SANSOTERRA GROUP LLC

HANG ‘EM ALL AND SAVE 6 FOR PALLBEARERS

I confess to reading some of the comics in the few remaining newspapers. What I like best is how gravity can be suspended and direction of travel can be reversed in an instant. Picture Wile E. Coyote realizing he’s stepped off the cliff, or Speed Racer airborne and you get the idea.

I also have running through my mind the concept of the first derivative – the concept in math of the change in the rate of change. An easy current example is the observation that the rate of decline in the economy is decreasing at an increasing rate – just like this disaster began by increasing at an increasing rate.

This kind of thinking is what makes me think of cartoons – the suspension of logic in the face of facts such that “less bad” is, somehow, good.

So I find myself thinking about speed and specifically about the speed at which money circulates in the economy or what the economist calls velocity. At the moment, it is suspended, much like Wile E., out over thin air and with not a scintilla of movement observed. Please hold that thought – that transactions – cash, credit card, retail, wholesale – all are at a low point; that the speed of money is very low. At the same moment, the **amount** of money in the system (and being added) is, simply, astronomical. You read what I read so we’ll skip noting the trillions of liquidity-increased money supply - - and simply note that the amount is an all-time record even when adjusted for our current sized economy.

The last piece of my 3-legged stool, if you would, is the consumer – the source of 2/3 of all consumption in our economy. He is saving, not spending, struggling to pay down debt and fearful for his job.

With these 3 pieces in mind, this quarter I’d like to touch on a number of specific areas and comment on likely directions or outcomes. What is most apparent in all this is that virtually nobody is blameless.

Banks

Where is all this money? Well, a lot is in money market mutual funds and the like, but according to Washington, the banks are sitting on it and refusing to lend. To my mind, most consumers and nearly all businesses don’t want to borrow right now – and surely not until their confidence returns and business retail demand greatly improves. Also, banks are under pressure to keep their ratio of liabilities to equity inside the rules – but not knowing what their toxic assets are **really** worth, will tend to build reserves lest they have to recognize loan losses and jeopardize their capital. So two forces are at work and neither seems near to being over. Major banks and super regionals hold no attraction to me here. Small start-up banks hold great appeal – as they should, lacking the toxic stuff, having growing deposits and lending in local markets they know. It’s no coincidence consumers are leaving mega banks to deposit with local start ups.

Consumers

Yes, they have begun to nibble at spending – I said earlier we are a people incapable of delaying spending and in times of stress, it’s a form of sublimation. The recent retail numbers, I believe, reflect only that a segment is still working and spending a bit – not everyone is out of work and overextended. Herein lies the first derivative fallacy – because the decline in consumer spending is falling “less fast” is not a harbinger of a turn – at the margin it’s cash buyers (credit card use is still falling) and the still employed and does not portend a return to great waves of credit-based consumption. Add to that that home equity loans, which fueled the consumption binge, are no

WWW.SANSGROUPLLC.COM
4900 WILLIAMS ROAD • SAN JOSE, CA 95129
408 253 3568 • FAX 408 253 3568

longer available. In my view, consumer confidence can and has begun to return, but it does not trigger significant new consumer spending - - - excess money will go, I think, to savings and debt pay down for a few years to come. In brief, a sadder but wiser consumer will be, at the margin, a saver, not a spender.

Stocks
A bear trap. Buying Citi at $1 and selling it a $2 and telling your friends about your "100% profit" is only musical chairs. Day traders should enjoy these times, but I am convinced that it's a zero-sum game – that losses will equal gains. Brokers love times like these and otherwise intelligent investors who buy real businesses and behave like owners will be sorely tempted to chase today's hot idea. As a fiduciary with a lifetime in this world I can only say "wait – this too shall pass." The risk and taxes aren't worth it – no one has done it successfully for very long. My clients are anywhere from 30% to 60% stock (age based) and in real firms with real products, real earnings and "only human" managers; they have not suffered as the broad indices have and need not go looking for 100% gain stories to get even. In my view, we have not seen the lows; this latest run up is a trap and why should become apparent later in this piece.

Bonds
There is money to be made in toxic assets. Few know how to find that value so I must pass for lack of ability. Otherwise, with astronomical amounts of money poised to trade, I see inflation – too much money chasing too few goods when this whole thing finally does turn and recovery begins. Mr. Bernanke notwithstanding, I don't see the Fed having the gumption/tools/integrity to pull money out of circulation when Congress has made billions/trillions of commitments. So, with inflation coming, bond prices fall as interest rates rise and, if you need bonds, wait a bit – let maturities go to cash – but I don't see much point in playing with toxic assets for yield.

