since 2001."** "Late payments on a cluster of consumer loans, including those for **autos, home improvement and certain home equity loans,** climbed in the summer to their highest point since the country's last recession in 2001." "....the delinquency rate on "indirect" **auto loans -- which are arranged through dealerships -- jumped in the third quarter to 2.86%, a 16-year high."**

12-15-08 === There have been so many articles over the past month or so - many have been covering deflation that is in the system and many have been covering inflation that is in the system. Thus, I want to make a few points about what has been and is happening (according to me):

We are transitioning from inflation to deflation. This is a process that takes time. The real estate market topped in most places in mid to late 2005, with real estate prices dropping since then. Thus, the transition has already been taking around 2 years. Accompanying the drop in real estate prices is the huge downturn in sales volumes of homes. **This huge drop in activity has very negatively impacted most people associated with real estate: real estate agents, appraisers, title people, mortgage brokers, etc. These people have seen their incomes drop and/or have lost there jobs. We have chronicled the closure of lots these types of businesses. Recently, large banks and savings and loans, like Washington Mutual and Citibank, have laid of lots of workers in these areas.** We have also documented the decline in commercial real estate activity and prices.

At the same time, CPI has been rising. However, **CPI is looking backwards. It also does not consider housing! Besides the downturn in everything related to real estate. This downturn is, as we forecast, starting to ripple.** Internet sales for Christmas have been stronger than last year, but this is to be expected as this new technology allows an easier shopping experience at less cost. However, **retail sales over all are coming in very very weak. You could easily forecast by watching the advertisements. There have been 25% off sales all over the place beginning weeks before Christmas. We have seen these sales advertised on T.V. and in the newspapers.** Our personal experience at Costco is that it has been almost empty every time we have visited in the last month - this has not been true during previous Christmases. Now we hear that Macy's is going to be open 24 hours a day - **the retailers would not be doing these things if were not a good reason - and that reason is that sales are way off.**

The trailing inflation statistics have given the FED a reason to not lower interest rates as quickly as they have in other cycles. For example, the yield on the U.S. Treasury t-bill has declined over 200 basis points so far this year but the FED has lowed Fed Funds by only 75 basis points. **Our point here is that the market itself - the over 200 basis**

point drop in the T-bill rate - is signaling an economic slow down - a decline in interest in borrowing to finance expansion - and, to us, deflation (like Japan has been having over the past 17 years and maybe significantly sharper). Thus, we believe THE MARKET will be right. Further the FED has take other rather dramatic steps to try to fix what they are saying is a "liquidity problem" - however, **we point out that it isn't just a liquidity problem - the real problem, which lowering interest rates will not fix is that assets have dropped below the level of debt at which they were financed - thus, it is a "solvency issue."** In addition, the FED has worked in concert with other central banks, to try to fix these problems - again, they wouldn't be doing this if there weren't a huge possible problem on the horizon.

I also want to point out **that from 2000 to 2002 the FED lowered Fed Funds a record number of times and we still went into a recession.** So, just because they are taking all these steps, does not mean we will not be in an economic slow down. To us, the size of the real estate bubble and the accompanying financing bubble indicate that this downturn will be dramatically worse than the most recent and could border on what happened in the early 1930's.

Thus, the credit contraction and deflation are showing themselves in the U.S. T-bill market rates, in the decline in real estate prices and real estate sales volumes, in the precipitous decline in the values of real estate based investment products like CD0's, in declines of incomes in real estate related industries and in job layoffs in those industries, and in the ripple effect into other areas like retail sales. Exacerbating the credit contraction is the raising of credit underwriting standards. Recently, FNMA has started charging around a $1,000 fee for refi's! This all is resulting because the debt levels are greater than the underlying assets that were borrowed against.

We believe the "recognition of this reality" is going to hit home soon (see our **Major Trend Change Indicators weblog, at http://www.risk-adjusted.com/ , for more information on "reality recognition").** In fact, we believe it is hitting home right now. We can see it in the market - the 200 basis point drop in the U.S. T-bill rate and the huge volatility increase in the stock and bond markets starting in late July 2007 - especially late July/early August 2007 and in late November/early December 2007 (through today), and the huge price declines in home builders and bank stocks, in addition, more subjectively, we can see negative trends in most broad equity indices such as the Dow Jones Transports and the Industrials, the Russell 2000, etc. Also, significant to us, is **the recent rise in the U.S. dollar. As the dollar rises (most likely to us do to debt liquidation - the need for U.S. dollar to pay of U.S. dollar denominated debt), the prices of things denominated in U.S. dollars will be falling** - thus, adding to the deflation.

