

LEADER CAPITAL NEWS

September 2010

The Cost of Capital

“Consumption is the end: everything else in the economy is merely a means to it.”¹

Leader Capital has developed the Cost of Capital model (see chart 2) in an effort to simplify a myriad of economic data that comes at us every month: PPI, CPI, Consumer confidence, GDP Estimated, GDP Annualized, GDP Actual, etc. These are all attempting to determine the health of the consumer and consequently the Corporate Earnings picture.

I've attached our simple (albeit painstaking) calculations on how we arrive at our Cost of Capital Index in order to understand the consumers' spendable bottom line. Much of the effort here is to determine accurate and current numbers, (most of which are government generated) some of which are over two years old and being reported today. So, the challenge has been in getting recent data. Based on the current health of the consumer's "bottom line" we assign a score of -4.85 from a possible -6 to +6 (-6 being the worst) and hence we arrive at our Cost of Capital Index (CCI). Please visit www.leadercapital.com for additional information. The reason for the low score is that the consumer for the first time, is precluded from access to credit and must rely solely on his income and savings which are negative. It is our conclusion that the consumer is out of the game and will be until actual GDP is 4% (or better) and 30 year mortgages are at 3.75%...or both.

These two statistics are important (especially the refinancing at 3.75%) because that reloads the consumer with a 30 year stream of income (approximately \$400/month savings on housing expense). GDP at 4% will encourage businesses to hire to maintain profit momentum. The CCI

¹ Author unknown

may not be a leading indicator historically, but with the consumer's lack of a balance sheet the CCI will be a good leading indicator going forward.

The CCI Model tells us one of two things (or perhaps both). Incomes need to go up or expenses must come down (housing being the biggest expense).

With foreign wages much lower than wages in the United States it is unlikely wages will rise and very likely we will get extreme downward pressure on wages and pricing. In addition, it is unlikely any increase in the cost of goods and services will be passed on to the consumer in the form of higher prices; this does not bode well for corporate profits going forward. Therefore, mergers and acquisitions will be the outlet for excess corporate cash as companies grow through attrition and acquisitions not direct hiring. The average termination that accompanies each merger is about 14.7%. So again, we are in a downward spiral until GDP improves through consolidation and/or cost cutting. Also, earnings accretion is usually slower to materialize than acquisition proformas suggest.

Unemployment should peak at 24% (U6²) and 15% (U3³) so we believe another 5% of the workforce will be on the dole by 2nd Quarter 2011. In addition, municipalities are just beginning to address their problems. "If states get no further federal assistance, the steps they will have to take to eliminate deficits will likely take a full percentage point off the Gross Domestic Product. That, in turn, could cost the economy 900,000 jobs next year."⁴ In summary, the following will lead to higher unemployment:

- a. Mergers and Acquisitions
- b. Municipal Firings
- c. Corporate efficiencies
- d. Less consumer demand for Goods & Services

² Total unemployed, plus all marginally attached workers, plus total employed part time for economic reasons, as a percent of the civilian labor force plus all marginally attached workers.

