

January 04, 2010

Xerxes Financial Group, Inc.
9554 Old Keene Mill Rd,
Suite G
Burke, VA 22015
703-913-7701
www.xerxesfinancial.com

Asset Management Services
Retirement & Investment Planning
Employee Benefits

A Matter of Fact

A Bi-Monthly Publication of Xerxes Financial Group, Inc.

RE: Commercial

Hello 2010

The good news about Commercial Real Estate (CRE) is that losses are narrowing and the bottom has not dropped as many had been expecting, leading to further troubles for banks. At least not yet.

The Commercial Leading Indicator for Brokerage Activity (CLIBA) has declined steadily year-over-year since 2006. The rate of decline has leveled off suggesting that the worst of the credit crisis may be over.

According to research conducted by the National Association of Realtors (NAR), the decline was driven by decreased industrial production, sharp drop in demand for office & retail space and reduced consumer spending.

Recent data shows that industrial production has picked up, consumer spending is rebounding and office & retail space vacancies have slowed, albeit at discount & increase in tenant concessions. The trend suggests that enough of the uncertainty has passed to justify risk taking.

For these reasons, as well as pent up demand, real estate investors seem to be ready to jump in and acquire properties that have been slammed in the past year by falling property values, occupancies and rents.

The bad news is that the sector remains fraught with challenges that could impede transactions, as well as the return they hope to realize. Specifically, four conditions that

(Continued on page 3, Column 1)

America serves as the global model to generate prosperity and improved standard of living. Known for its melting pot of the “best the world has to offer,” countries around the globe have begun to diversify their often single line economy and embrace capitalism.

America has proven that the best ideas for growth & prosperity are often not a result of closed, elite or privileged leaders. Rather, it is a result of free markets that nurture growth.

Noting America’s diverse workforce and dynamic financial markets, countries such as China, Dubai, Russia, and many others, has sought to emulate the U.S. economy and adapt it to theirs. Indeed, with the fall of communism, the global economy has become more like us. So it stands to reason that the global economy followed – and in some cases advanced – the United States’ soaring growth and the ensuing swoon during the past decade.

For America, peaks and troughs are nothing new. We have experienced the benefits of “wealth effect” as well as periods of violent market gyrations and a shrinking economy. Other nations, however, are not so fortunate. As younger nations adopted our economic model and reaped initial benefits over the past two decades, many are now dealing with devastating results of unanticipated and unintended consequences. Eastern Europe, for instance, is burdened with excessive debt and few solvent customers in their west European export markets. Additionally, financial institutions have tightened credit making the days of “easy money” all but a memory. Adding salt to the wound, countries that appear to have lost control of their finances could see their exchange rates suffer, making their already heavy debt burden even more onerous.

Conversely, the U.S. has the wealth and dynamic markets to pour in a tsunami of fiscal and monetary stimulus to douse the fire. The Federal Reserve introduced extraordinary measures to deal with the credit crunch, including guarantees of bank debt, outright purchases of assets and bailouts. Also, developed countries are not likely to default on their debt obligations, thereby allowing for a more stable or stronger currency.

So, what does this mean as we enter 2010? We can safely assume three factors that will continue in the year ahead. They are:

1. Central Banks will keep rates unusually low.
2. Near zero savings rates will encourage investors to gravitate to stock & bond markets for higher yields.
3. The scale of this recession is more deflationary biased than inflationary.

Throughout 2008 and much of 2009, the unprecedented fiscal and

(Continued on page 2, Column 1)

In This Issue:

2010 Outlook	page 1
Commercial Real Estate	page 1
Vital Signs	page 4

2010 (continued)

(Continued from page 1)

monetary stimulus seemed an utter failure. On January 22, 2008, the Federal Reserve took a bold step between regularly scheduled session and slashed rates by three quarters of a percent to 3.5% - the largest rate reduction in 24 years. Before leaving office, President Bush pushed for further rate reductions, increase in the Money Supply, emergency programs and outright bailouts. The strategy spilled in to the New Year with President Obama continuing similar policies.

It appeared that the \$700 billion TARP (Troubled Asset Relief Program) and \$810 billion ARRA (American Recovery and Reinvestment Act) programs only added to our deficit and did nothing to address the two major issues sinking the American tax payer – negative home equity and a rise in jobless claims.

Despite the pain of the past two years, some positive developments have occurred due to the recession. Most importantly, global demand for oil has reduced its price to below \$80 per barrel from its peak of \$148. Without a doubt high oil prices are bad for our markets. The run up was due to systemic problems that led speculators to drive up the price of oil, rather than supply worries. The driver to speculation, however, is low interest rates and a weak dollar. Stable oil price, dampened demand, an economy on the cusp of strengthening and inflation remaining in check, 2010 does not appear to be the year in which high interest rates or run away inflation should be of concern.