To us, if these trends continue just a bit more, we will be in a "reality recognition" market (if we aren't already) and outright deflation will be upon us.

Of course, no one knows for sure what is going to happen, but we recommend owning as few risky assets like stocks and real estate and junk bonds as possible.

11-08-2007, BLOOMBERG, **"Sotheby's Stock Drops by Record: Van Gogh Has No Bids;"** "Sotheby's stock ["BID"] fell the most ever after a **Vincent van Gogh drew NO BIDS at an impressionist-art auction**, prompting speculation that **credit-market losses are seeping into the art world." Sotheby's stock fell 35% today!** - wow. We have noted that we believe several stock indices have seen major peaks (even while the Dow Jones Industrials, S&P 500, NASDAQ have continued to climb). Those that have probably passed their peaks are the Transports, Home Builders, Financials, and Discretionary Consumable and Retailers. **Sotheby and high end art are probably "the ultimate discretionary consumables"** so today's huge price drop likely is the market putting an exclamation point on the topping process for this sector.

November 6, 2007, INSTITUTIONAL INVESTOR (October 2007 Issue), **"Commercial Contagion: Residential Mortgage Woes Are Hurting Commercial Real Estate, Despite Strong Fundamentals;"** This is a very interesting article as it points out that around $30 billion to $40 billion of CDO's (collateralized debt obligations - similar to the ones that contain sub-prime residential real estate mortgages) have been issued per year over the last several years that contain commercial real estate loans. The article points out that many holders of CDO's containing sub-prime residential loans also own Commercial Real Estate CDO's and have been having to sell the Commercial Real Estate CDO's to raise cash because they can't get any where near a "decent" bid for Sub-prime CDO's. And many lenders are no longer lending or providing financing to buyers of commercial real estate CDO's. "Their balance sheets are full, and they need to go to market." This and a lack of buyers (because they can't get financing to buy CDO debt - seems a bit circular here doesn't it) has created a lack of liquidity for Commercial Real Estate CDO's - "I haven't seen such a lack of liquidity for a very long time." When we read about this, we ask, what if that CDO financing wasn't available in the first place, where would the prices for commercial real estate be? To us, it points to a poor allocation of resources into commercial real estate that will likely have to be "corrected" now that that low cost financing is no longer available.

November 4, 2007, SAN DIEGO UNION-TRIBUNE, **"Think home-price slide is over? The worst appears yet to come;"** This is a very good article with lots of good facts we can use - it is very similar to our analysis of real estate prices and home values that we have published several times over the years to demonstrate that either the home prices are far too high or the salaries must rise - we concluded that it was unlikely salaries would rise but very likely that real estate prices would fall. What is interesting is that this type of analysis was not published by the major media during the large up leg in the housing bubble - we explain this as the major media just going with the flow.

	San Diego County	Madison WI	Denver CO	Norwich CT	Worcester MA
Median Family Income	$69,400	$73,700	$71,400	$72,600	$72,800
Median Sale					

Price SF Home	$614,000	$223,500	$255,200	$276,600	$278,900
Price/Income	**8.8x**	**3.0x**	**3.6x**	**3.8x**	**3.8x**

Thus, you can see that San Diego's real estate prices (and those with similar ratios) are most likely significantly overvalued. If a 3.8x multiple is applied on San Diego's median family income, the average home value would be only $263,720 or a whopping $350,280 lower than the current median - meaning the average San Diego house value would have to fall 57% to get to the 3.8x multiple.

The article makes the point that "...When home buyers nobody was paying attention to what was written on a loan document - i.e. before January [2007] - it was possible for a median-income San Diegan to buy a median-priced home with the help of a little fibbing......there was just one itsy-bitsy problem: The buyers couldn't afford the homes! This lead to a wave of delinquencies and foreclosures, besides putting quite a few mortgage lenders out of business."

He then points out how things have changed and the consequences of that - all of which we call a "credit contraction" and we have covered most of this before - first we forecasted it and then it happened, and now, here we are reading about it.

Most borrowers now have to prove how much money they are earning - "this will result in a substantial cutback in the number of buyers in the market place, which could not have thrived the way it did between 2002 and 2006 without the thousands of liars whose homes are now entering foreclosure."

Most borrowers will likely have to actually make a down payment on their home. He asks, "How many home-seekers in the San Diego market have $47,500 to plunk down on a $475,000 median priced home (this median was from another source)?"