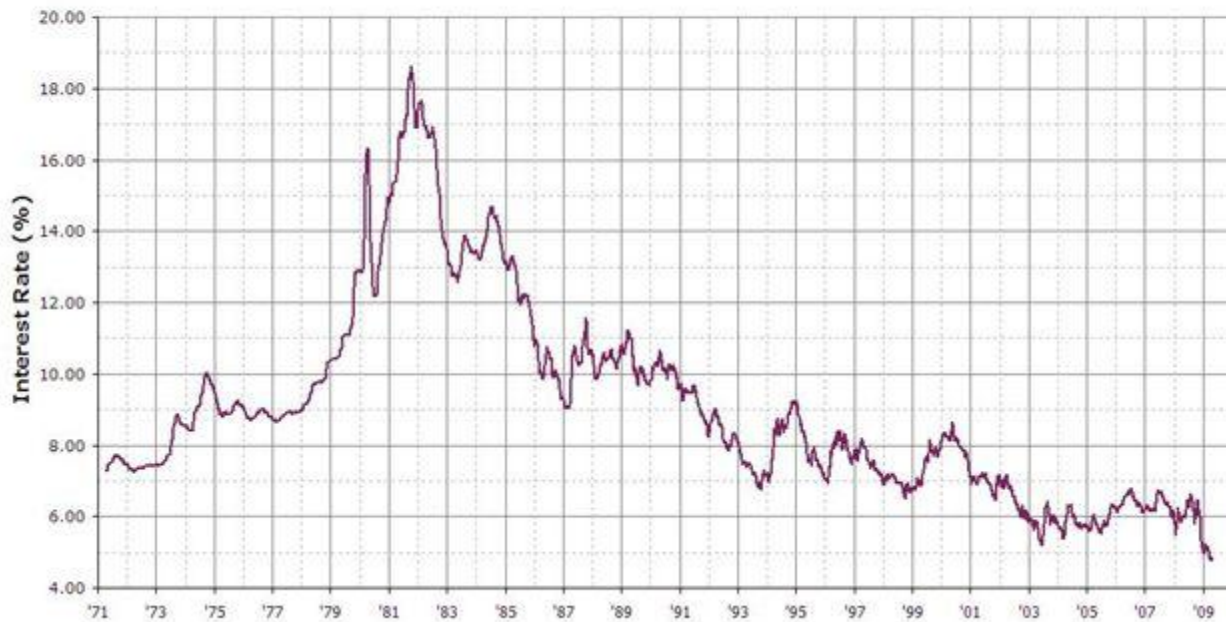
³ Total unemployed, as a percent of the civilian labor force (the official unemployment rate)

⁴ Center on Budget and Policy Priorities; July 15, 2010

The 30-Year Bond is going to 2.75% (see our Tip of the Iceberg Newsletter – July 2009) because the 30-Year rule of thumb is 2% + the growth rate (GDP) which is close to 0%. This will set up a major home refinancing by the consumer and a post-Geithner program that works (that's right, post Geithner). Fannie Mae and Freddie Mac will be around but with a government guarantee (or they will merge as a new entity), either way the effect is the same, a government sponsored entity that provides liquidity to the banking system.

Housing prices must go lower to be affordable in our model (down another 20% from here) along with a refinancing benefit - 3.75% mortgages are coming!!! It doesn't seem like much (20%) but it's another \$2 trillion haircut and it will affect about half of the excess reserves the banks have, as they actually sell their bad loans/REO's.

Chart 1: **Historic Conventional Conforming 30-Year Fixed Mortgage Rates 1971 - 2009**



The Dollar & Stagflation

The current status of the dollar is a fairly major concern to us along with the financial health of the consumer. The current move up in Treasuries without the dollar rising means we're losing foreign buyers; look for more multi-national companies like McDonalds to issue debt in Yuan (or other stronger currencies). Look for the dollar to lose its percentage of world reserve currencies and come under pressure. This in time will cause short rates to rise, while longer rates remain low as the United States competes for investment dollars and GDP declines. Repatriation will be a major earnings boost in 2011. That's 2011, not 2010.

“Stagflation was cured by a set of policies that reversed the Keynesian nostrums then in vogue and that are again the core basis for federal economic policy.⁵ In the early 1980s, the Fed tightened money, tax rates were cut, economic regulation was pared sharply and an effort was made to curb nondefense spending. It worked quite well, producing 25 years of economic growth. It will be much harder to repair today's damage, but the need to make another try is becoming urgent.” We are not saying stagflation is a threat yet, but it is on our radar screen. Our view is all prices move down in any case. However, if stagflation gets in the system for more than 120 days it will raise costs in our CCI Model. We believe commodities and the dollar will trend lower together and we will not get the traditional “market rally” due to rising commodities as a result of a falling dollar.

