



## A LULL IN THE STORM: *The Looming Rich Man's Recession*

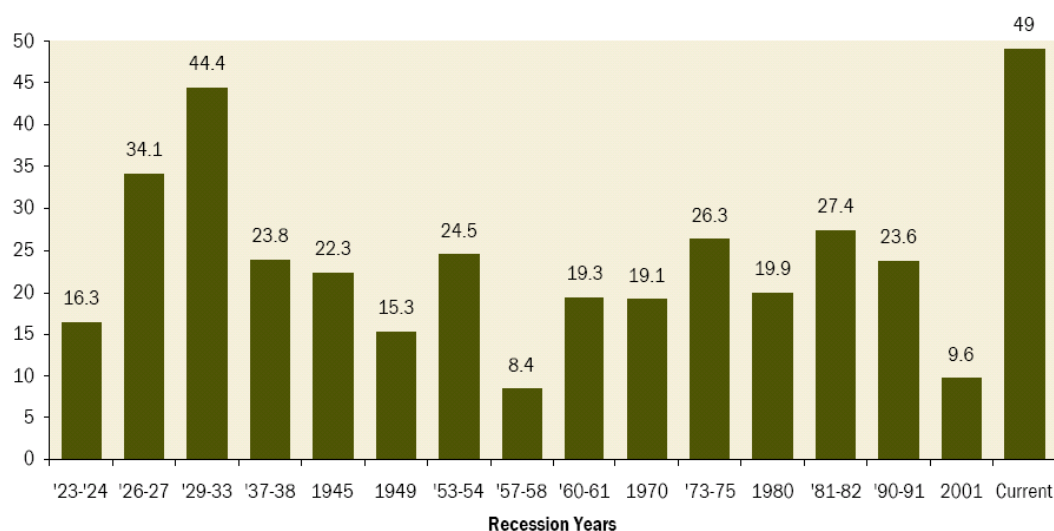
The economic optimism we have experienced over the last few months has been a wonderful reprieve. In fact, this is the most significant recovery the U.S. stock market has ever experienced in the context of pricing out of a recession. Though the break in the clouds has provided *a lull in the storm*, a new wave of risks are looming on the horizon for wealthier Americans.

The chart below shows the historical market gains from the trough (bottom of the market) until the official end of the downturn. The primary driver behind this rally has been liquidity. Yet, according to Citigroup, there is still \$3.5 trillion sitting idly in cash on the sidelines, possibly setting the stage for even further gains. While we have enjoyed this huge rally from the lows in March, we are still down over 30% from the high of October 2007 (almost two years ago).

### CHART 1: SHARPEST EQUITY MARKET RALLY EVER IN THE CONTEXT OF PRICING OUT THE RECESSION

#### United States: S&P 500 Composite

(% change from market trough during recession to the official end of the downturn)



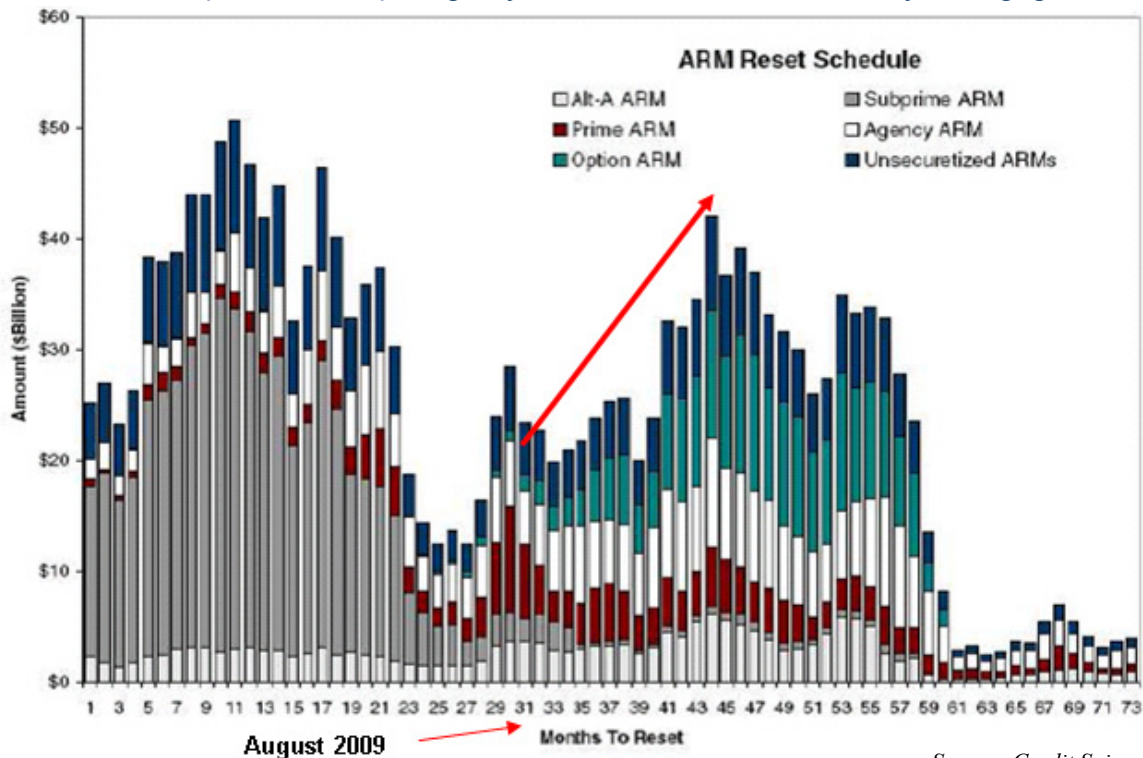
Source: Haver Analytics, Gluskin Sheff

In the fall of 2007, we published the chart on the next page and warned of a coming crisis that would affect all homeowners and place historic pressure on the financial system. We cautioned that an enormous amount of loans were about to reset to much higher rates and many people who had

purchased homes they could not afford would default. Though we expected turbulence, even we were surprised by the extent of damage these loans created.