Even if you have the $47,500 down payment, you have to make the mortgage which would be around $3,700 per month, after factoring in principal, interest, taxes and insurance. "That kind of borrower (or dual-income couple) would have to make about $120,000 per year to qualify for the loan!!!

"To qualify for the $614,000 median, the borrower would need to make about $138,000..." or about 2x the family median.

He then points out that few in San Diego could qualify for such a loan & thus, he concludes that it is unlikely for the San Diego housing market to rebound anytime too - we concur with his conclusion and have demonstrated this analysis several times over the past several years.

November 3, 2007, SAN DIEGO UNION-TRIBUNE, **"New Car Sales Fall as Buyers Shun Debt: Dealers: 'Tenuous financial state' leaves consumers wary;"** "New car sales slumped in San Diego County and the rest of California through the first nine months of this year, as debt-laden consumers stayed away from car lots despite rock-bottom interest rates and other inducements, according to the latest data from the auto industry." That first sentence from the article says a lot. **What it says is that we are in a "credit contraction" - people are reluctant to spend because they are already loaded in debt and are afraid to borrow.**

The article also says, "The decline in sales has been accompanied by layoffs at car dealerships throughout the county [San Diego County]. Since its peak of 20,800 employees in December 2004, the industry [in San Diego County] has shed 7% of its work force, dropping to 19,300." **Thus, at least in San Diego, we get a sense that the credit contraction started in December 2004**, probably a couple of years earlier than the nation overall. Also, its effects have already rippled, resulting in layoffs in the auto industry.

October 23, 2007, THE WALL STREET JOURNAL, **"Lenders Curb new Mortgages in Weaker Areas - Move may put added pressure on prices in hard-hit States; Submarket Collateral Damage;"** The long, extended headline pretty much says it. "Some lenders are now making it [even] tougher for borrowers in softening housing markets to get a mortgage." We added the word "even" because, as we documented (below) on March 9th, (the date we deemed to beginning of the "credit contraction"), credit quality lending standards have already been raised substantially. So now they are being raised "even more" and that is the point we want to make from this article. "Lenders such as J.P. Morgan Chase, Citigroup, and Wells Fargo are cutting the maximum amount some borrowers can finance in counties or states where home prices are declining. Mortgage Companies are also taking a tougher look at appraisals in housing markets with falling prices." Ah, can you see a self-reinforcing cycle here? Importantly, "...with house prices falling, lenders are looking to control their risk..." In fact, a chief economist agrees with us and says, "there's a little bit of a self-reinforcing prophecy....if you tighten standards, fewer people can qualify for a mortgage. Effective demand is going to be lower, resulting in lower house prices." We would agree with that and have made that point several times previously & now it is starting to happen, unfortunately.

October 14, 2007, SOUTH FLORIDA SUN-SENTINEL.COM, **"Condo Buyers' cold feet give bank a headache;"** This is a very interesting story about a possible **"trigger"** that could push the condo market down soon. **"Many condo projects that started during the real estate boom are just being completed, and developers must begin repaying construction loans take out before the market turned sour. If buyers do not close, and developers struggle, lenders like Corus may be left holding the bag."**

"In the three-month period from June through August [2007], sales [volumes] fell 46% in Las Vegas and 29% in Miami from the year-earlier period..." Not only that, according to the article most buyers of these at-the-time yet-to-be-finished were **flippers and second home buyers who are now walking from large deposits to avoid even larger losses due to the real estate downturn.** The potential "trigger" is that these huge condo complexes are just now being completed unfortunately as buying has substantially dried up.

October 11, 2007, THE ORANGE COUNTY REGISTER, **"Imports fall 7 percent at ports of Los Angeles and Long Beach;"** "In another indicator that the Southern California economy is slowing, the number of shipping containers unloaded at the ports of Los Angeles and Long Beach fell 7% in August compared with the same month a year earlier..."

October 11, 2007, BLOOMBERG, **"Foreclosures Doubled in September [2007] as Loan Rates Rise;"** "U.S. home foreclosures doubled in September [2007] from a year earlier as sub-prime borrowers struggled to make payments on adjustable-rate mortgages...." Thus, as we predicted, the very large amount of adjustable-rate mortgages that started resetting about 3 months ago is now starting to show up as an increase in the default rates as people fail to make their payments for 3 months in a row and banks start to foreclose.