Elections

Look for November and the ousting of the incumbents (all the incumbents) to set up a road block for additional government spending and stimulus, and allow the true face of the market to emerge.

U.S. consumer wages are approximately 70% of GDP. The consumer can no longer leverage his balance sheet; he must rely solely on income which is going lower. Incomes Corporate/Consumer) drove asset prices up but look for the reverse going forward. As prices move down to meet incomes and incomes move lower due to higher unemployment we believe earnings in the U.S. and abroad will move much lower. The current opportunity is to keep your shirt...high quality fixed income as a main course and look to deploy into riskier asset classes later in the cycle.

⁵ WSJ-8/24/10-The Fed Can Create Money, Not Confidence

We have started a Total Return Fund (LCTRX/LCTIX) to take advantage of opportunities as they arise and expect the best opportunities later in the cycle.

Infrastructure

Infrastructure and lower costs are coming; China had a slight delay in traffic on a 350 mile route from Mongolia to China's capital (it took one truck driver 5 days). You can go 350 miles anywhere in the USA in less than 7 hours. The United States boasts the best infrastructure in the world. Our infrastructure combined with lower costs (wages, housing, rents, commerce, trucks, etc.) will bring on a new bull market in 2012, that's 2012 not 2010. The only traffic jam we have is political.

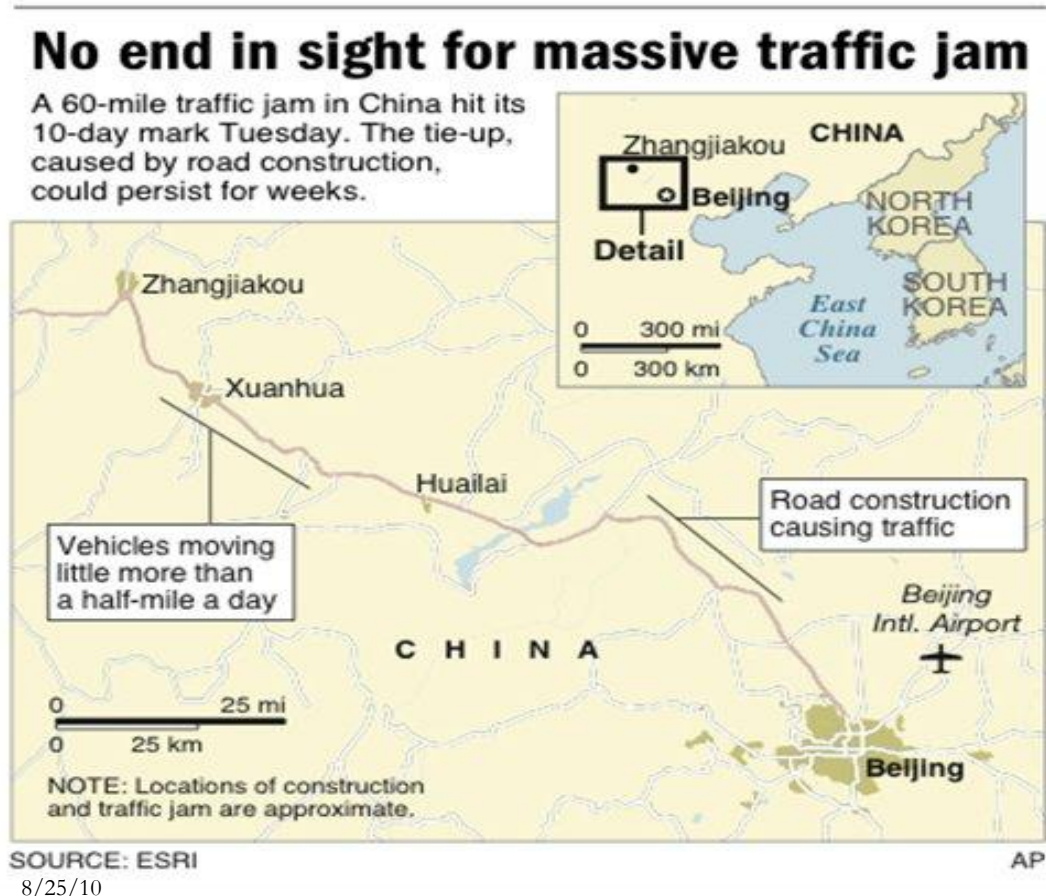


Chart 2:

CCI - Annual Household Cash Flow

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010 Annualized
Income & Taxes											
Median Household Income	\$49,563	\$50,218	\$50,131	\$51,193	\$52,400	\$54,835	\$57,386	\$58,921	\$59,364	\$57,464	\$57,364
Taxes	(\$11,168)	(\$11,511)	(\$11,247)	(\$11,838)	(\$11,955)	(\$12,491)	(\$12,989)	(\$13,595)	(\$14,181)	(\$14,065)	(\$13,477)
After Tax Income	\$38,395	\$38,707	\$38,883	\$39,355	\$40,445	\$42,344	\$44,397	\$45,326	\$45,183	\$43,399	\$43,888

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010 Annualized
Fixed Costs											
Housing	(\$13,201)	(\$13,136)	(\$14,234)	(\$13,906)	(\$15,021)	(\$15,784)	(\$16,454)	(\$15,739)	(\$13,967)	(\$12,941)	(\$13,378)
Telephone	(\$686)	(\$641)	(\$620)	(\$592)	(\$570)	(\$542)	(\$482)	(\$468)	(\$437)	(\$407)	(\$433)
Cable	(\$502)	(\$523)	(\$561)	(\$582)	(\$605)	(\$625)	(\$641)	(\$657)	(\$669)	(\$685)	(\$810)
Internet	(\$728)	(\$758)	(\$746)	(\$771)	(\$791)	(\$835)	(\$919)	(\$980)	(\$1,020)	(\$990)	(\$1,386)
Heating/Gas	(\$328)	(\$407)	(\$333)	(\$407)	(\$454)	(\$536)	(\$580)	(\$551)	(\$578)	(\$626)	(\$349)
Water/Garbage	(\$480)	(\$490)	(\$500)	(\$510)	(\$521)	(\$531)	(\$542)	(\$553)	(\$589)	(\$598)	(\$625)
Car Payment	(\$4,358)	(\$4,563)	(\$4,673)	(\$4,758)	(\$4,331)	(\$4,519)	(\$4,362)	(\$4,136)	(\$4,133)	(\$4,339)	(\$4,795)
Car Insurance	(\$1,460)	(\$1,520)	(\$1,581)	(\$1,492)	(\$1,514)	(\$1,497)	(\$1,526)	(\$1,659)	(\$1,652)	(\$1,682)	(\$1,578)
Health Insurance	(\$1,800)	(\$1,994)	(\$2,189)	(\$2,383)	(\$2,578)	(\$2,772)	(\$2,967)	(\$3,161)	(\$3,356)	(\$3,550)	(\$3,745)
Home/Renters Insurance	(\$352)	(\$365)	(\$370)	(\$380)	(\$387)	(\$400)	(\$414)	(\$425)	(\$443)	(\$443)	(\$456)
Retirement	(\$2,610)	(\$2,610)	(\$2,610)	(\$2,610)	(\$2,610)	(\$2,610)	(\$2,610)	(\$2,610)	(\$2,610)	(\$2,610)	(\$2,610)
Sub Total	(\$27,007)	(\$27,533)	(\$28,940)	(\$28,903)	(\$29,891)	(\$31,147)	(\$31,903)	(\$31,324)	(\$29,853)	(\$29,274)	(\$30,687)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010 Annualized
Variable Costs											
Cell Phones	(\$146)	(\$210)	(\$294)	(\$316)	(\$378)	(\$455)	(\$524)	(\$608)	(\$654)	(\$756)	(\$1,054)
Travel	(\$1,215)	(\$1,257)	(\$1,278)	(\$1,309)	(\$1,335)	(\$1,380)	(\$1,429)	(\$1,465)	(\$1,528)	(\$1,530)	(\$1,540)
Entertainment	(\$1,863)	(\$1,953)	(\$2,079)	(\$2,060)	(\$2,218)	(\$2,388)	(\$2,376)	(\$2,660)	(\$2,470)	(\$2,374)	(\$556)
Apparel	(\$1,856)	(\$1,743)	(\$1,749)	(\$1,640)	(\$1,816)	(\$1,886)	(\$1,874)	(\$1,881)	(\$1,882)	(\$1,898)	(\$1,656)
Food											
Groceries	(\$2,991)	(\$3,086)	(\$3,117)	(\$3,097)	(\$3,352)	(\$3,439)	(\$3,544)	(\$3,557)	(\$3,673)	(\$3,762)	(\$3,700)
Eating Out	(\$2,167)	(\$2,235)	(\$2,258)	(\$2,243)	(\$2,429)	(\$2,492)	(\$2,567)	(\$2,576)	(\$2,661)	(\$2,725)	(\$2,681)
Personal Care	(\$545)	(\$564)	(\$574)	(\$588)	(\$599)	(\$619)	(\$641)	(\$658)	(\$686)	(\$687)	(\$687)
Pets	(\$414)	(\$429)	(\$436)	(\$446)	(\$455)	(\$471)	(\$487)	(\$500)	(\$521)	(\$522)	(\$523)
Car Maintenance	(\$711)	(\$736)	(\$748)	(\$766)	(\$781)	(\$808)	(\$836)	(\$858)	(\$894)	(\$895)	(\$920)
Home Maintenance	(\$423)	(\$438)	(\$445)	(\$456)	(\$465)	(\$481)	(\$498)	(\$511)	(\$533)	(\$533)	(\$535)
Gasoline	(\$1,291)	(\$1,279)	(\$1,235)	(\$1,333)	(\$1,598)	(\$2,013)	(\$2,227)	(\$2,384)	(\$2,872)	(\$1,885)	(\$2,504)
Credit Card	(\$1,437)	(\$1,522)	(\$1,605)	(\$1,687)	(\$1,783)	(\$1,818)	(\$1,909)	(\$2,028)	(\$2,052)	(\$2,023)	(\$2,627)
Sub Total	(\$15,059)	(\$15,453)	(\$15,818)	(\$15,942)	(\$17,209)	(\$18,251)	(\$18,912)	(\$19,686)	(\$20,426)	(\$19,590)	(\$18,984)