Everyone knows that lower interest rates make debt less expensive for consumers and business alike. The lower cost of capital then serves to drive the economy. Interest rates are also a factor in how professionals value stocks, bonds and real estate. So as interest rates remain near zero, professional investors with access to inexpensive capital take on more risk than they might otherwise.

Consumers may not know it, but they act similarly to professional investors. When consumers buy (or invest in) a house, for instance, they make a purchase decision based on the monthly payment, not price. That is because payment levels are the key to affordability.

The chart below demonstrates the affect of higher rates on property prices. It also helps understand the argument in favor of lower rates to help prop up real estate values, especially at a time when an estimated 25% of all homes are valued below their mortgage debt (in Nevada the number stands at 65%*).

Property Value	\$400,000	\$295,000
Interest	5%	8%
Term	360	360
Monthly Payment	\$2,147	\$2,165

So, low interest rates have the effect of reducing cost of capital. Unfortunately, these same conditions translate to poor rates of return on cash. In other words, the interest rates we realize on our savings accounts are likely below 1%. In order to receive returns above that, investors

must be willing to carry “risk” for a higher yield on their money.

For instance, Verizon Communications Inc. (Ticker: VZ), currently pays approximately 6% just for owing its stock. While there may be stock price volatility, long term investors will find the six fold increase in income a worthwhile risk to add to their portfolio when compared to keeping their money in cash. Such actions could help attract billion of dollars to the market that are currently sitting on the “sidelines”.

Though it is difficult to pin point the cause of past recessions, most were invariably induced by increase in interest rates or decline in consumer confidence, and pale in comparison to the severity of the Great Recession we are experiencing. Indeed, this time around the cause can be identified as a debt driven expansion as globalization has changed the nature of the business cycle, along with the tools used to combat past recessions.

Perhaps far more impactful in the long term will be the huge monies spent on stimulus and bailout programs, as well as the sharp reduction in interest rates. With no scale to measure success, tax payer dollars are being rushed into the market to help prop up the economy until the private sector can figure a way to unwind their illiquid positions. The financial damage we could do to ourselves economically will most likely in the long run be 100 fold that accomplished by terrorists, if our elected officials mismanage these funds.

Business growth and new jobs is, of course, the bottom line of economics. Everything the President, Congress or the Federal Reserve do to stimulate the economy is a house of cards absent job growth. Latest readings on unemployment suggest that the peak may have been reached and unemployed workers are beginning to return to the work force. If this trend proves to be short lived, we will likely enter a double dip recession later

(Continued on page 4)

Disclosures: Past performance is not indicative of future results. Securities are subject to market volatility. Investing may not be appropriate for all individuals, always consult a qualified professional prior to making any investment decision.

RE: Commercial (continued)

(Continued from page 1)

could negatively impact CRE markets are:

1. Continued lack of financing available
2. Gap between buyer & seller price expectation
3. Cost of capital
4. Job market

While it is true that many investors have amassed private capital in preparation of buying opportunities, the fact remains that traditional financing by financial institutions have undergone extremely conservative underwriting standards. Such tightening has led investors to adopt ultra conservative strategies to counter market volatility.

Equally challenging is the gap between buyer & seller on pricing. Buyers, naturally, would like larger price discounts, while sellers are reluctant to sell an income producing asset in a depressed market. This hurdle is not easy to overcome, as the following example will illustrate.

Capitalization ratio is a tool used often in real estate transactions to determine its net income potential. The equation is:

$$\text{Capitalization Ratio} = \frac{\text{Annual Net Operating Income}}{\text{Cost (or Market Value)}}$$

So, a building with net operating income of \$80,000, for example, and a market value of \$1 million would realize an 8% Cap Rate – a desirable return – and would likely not be willing to sell unless, of course, the buyer is willing to raise the denominator to entice the seller. Indeed, banks are underwriting cash flow, with little attention being paid to potential capital appreciation.

Current Cap Rates for top tier apartments are approximately 6.25%, while retail (grocery/pharmacy-anchored centers) yield 7.25%. The disparity between current Cap Rates and the more desirable 10%, points to a lingering pricing expectation among buyers & sellers (i.e. the denominator would have to come down some 20% from current valuations to achieve a 10% Cap Rate in the above example).

Continued lack of financing combined with the price gap between buyer & seller leads us to cost of capital, which is determined by interest rates.

The Federal Reserve has committed to a “long period of keeping rates unusually low” (See ‘2010

Outlook’). During past recessions, low interest rates were the engine for recoveries. In the past, lowering the interest rate would encourage capital spending and help put the economy back on a growth path.

The Great Recession, however, has not behaved similarly. Despite near zero rates and the trillions of dollars of stimulus money poured into the markets, banks continue to limit, not extend, credit. Those fortunate few who have access to cheap capital also have the luxury of holding on to real estate assets and not sell at depressed prices.