October 5, 2007, BUSINESS WEEK (October 15th edition), **"That Sinking Feeling;" "Homebuilders are getting slammed as builders slash prices. The big question: Will this shock treatment help hasten the end of the painful downturn?"**

An article similar to the BLOOMBERG one, we detailed below. It details builders debt and discounts and incentives being offered. **It discusses the fact that "this is the first housing slump in which the industry has been big enough and well enough capitalized to even consider such extreme measures. And they are extreme."** Basically the extreme measures are taking huge discounts now to get the downturn over with as quickly as possible. To us it seems similar to Bernanke's "pre-emptive" rate cuts (Discount Rate & Fed Funds) early in the current economic downturn. However, this article lists "much that could go wrong." **Basically it speculates on the possibility of a self-re-inforcing downward spiral** as builder selling pushes down prices of the value of other real estate, forcing builders to write off even more of their raw land and buyers canceling purchases hoping for lower prices (what we call "deflationary psychology") and also preventing people from refinancing resulting in "the rising number of foreclosures [adding] to the backlog of unsold homes **faster** than they can clear them out." We would say that is the worst case scenario - a perfect storm that we have highlighted previously and is, unfortunately to us, very possible.

An interesting fact reported is that **"On September 25th [2007], the number of unsold existing homes for sale nationwide, including vacant and owner-occupied listings, hit a 19-year peak of 4.58 million, up from 2.15 million in January 2005**, according to the National Association of Realtors."

October 5, 2007, BLOOMBERG, **"Homebuilders Liquidate Assets in Desperation Sales;"** The title pretty much says it. The article highlights the largest builders of homes across the nation and how **they are having to unload their inventory at discounts of up**

to 37% (even more according to BUSINESS WEEK) in order to free up cash to keep making their interest payments.

One interesting part of the article was where it pointed out and "accounting trick" being used to represent that sales prices are actually higher than they really are. Throwing in a washer-dryer and $2,500 toward closing costs are not reflected as a reduction in the selling price....." still allow[ing] them to show the highest selling price they can." So, at least for houses sold with incentives by builders, you can expect that the sales price drops are actually worse than reported.

Also interesting, was that "...**September 2005, [was] the last month of the national housing boom**, according to a survey by the National Association of Home Builders."

As for the home builders, "at least seven publicly traded homebuilders have asked their banks for more lenient lending terms in the past four months...." And an analyst chimes in, "We would not be surprised to see one or more of the larger homebuilders become insolvent if current pricing trends persist into 2008." The fifteen largest homebuilders have around $8billion in debt to be repaid through 2009. To us, that is a very short term and a trigger for homebuilders to continue to unload their inventory whether prices drop or not - basically they are being forced to do so. **The problem we see is that homebuilders have no real assets - along with no real barriers to entry nor proprietary assets/technology, etc. that help them build their products, homes. They are just manufacturing homes using primarily human labor. Thus, when push comes to shove there will be no assets left other than cash and unsold inventory, if a builder closes its doors. In that case, bondholders will likely foreclose on the cash leaving little to nothing for equity holders**. Therefore, we believe that once the value of a company's cash and real estate is less than the face amount of their debt, the bondholders will immediately declare them in default and either throw them into bankruptcy or restructuring, resulting in liquidation. Given the Adjustable Rate Mortgage trigger we have outlined (below and several times previously) we give a high probability to several liquidations in this industry during this down cycle.

October 3, 2007, SAN JOSE MERCURY NEWS, **"Bargain Hunters Flock to Foreclosure Auctions - Real Estate Bust: Distressed Properties on Block;"** We will be short with this one. A caption for the article reads: **"$400,000 estimated value for the property. Home have been going for 20% to 30% below market price."** Even though it is very sad, we have to laugh when we read statements like that - and we have seen similar statements many times recently. Obviously, if homes have been going for 20% to 30% below "market price," then, market price is actually 20% to 30% lower. What this means is that the market for these houses has dropped at least 20% to 30%. It is simply an effort to try to deny that the market has dropped.

Background we think is Important - **Below in June 2007 we (at Stamper Capital) reported on the huge number of adjustable rate mortgage resets beginning June 2007 through late 2008.**

$515 billion from June 2007 through December 2007
$680 billion resetting in calendar 2008.

Prior to June 2007 the amount of mortgages resetting were dramatically lower than now. After 2008, the amount of mortgages being reset drops substantially. Also note, we reported 70% of the resetting mortgages were sub-prime and, at that time 14% of sub-prime mortgages resetting were going into default (note that default percentage has stepped up).