Net Income	(\$3,672)	(\$4,279)	(\$5,875)	(\$5,490)	(\$6,655)	(\$7,054)	(\$6,418)	(\$5,684)	(\$5,097)	(\$5,465)	(\$5,783)
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	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010 Annualized
Income											
Average Income	\$57,135	\$58,208	\$57,852	\$59,067	\$60,466	\$63,344	\$66,570	\$67,609	\$68,424	\$66,234	\$66,433
Median Income	\$41,990	\$42,228	\$42,409	\$43,318	\$44,334	\$46,326	\$48,201	\$50,233	\$50,303	\$48,693	\$48,839
(Avg. + Med.) / 2	\$49,563	\$50,218	\$50,131	\$51,193	\$52,400	\$54,835	\$57,386	\$58,921	\$59,364	\$57,464	\$57,364

Predictions

- 30-Year Bond 2.75%, mortgages 3.75%
- DOW Jones Industrial Average 5,500 by 2nd Quarter 2011
- 20% lower housing prices (2.0 trillion in value lost)
- Massive refinancing ahead
- Higher Unemployment (24% U6)
- Commodities (lower) and Dollar lower!!!

GDP should be the leading indicator to a sustainable recovery; i.e. fewer people doing the same amount of work with cheaper goods and services. Employment will follow with the Fed raising rates in 2011 or late 2012.



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