Debt servicing costs (the interest expense associated with borrowing money) are a function of interest rates – the lower the rate, the lower the cost of capital. This helps explain why prices in CRE sector have not fallen as sharply as the residential sector. The carrying costs associated with properties are so low that even marginally managed properties can continue operating without incurring losses. A rise in interest rates, however, would quickly change these conditions and push prices lower.

Another explanation for the disconnect in commercial and residential markets is that the government’s role in purchasing such assets has falsely held up the market and contributed to the bottle neck. The government solutions, they argue, are creating a delay in the discounting and ultimate sale of these assets.

Both arguments are worth considering. At some point the government will have to unwind its positions, and interest rates will rise. Both events suggest that CRE prices do not appear to be firmly grounded.

Even so, if cost of capital remains low and the government successfully stalls/prevents a repeat of the residential market fiasco, for CRE to truly gain traction and return to its former glory job growth remains the key for a vibrant economy.

The latest data on unemployment has dipped to 10% in November, slightly off its peak of 10.2% set in the prior month, and will likely shrink further in the near term. Adding underemployed workers (those who work less than 40 hours per week, and/or who hold multiple jobs) to the mix raises the statistics to 17.2%. It, too, is down from 17.5% set in the previous month makes the long road to recovery more visible. Even if the trend has reversed, one in every ten American workers unemployed does not a growth economy make. So long as businesses can not absorb the unemployed, vacancies will likely continue to rise.

We believe that the CRE market is likely over priced and will experience reduced Net Operating Income as well as further devaluation in 2010. Such conditions will allow for well managed companies with adequate capital and low debt burden to increase their portfolio and position themselves for a thriving 5 years to follow. **XFG**

SOURCE: National Association of Realtors, Bureau of Labor Statistics, Marcus & Millichap.

2010 (continued)

(Continued from page 2)

this year.

The central bank must stay ahead of the curve in withdrawing stimulus money from the economy and raising interest rates to fight inflation and thwart future bubbles. Both strategies are fraught with risk as we revert once again to growth. The former, however, is perhaps the trickier of the two as no “blue print” exists to use as a case study.

This is in fact where we stand today. The economy has improved from this time last year. The wonderful thing about the American economy and capitalist economies in general, is that their natural tendency is towards growth. This growth can be interrupted by crisis and bad government policy, but a little bit of freedom is all that is necessary for growth.

Our conclusion, therefore, is to stay vigilant to see if the balance of the \$810 billion “Recovery Act” can hold up to its name and spur sustainable growth, or trigger a further weakening of a very fragile economy. In the meantime sticking with our long term investments and looking for new investments is the order of the day. **XFG**

* First American Core Logic (www.facorelogic.com)

Disclosures:

INDICES All indices are unmanaged and can not be directly invested into. The Dow Jones Industrial Average is computed by summing the prices of the stocks of 30 large companies and then dividing that total by an adjusted value, one which has been adjusted over the years to account for the effects of stock splits on the prices of the 30 companies. Dividends are reinvested to reflect the actual performance of the underlying securities. The NASDAQ Composite Index measures the performance of all issues listed in the NASDAQ Stock Market, except for rights, warrants, units, and convertible debentures. The S&P 500 is based on the average performance of the 500 industrial stocks monitored by Standard & Poor’s. XFG’s client assets are custodied at Charles Schwab, member SIPC. For more information on SIPC, please visit www.sipc.org

Securities and advisory services offered through Xerxes Financial Group, Inc., a Virginia domiciled Registered Investment Advisor. The following information should not be considered a solicitation or recommendation. None of the information in this material should be considered legal or tax advice. You should consult your legal or tax advisor for information concerning your own specific tax situation.

Vital Signs

	Dow Jones <u>Industrial</u>	S&P <u>500</u>	10 Yr. Bond <u>Yield</u>	<u>Inflation</u>	National <u>Unemployment Rate</u>	Fed Funds <u>Rate</u>
2009	10,428	1,115	3.2	1.8*	10.0	0-.25
2008	8,776	903	3.6	3.9	6.7	1.00
2007	13,265	1,468	4.6	2.9	4.6	5.02
2006	12,463	1,418	4.8	3.2	4.6	4.97
2005	10,718	1,248	4.3	3.4	5.1	3.22
2004	10,783	1,212	4.3	2.7	5.5	1.35
2003	10,454	1,112	4.0	2.3	6.0	1.13
2002	8,342	880	4.6	1.6	5.8	1.67
2001	10,022	1,148	5.0	2.9	4.7	3.88
2000	10,788	1,320	6.0	3.4	4.0	6.24
1999	11,497	1,469	5.7	2.2	4.2	4.97
1995	5,117	616	6.6	2.8	5.6	5.83

* Estimated. Source: Dow Jones, S&P, Freddie Mac, Federal Reserve, Bureau of Labor Statistics and Wall Street Journal