The Elusive Lag - Typically home borrowers can miss three mortgage payments before the bank forecloses on them. Then it might take anther few weeks or a month to put the property on the market for sale. **Thus, there is a 3 to 4 month lag on foreclosures versus the reset** - (so this lag isn't really all that elusive as most are). The important point is that this high level of foreclosures is now going to continue every month, like a flood, until a few months after December 2008. Unfortunately, it will put more and more supply of houses onto the market.

Low and behold (unfortunately) foreclosures have just stepped up immensely a few months after the immense step up in sub-prime adjustable rate mortgages that are resetting, as these next articles report :

September 19, 2007, BRADENTON HERALD, **"Foreclosures soar to 243,947, August [2007]: Florida reported one filing for every 243 households;"** "The number of foreclosure filings reported in the United States last month [August 2007] more than doubled versus August 2006 and jumped 36% from July..." "A total of of 243,947 foreclosure filings were reported in August [2007], up 115 percent from 113,300 in the same month a year ago..."

In table form:

Foreclosures in August 2007	= 243,947
Foreclosures in July 2007	= 179,599
Foreclosures in August 2006	= 113,300

Bank Repossessions:

August 2007	= 42,789
July 2007	= 26,842
August 2006	= 20,116

The important point is that this high level of foreclosures is almost certainly going to continue every month until a few months after December 2008. Unfortunately, it will put more and more supply of houses onto the market. Normally, increased supply will drive prices down.

September 19, 2007, SAN DIEGO UNION TRIBUNE, **"Foreclosures countywide jumped 80% in August;"** This is pretty much the same story but related to San Diego. However it did include some additional statistics.

San Diego Filings:

	July 2008	August 2008
notices of default	2,294	3,818
trustee sales at auction	328	423
bank repossessions	77	604

Note: notices of default are the first step in the foreclosure process.

I imagine these numbers are substantially higher than numbers last year before the big step up in sub-prime resets.

September 18, 2007, BLOOMBERG, **"Subprime Borrowers to Lose Homes at Record Pace as Rates Rise;"** "As many as half of the 450,000 sub-prime borrowers whose mortgages payments increase in the next three months may lose their homes because they can't sell, refinance or qualify for help from the U.S. Government." "The number of borrowers whose mortgage payments jump in the next three months will be the second-highest ever for a quarter....27% have already missed a payment...."

"About 57% of mortgage broker customers with adjustable-rate mortgages were unable to refinance into new loans in August [2007]...."

"Adjustable-rate mortgages to sub-prime borrowers account for 44% of all new foreclosures, according to the Mortgage Bankers Association." So that leaves a bunch of others who are defaulting, we note.

The article also details the FHA bailout program, FHASecure. This program requires the borrower to have at least 3% equity in the home, and to have not missed making any mortgage payments. "...eligible borrowers must have a job and the income to cover the payments..." Thus, analysts in the article conclude that most sub-prime borrowers will not qualify as they have essentially no equity and many are missing payments.

September 5, 2007, BLOOMBERG, **"Commercial Real Estate in U.S. Poised for Price Drop;"** "U.S. commercial real estate prices may fall as much as 15% over the next year in the broadest decline since the 2001 recession as rising borrowing costs force property owners to accept less or postpone sales." " 'There are so many deals falling apart....People who can get out are getting out'."

For background, on our Deflation Watch Weblog, we reported on June 29, 2007 - **Stamper Capital Deflation Report - "Deflation is Already Here - you just haven't read about it in the press yet;"**

	Top	Currently	Decline
Dow US Home Const.Index	5-05-06*@ $50.1	$31.3	-38%
Gold	5-11-06 @ $771	$643.50	-17%
Silver	5-11-06 @ $15	$12.16	-19%
CRB (commodity) Index	5-11-06 @ 365	313	-13.7%
Oil	8-07-06 @ $80.8	$70.7	-12.5%
U.S. Long Bond pric	12-04-06 @ 114.6	107.75	-5.9%
CDO, BBB- rated tranches	1-19-07 @ 96	55	-43%**
Dow Real Estate Index	2-07-07 @ 94.57	77.42	-18%
KBW Bank Index***	2-20-07 @ 121.06	105.80	-6.7%
Dow Utilities	5-21-07 @ 535.7	498.2	-7.0%
Dow Transports	6-01-07 @ 5,326	5,099	-4.3%

* Note: The I-shares Dow Jones U.S. Home Construction Index ("ITB") commenced 5-5-06 and went down right from the get go; however, **most home builder stocks peaked in mid 2005 and are down around 50%.**

****** According to ABX, note, this is the mid-grade tranche; per other financial articles, "Toxic Waste" CDO (Collateralized Bond Obligation) tranches are down at 35 bid, an 85% drop. and high grade CDO tranches are down about 15%.