Now that “sub-prime” is largely in the rearview mirror, there are other sectors within the mortgage market that concern us. Though names like Prime, Option ARM and Alt A are not readily known now, in the not too distant future, they will probably become as well-known as the infamous “sub-prime” loans that will haunt investors for years to come.

*We are currently in the early stages of another massive amount of mortgage resets*



Source: Credit Suisse

Unlike sub-prime where housing in the middle to low-end markets has been impacted most, this time it will be the high-end housing sector that will take the brunt of this reset phenomenon. There is a large segment of the high-end market where homeowners could face a large increase in their monthly payment. To illustrate this point, we have constructed an example of a typical Option ARM mortgage that was issued aggressively by the mortgage industry to high-end homeowners around the country over the past three to five years.

| Rich Man's Mortgage                      |   |
|--|---|
| Mortgage Product                         | Option ARM / Negative Amortization Using Minimum Payment Option |
| Mortgage Amount                          | \$2,000,000   |
| <b>Min. Monthly Payment BEFORE Reset</b> | <b>\$6,432</b>  |
| Regular Amortization Payment             | \$13,984  |
| Mortgage Balance After Reset in Yr. 3    | \$2,218,448   |
| Mortgage Reset Interest Rate             | 4.50%   |
| <b>Monthly Payment AFTER Reset</b>       | <b>\$11,240</b>   |

Source: United Capital Financial Advisers, LLC

As you can see, after three years the homeowner has a mortgage balance \$218,448 higher than the original mortgage. Even more ominously, the monthly payment is almost double at the time of reset, even though the rate is historically low at 4.5%. This is because the loan principal has to be paid and the minimum payment option is no longer available. In addition, the new rate is adjustable so it will go up whenever interest rates increase. Wealthier Americans took these loans for the same reasons as borrowers with subprime loans; 1) It allowed them to buy a nicer home than they could afford with a regular loan, and 2) allowed them to keep payments as low as possible until the home increased in value. These Option Arms represent about half of the risky resets.

The other half are called Alt A loans. This is where borrowers either have no verified income or some modest credit issues. Alt A loans also adjust in the coming months, though the impact varies greatly on the type of terms. **Fortunately rates are still very low, so while most of these people cannot refinance their existing loans, the loans will be adjusting to low rates.**

This current reset cycle will place another wave of expensive homes on the market causing pricing pressure on these high-end homes, even while the low-end stabilizes. Paradoxically, during this cycle we anticipate that the national average home price might increase due to the mathematical quirk of increased selling at the high-end pushing the average home price higher even though prices are declining for the high-end market.

Recent reports have indicated that 23% of US homeowners are “upside down” (negative net equity) on their mortgages.<sup>1</sup> As this cycle takes root, more high-end homes will become “upside down” placing the homeowner in a precarious position with limited options. As many sell to reduce their expenses, their neighbors will watch the equity in their home drop in value. This is what borrowers in subprime areas have experienced in the past few years.

### *Welcome to the Rich Man's Recession.*

There will be zero public sympathy for the “rich man's” (and we use that term loosely) plight so there will be none of the help from Washington that aided the sub-prime homeowners. One area of concern is the “trickle down effect”. The probable implications for investors are:

1. High end home prices will probably continue to fall for the next 18 months. Though we will probably see the average home price nationally improve due to stabilization for lower cost homes.
2. Luxury goods and services will likely underperform for years to come: retailers, hotels and luxury services to the wealthy will continue to languish. There is currently an overabundance of services and goods catering to high-end spenders.
3. Inflation will likely be held in check for the time being. While we have been very concerned that the fiscal spending and budget deficit would lead to a collapse of the dollar and rampant inflation, as long as the economic recovery is lax, this issue is on hold. We are still mindful but this issue might not be important until late 2010.

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<sup>1</sup> Gluskin Sheff “Breakfast with Dave” (8/19/2009)

4. A slow recovery is anticipated due to reduced spending from the high income segment and reduced lending by banks. The stimulus programs, specifically for autos and housing, have given us a temporary boost. However, with these programs currently unwinding, what will contribute to economic activity once these programs expire? The recovery could also be impacted by a pending tax increase in 2011.
5. We have had an amazing recovery, but the near-term future will likely be volatile once summer is over and the economy digests the implications of all of these issues. Cautious and selective investing will be crucial from here on out.

Our country still faces some serious headwinds but the stock market likes to climb a wall of worry. While we should all prepare for a little more turbulence in the fall, we probably will not experience the generational wealth destruction we witnessed six months ago. We encourage you to visit with your wealth counseling team to discuss strategies to keep you comfortable, and to make the appropriate adjustments to your portfolio. There is no better time than after a recovery to make changes to your strategy.

Our team continues to work every day on finding the right solutions for you and your family to live your *One Best Financial Life™*.

Thank you for your ongoing trust and confidence,

Joe Duran CFA & the Investment Committee

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