Gold
My clients own gold. I believe it is an anachronism, touted by "gold bugs" and others, but right now it is a **global** safe haven. It may take another year to be right, but when inflation kicks in, gold will be a way to mitigate it. Note also the weaker economies are buyers – using their (declining) currencies to acquire it, to wit: Russia.

Dollar/Euro
The Euro is a currency common to a group of countries, each with its own central bank. The dollar is the currency of one country with one central bank. I cannot see how disparate country interests will ever work in concert to support a common currency and accordingly, still see the Euro under long-term pressure vis-à-vis the dollar. The dollar is no saint – it's just better, now, versus the Euro. I do see dollar devaluation coming – sizeable – as the full impact of the Democrats' budget kicks in over the next few years. China calling for a basket of currencies instead of the dollar makes sense if you see devaluation coming – we all know how much they hold. [As a side thought – lacking a consumer-based economy, China must sell to the world, in dollars, to keep their people employed – or face massive social unrest. Interesting conundrum – has our dollars, needs our dollars, fears devaluation and social revolt – what to do, what to do.]

In this case, I believe the Euro-denominated countries are well behind the U. S. on re-starting their economic engines. When reality forces them to take extreme stimulus efforts, the Euro will, I believe, suffer vis-à-vis the dollar. Fundamentally this is a global devaluation driven by massive new government debt world wide. One could argue the two – Euro and Dollar – will both decline proportionally, but I suspect the dollar will remain stronger, relative, primarily because we do not have to deal with the multiple central bank problem of Euroland.

WWW.SANSGROUPLLC.COM
4900 WILLIAMS ROAD • SAN JOSE, CA 95129
408 253 3568 • FAX 408 253 3568

Policy
I suspect we have passed the point of denial and bargaining with ourselves and likely passed the point of uncertainty – in short reality is here in the U. S. Few suspect how deadly serious the remaining problems are – how severe the debt of $3 trillion will hit us for years to come and, worse, how worthless the debt now on the books, is. Two policies – monetary stimulus and fiscal (government) spending – have been inaugurated. I fear the current Congress will take credit for the nascent recovery, expected to arrive between late this year and late next. Fact is, any recovery will be attributable to monetary policy as the fiscal steps are at least a year, perhaps two, from implementation – and will do little for unemployment. Resistance to an over-ambitious budget is, thankfully, growing, as this recognition spreads..

Unemployment
At 8%+, I suspect that unemployment will be a new, secular problem. With a likely 7%-9% range for a few years to come (excess labor world wide and reduced demand in developed countries) and the loss of our traditional mobility in the labor force [". . . I'd take a job in Texas if I could sell my house in -------------"]. I am not optimistic for a quick turn. This is my bear – or worst – case, and it will impact consumer spending for as long as it prevails.

Corporate Earnings
Talk of a positive number in 2009 – of earnings swinging up 25% from 2008 – is a dangerous perspective. In reality world, earnings are more likely to be down 14% with the huge off-setting increase coming in bank stocks. The rebound in their earnings is both a function of softer rules about pricing toxic assets [". . . mark to market price or mark to cost? Best guess? Model? . . . "] and the law of small numbers. If you normally earn, say $1 per share, made 12 cents last year and 18 cents in 2009, sure, go ahead and tell the world earnings will be up 50% in 2009.

The wild card here could be capital investment. If most firms simply reduce reinvestment in plant and equipment because they see reduced future demand, earnings for non-financials could be a tad better.

In the long run . . . .
The truly rich will be fine but even billionaires are fewer this year. Regrettably, only 1% or so are truly immune to all this. If Madoff goes to jail, so also should the key players from Citigroup, IndyMac, Moody's, Fannie Mae, et al or, in the alternate, accept that in all cases the **watchdogs** failed and bail them all out. I have long argued against fee-based compensation because the proponents have no skin in the game – hopefully the tide has turned on this subject and **applied** regulation, not new, will prevail. For now we have a ways to go. Last year, the system failed. This year, it will be corporations.

April 2009

This material is for your personal use and is neither an offer to sell or buy securities nor is it a solicitation of your business. It should not be redistributed in any manner without approval. We believe our sources to be reliable, but cannot warrant the information herein as complete or accurate – and it should not be treated or relied upon as such. An ADV Part II is available upon request.

WWW.SANSGROUPLLC.COM
4900 WILLIAMS ROAD • SAN JOSE, CA 95129
408 253 3568 • FAX 408 253 3568