*** KBW Bank Index ("BKX") consists of the 24 largest money center banks & leading regional institutions (Citibank, JP Morgan Chase, etc.)

Also note, **"Homeowners with about $515 billion in adjustable-rate home loans will see their monthly mortgage bills rise this year [the remainder of 2007, we believe] as rates reset to higher levels, and another $680 billion worth of mortgages will reset next year [2008],** the Banc of America report said. Of those adjustable rate loans, more than 70% are subprime [per MONTEREY COUNTY HERALD, "Fed sets subprime lending limits," 6-30-07]." Per another source, the subprime default rate is running around 14%. Most of those defaults have been after resets. So we calculate $515 billion * 70% * 14% = **$50.5 billion is the expected monetary default over the next six months based on the current run rate - yikes.** The number for full year 2008 would be $680 billion * 70% * 14% = $66.6 billion. Of course, those are only rough projections based on the numbers we have been given, but they are eye-popping.

For background, we published our determination that March 9, 2007 was our official beginning of the Credit Contraction in this piece from our Deflation Watch Weblog: March 9, 2007, REUTERS, **"Countrywide Financial Ends No Down Payment Lending;"** "Countrywide Financial Corp. ("CFC"-NYSE), the largest U.S. mortgage lender, on Friday [March 9, 2007] told its brokers to stop offering borrowers the option of a no-money down home loan, according to a document obtained by Reuters. A similar BLOOMBERG article (on 3-9-07) points out that "...other lenders that have started requiring borrowers to put at least 5% down on homes include Washington Mutual Inc. and General Electric Co.'s WMC Finance Co. unit.

That is the news - Our analysis of this news is that this loan underwriting measure is the official (to us) beginning of the Credit Crunch and Credit Contraction. While we realize "at the time" it was easy for these companies to get caught up in the real estate bubble, probably a year from now (or even now) many people will be saying, **"what were they thinking?" making 100% loan to value loans**. It just goes to show how even the largest companies can get caught up in irrational business practices during certain cyclical times. Other related themes along these same lines are the "no-documentation loans" and "sub-prime lending." Years from now, people will think it unbelievable that such respected financial institutions at the time would make "no doc" loans or even "sub-prime loans."

As for our Deflation Watch, a substantial increase in lending standards such as this (going from 100% loan to value to a max of 95% L-T-V) means less loans will be made. This experience is by definition a credit contraction. Two other "flies in the ointment" of the real estate bubble are the $1 trillion of adjustable rate loans that are reseting in 2007 and by the end of 2008 and the admission of experts/authorities of the huge amount of underwriting (and outright fraud) to buyers that really did not qualify that happened as a result of the "no doc" and "sub-prime lending over the past few years.

This situation creates a One, Two KnockOut Punch for Real Estate:

1). **Punch One - lots of supply for sale on the market** as defaults step up and properties go back to the banks which then unload them on the market. Defaults from borrowers who can't make new payments when their adjustable rate mortgages reset; borrowers who purchased 100% L-T-V loans and can't make the payments; borrowers who didn't qualify in the first place, etc.

2). **Punch Two - Less Demand - Fewer buyers now** that the lending standards have been raised to 95% L-T-V and those who should not have qualified previously, definitely won't be qualifying in the future.

3). **Third Punch - Buyers who bought on Spec,** and this is a very large percentage of home ownership, will be flushed out. Thus, additional supply (and defaults).

As reported previously around 40% of the recovery since 2002 is widely attributed to the real estate industry. **Thus, we believe the collapse of the real estate bubble will create a huge negative ripple across the economy.** We believe collapsing prices of real estate will most likely morph into deflation in many other categories - certainly prices of other risky asset classes.

Stamper Capital & Investments, Inc. has been the sub-adviser to this Fund since October 1995 and B. Clark Stamper, our President, has been its Portfolio Manager since June 1990.

Past performance does not guarantee future results, and current performance may be higher or lower than the performance data quoted. Investment return and principal value of an investment will fluctuate so that investor's shares, when redeemed, may be worth more or less than their original cost.

Returns - Figures quoted are total returns calculated for the share class and time periods shown. Performance includes the reinvestment of income dividends and capital gains distributions. Performance does not reflect the deduction of taxes that a shareholder would pay on a fund distribution or the redemption of fund shares. Please go to Morningstar's and/or Lipper's websites for more information.
