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*The thoughts of others  
Were light and fleeting,  
Of lovers' meeting  
Or luck or fame.  
Mine were of trouble,  
And mine were steady,  
So I was ready  
When trouble came.*

*A.E. Housman*

**These words from the poet, A.E. Housman, strike a deep chord within us. As you are aware, we have been thinking of trouble for some time. During the first quarter of 2008 it became quite apparent that trouble is here. We believe that there is more trouble to come.**

**The root of the current problems lay in the loose monetary policies put in place earlier in the century by then Federal Reserve Chairman Alan Greenspan. He dropped interest rates far to low and kept them there far to long in response to a mild economic slowdown following the bursting of the internet bubble and the terrorist attacks. The result of these low rates was to encourage excess borrowing in all areas of the economy. Most importantly consumers went on a borrowing binge; using the rising values of their homes as ATM machines. As the Wall Street Journal writes: “**

**Homes became the collateral for trillions of dollars in household borrowing. That depressed savings, inflated consumption, fueled rapid lending and loosened lending standards to households, businesses and speculators.”<sup>1</sup>**

**Like all bubbles, it too burst.**

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<sup>1</sup> Greg Ip  
Wall Street Journal Online, May 4, 2008

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**Burst real estate bubbles are very serious and difficult to contain because they cause massive wealth destruction. Home values dropped in the latter half of 2007 and have dropped a further ten per cent so far this year. Some economists are predicting that housing prices could fall a further ten per cent this year and an additional ten per cent in 2009. The total decline in home values could total forty to fifty per cent since their peak. Should these declines occur, twenty one million of the fifty one million homeowners in the United States could find themselves in a negative equity position. As a result, several indicators are starting to show that consumers are starting to retrench:**

**Consumer confidence is at the lowest level in twenty six years**

**Consumer spending is declining**

**Auto makers are reporting double digit sales declines**

**The inventory of unsold homes is near all time highs**

**In response to what several observers have described as the worst crisis in a generation the Federal Reserve and central banks around the world have dropped rates quite sharply over the past several months. However, these efforts are being complicated by record energy prices and soaring food costs. When it rains it pours!**

**In contrast to our cautious view, many market participants believe that the worst of the turmoil has passed. They argue that the aggressive interest rate cuts mentioned above, government bailouts of troubled financial institutions and increased fiscal stimulus will result in a resumption of growth in the latter half of this year. Equity investors appear to share this view. The Dow Jones Industrial Average has increased by approximately eleven per cent since its low point in mid March.**

**We strongly disagree with this view. In fact we strongly believe that there is more trouble to come. Historically, there has never been a time when real estate values have declined dramatically without serious economic fallout. Historical precedence would suggest that:**

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**Consumer spending will continue to fall**

**Unemployment will rise**

**Corporate profits will decline**

**Many financial institutions will continue to record large losses**

**In short we think that we are in the early stages of an economic slowdown and that a serious recession is in the offing.**

**As we discussed in our last newsletter (available at [www.patientcapital.com](http://www.patientcapital.com)) equity valuations are still above long term averages. These “extended” valuations against a backdrop of deteriorating economic fundamentals scream RISK to us. Trouble is here with more to come.**

**But we at PCM are ready. We are entering these turbulent times with substantial cash balances. Our philosophy of purchasing high quality companies at very attractive valuations has helped us to avoid trouble and put us in a position to capitalize on opportunities as they present themselves.**

**Indeed we have already begun to see opportunities. During the last quarter our equity investments have increased from fifteen per cent of the portfolio to thirty per cent; an increase of one hundred per cent! These new investments are in industry leading companies purchased at substantial discounts to their intrinsic values. We believe that the potential for substantial long term returns is quite high.**

**After patiently waiting for a long time circumstances may be coming our way. We are excited because in the face of trouble we are steadfast and ready!**

**Vito Maida**

**May 2008**

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