QuarterNotes

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October 2010 | Fourth Quarter 2010 | Volume 18 No 3

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Market Summary

Year-to-date gains have been modest. Confidence remains weak for consumers and businesses. While continued worries about the economy and deficits are legitimate, history shows that markets react well in advance of an actual economic recovery. One of the best indicators of potential long-term gains is whether the markets are currently cheap or expensive. With a forward price/earnings ratio of 13.5, markets look poised for growth.

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Recession Ended; Why Don't We Feel Like It?

The longest-running recession since the Great Depression is officially over. The 18-month downturn that began in December 2007 ended in June 2009. A double-dip recession, while still a slim possibility, is not the future most economists are predicting; neither is a robust improvement in employment. It certainly doesn't feel as if we are in a recovery. Frightened consumers have curtailed spending, and timid businesses, fearing lack of sales, won't hire. This combination leaves the economy in a Catch 22.

In August the Federal Reserve disclosed publicly that inflation is running well below trend at unacceptably low levels. At the same time the Fed signaled its intention to increase the money supply, referred to as Quantitative Easing, in order to promote growth and ward off further deterioration in market fundamentals. The latest subpar economic reports and lackluster real estate data have confirmed expectations for a slow-growth economy. In the face of the Fed's somber remarks, the stock market jumped by 9% in September, its biggest September gain in 71 years.

What factors give us confidence that we are actually recovering, albeit at a snail's pace? Last quarter we observed annualized GDP growth of only 1.7%. However, despite a slowing pace, manufacturing has remained resilient and expanded again in August for the 13th consecutive month. Commercial real estate construction, a consistent drag on economic activity for the prior 21 months, turned the corner in Q2 2010. Commercial real estate is still suffering from elevated vacancy rates and declining rents. The trend is expected to continue through 2011, but most of the damage appears to be behind us.

Index	9/30/2010	% YTD
Dow Industrials	10788.05	3.50%
S&P 500 Index	1141.20	2.30%
Nasdaq Comp.	2368.62	4.40%
Russell 2000	676.14	8.10%
MSCI EAFE	1561.01	-1.20%
10Year Treasury	2.50%	

The slow pace of recovery is doing little to rescue the long-term unemployed, who continue to suffer and have understandably become disillusioned. The Congressional Budget Office estimates that unemployment will remain higher than 8% through 2012. Employment data in August showed initial signs of improvement, with 67,000 new private-sector jobs added and a decline of 323,000 in the number of longer-term unemployed. Much more dramatic change will be needed to materially lower the unemployment rate, and a return to full employment will probably take several years. To cope with a difficult job market and a less certain retirement, household savings increased to 6% as consumer spending fell.

High unemployment and tepid consumer sales continue to hold inflation in check. Consumer prices increased just 1.1% over the last 12 months. Despite the low core Consumer Price Index, increases in producer prices and energy costs lie just below the surface. The prices producers pay for goods increased 3.1%, energy prices climbed 5.1%, and the RJ/CRB index, measuring commodity prices, rose 13% over the past year. Improvements in business productivity and profitability have allowed corporations the temporary luxury of limiting price increases until consumer spending improves. Before they are willing to spend, consumers need jobs that they feel are secure.

Other Notes

Single Digit Returns: "Even the wildest bulls on Wall Street and worldwide bourses would be hard-pressed to manufacture 12 percent equity returns from nominal GDP growth of 2 to 3 percent." *Source:Bill Gross September 2010*

Mortgage rates hit new lows: 30 year home mortgages dropped to 4.3%. Many who would like to refinance cannot because of diminished home appraisals and stricter underwriting standards.

Gold Reaches All-Time Highs: Gold closed the quarter over $1300 an ounce, up more than 20% since the first of the year. Investors view gold as a safe haven as well as a hedge against decreasing currency values.

Bonds: Investors betting against bonds missed out on big moves up as interest rartes continue to drop. Since yields can't fall below zero, at some point in the future interest rates will begin to rise.

Deficits Do Matter

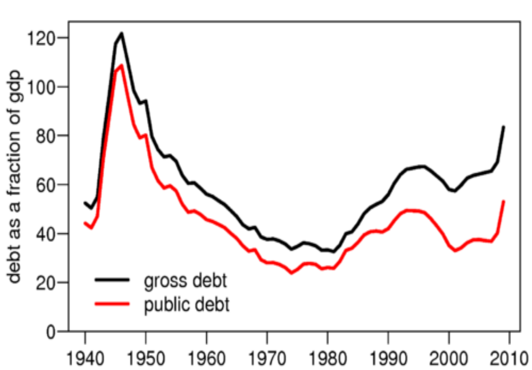
The stark economic times have focused our attention on the growing federal deficit. When the books close on this fiscal year September 30th, the 2009-10 the deficit is expected to be $1.3 trillion. That's down from $1.4 trillion for FYE 2008-9. Total outstanding debt, including intergovernmental debt like Social Security, is about 93% of GDP.

Many countries with sizable debt-to-GDP ratios face higher borrowing costs. Fortunately, as the US is still seen as a safe-haven in troubled times, we have had no trouble floating our sovereign debt at very favorable interest rates. As many underwater consumers have learned, even when credit is available and they can currently afford the payments, someday the bills will come due and have to be paid.

Much of our debt is held by foreigners, principally China. The interest expense on the mounting debt sends an increasing amount of our wealth overseas. The problem will compound when interest rates rise as debt continues to balloon.

Given the difficult economy over the past couple of years, reducing the deficit will probably have to be put on the back burner for now. Our politicians need to start talking about realistic steps that can be taken when the recovery is on firmer ground.

After having balanced the federal budget at the turn of the century, we cut taxes, added a prescription drug benefit to Medicare, and went to war on two fronts without a plan to pay for any of it. On top of that, the near collapse of the financial system and the recession that followed decreased tax revenue and increased government obligations. In order to make a dent in the deficit and put the country on a more responsible footing, we are going to have to make unpopular choices. There are only three ways to reduce the deficit: 1) Cut spending; 2) Increase taxes; 3) Grow the economy.



This year France, Germany and Greece proposed cuts that would have seemed unimaginable not long ago, such as attempting to raise the retirement age and increasing the workweek.The U.S., like our European counterparts, will have to put everything on the table. We'll have to see whether our leaders have the political will to tackle these tough issues.

Outlook for Real Estate

Real estate seems to have bottomed out. While there are still negative trends, the bad news has slowed considerably. Commercial property values appear to have stabilized and shown modest gains. The Moody's/REAL Commercial Property Index has risen five out of the last eight months and so far has rebounded 4.2% since the sector's October 2009 bottom.

In the past few months more office space has been leased than given back, making for the first positive net absorption rate since the 4th quarter of 2008. Still, vacancy rates remain high as a strong reminder that challenges remain. The multifamily segment has been a surprise on the upside. Strong demand and higher tenant retention rates are linked to jobless claims, as well as an increase in the number of renters caused by homeowner foreclosures. The recovery in retail and industrial space remains slow, but the worst appears to be over.

Home prices seem to have stopped falling, and are up 3% since bottoming last year. The market must work off excess inventory, a difficult task with foreclosures and short sales accounting for nearly one third of all closings. Although sales volume increased in August, the pace has fallen about 25% year over year without the stimulus of housing tax credits. Mortgage rates reaching all-time lows and prices down 30-40% are providing some suport for the market. If there is a silver lining in all this, homeownership is now more affordable than at any time during the past two decades.