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E.Q Trendwatch™

Looking through to the upside of down

> ***"The fallout of this CDO mess is likely to end up into $100 billion plus of losses for banks, financial institutions, hedge funds and investors once these CDOs and sub prime mortgage backed securities are marked-to-market rather than being marked-to-a-delusional-misrated-model. Thus, the Bear [Stearns] disaster is only the tip of the iceberg of a much bigger financial mess that will unravel in the next few months: the pile of rising sub prime and near prime delinquencies will take a toll on the toxic waste of mortgage backed securities that a rating "voodoo magic" pretended to turn below-junk securities into A-rated ones."***
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> **-Economist Nouriel Roubini | Jun 27, 2007**

Our readers will know that we at Venable Park have been worried about the abuse of credit and credit-derivatives over the past couple of years of this business cycle. It has made us cautious and concerned that the underpinnings of the debt that drove bond, equity and realty markets during recent gains were rotten and unsustainable. We have definitely taken some abuse for these views and it has not been easy to stick to our convictions. But in our central pledge to look out for the best interests of our clients we saw that we had no choice but to proceed with abundant caution so that we would have capital protected and ready to scoop up valuable investments at future discounts. It seems the long-looming re-pricing storm may be finally breaking upon world markets.

<u>To summarize the sub prime parts:</u>

- since interest rates were cut to 50 year lows in the world after 9-11, money became excessively cheap,
- with rates so low, lenders look to leverage and higher risk strategies to ramp up profits,
- the brokerage/underwriters rose to the challenge by funnelling a couple of trillion dollars to mortgage brokers who earned commissions making liberal loans to anyone who had a pulse. Many of the borrowers could not normally have qualified for the loans under normal lending standards and so these new deals came to be denoted as "sub-prime", "near-prime" and "Alt A",
- so lax became the lending standards that borrowers were able to get all kinds of credit with remarkable ease including no proof of income or financial disclosure. These came to be called "liar loans." Lenders also offered introductory

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sweeteners where borrowers took advantage of no or low-interest periods when regular payments were suspended or postponed before popping up to above market-rates down the road,

- in order to spread the risk of these very risky loans, Wall Street underwriters then packaged the risky loans into funds (CDO's, CMO'S, CD's etc) that sold different tranches of varying yield to different investors looking for above market "guaranteed" income,

- desperate for fixed income returns in the low rate environment, many pension funds and foreign investors around the world bought these high-risk loans from underwriting firms on their happy assurance that low grade loans were now magically transformed into low risk, AAA bonds,

- Wall Street firms paid hundreds of millions in fees to the various credit rating agencies that were supposed to be independent bean counters, in order to secure higher-grade bond ratings,

- through the miracle of this unprecedented leverage, asset markets around the world (stocks, bonds and real estate) enjoyed massive amounts of inflows also known as liquidity,

- since there were suddenly more people able to buy real estate, realty values soared well beyond historical return levels in most areas. By continuing to refinance against increased realty values, consumers were able to consume more and more goods regardless of the fact that their incomes could not support such spending,

- seemingly insatiable spending spurred global demand and inflation. Central bankers charged with the primary duty of containing inflation in world economies have been raising interest rates in concert now for over 3 years. Since inflation is a lagging indicator, it is widely expected that global interest rates will be continuing to increase for some time yet, even while economic growth is already stalling, (potential stagflation)

- peaking in 2005, realty markets have been falling in value now for over a year. As the party music ends, people are finding themselves with enormous debt levels coupled with rising interest rates,

- meanwhile the innovative mortgage and loan products are resetting at higher and higher interest rates at a time when borrowers have negative savings and energy expenses at the highest seen since the crisis of the 1970's,

- not surprisingly escalating numbers of people are now defaulting on their loans. Many more are expected to follow as we are presently at the tip of rate resets slated to follow over the next year and beyond,

- as waves of defaults hit, the losses to mortgage pools held in CDO's, CMO's, CD'S etc are huge,

- recently a couple of these levered mortgage funds run by Bear Stearns closed due to solvency issues caused by the escalating mortgage default rates in their portfolios. In an effort to liquidate the remaining mortgage portfolios, the trustees placed them up for auction on the open market where bids were attracting offers of .30 cents on the dollar,

- this reality presents a problem for holders of remaining mortgage pools because they will now also have to admit that their mortgage pools are not worth the par value they have allotted them on their balance sheets,

- any real time sales of these assets will trigger a market value which is 50-70% below their recorded book value and forces an admission of real market values, and portfolio losses and sends a wave of re-pricing lower across all asset classes:

> "That would require a massive re-pricing of portfolios all across the globe. It would turn some winning portfolios into losers and turn modest losses into debacles. It would force pension funds and insurance companies to make up massive shortfalls in the value of their portfolios. Some hedge-fund managers and Wall Street investment bankers, whose bonuses are determined by profits on these fictitious prices, might see bonuses disappear completely. They might even—be still my beating heart—have to give back performance-based fees."
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> – Jim Jubak: MSN Money June 27, 2007

Contrary to what many would like us to think, the present problems with asset markets are sadly not contained to just a few high-risk borrowers of high-ratio mortgages. Through the "genius" of financial derivatives and the greed of large numbers, the risk has now been spread throughout all markets in all parts of the world. Its breadth makes this problem wide spread and mainstream. Wall Street and Bay Street have profited handsomely once again (they are always careful to get their underwriting fees upfront). But as Bill Gross of PIMCO the world's largest Bond fund wrote this week:

> "Currently 7% of subprime loans are in default. The percentage will grow and grow…the point is there are hundreds of billions of this toxic waste and whether or not they're CDO's or Bear Stearns hedge funds matters only to the extent of the timing of the unwind. To death and taxes you can add this to your list of inevitabilities: the subprime crisis is not an isolated event and it won't be contained to a neat little Petri dish in some mad scientist's laboratory. Ultimately through capital market arbitrage it will affect risk spreads in markets completely divorced from US housing."
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> -- Bill Gross: July Investment Outlook. www.pimco.com

It is the regular people, not prepared for these developments, and the overall economy that are once again left paying the price through losses to savings and pension plans, losses in real estate markets and ultimately job losses as the economy contracts.

With over 80% of public pension plans already running funding deficits due to market losses suffered in 2000-2002, further losses to their fixed income holdings could not come at a less opportune time. In aggressively reaching for higher yields, pension trustees and other fixed income investors have blindly subjected their funds to enormous risks yet again.

This week in the UK Telegraph, the Bank of International Settlements "BIS" (the bank of the world's central bankers), issued a warning (horrendously late to those who have been watching this saga unfold) saying: "years of loose monetary policy have fuelled a dangerous credit bubble…" The BIS pointed to multiple worrying signs, including mass issuance of new types of credit instruments, soaring levels of household debt, extreme appetite for risk shown by investors, and entrenched imbalances in the world currency system.

Some interviewers and media have accused us of being dark over the past few months. But, as we frequently find ourselves pointing out, it is not Venable Park painting this negative picture. We are simply one of several messengers reporting the risks as they now are. Apparently the BIS felt compelled to do the same, regardless of how unpopular this message may seem.

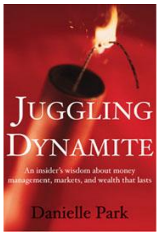
Despite how it may appear on the daily news, year to date all major foreign stock indices have now lost money during 2007 in Canadian dollar terms. Bonds have also lost value year to date with very long terms losing more than 3%. People that have remained fully invested over the past 6 months have had negative returns as payment for significant risk to their capital.

The Upside of Down:

We at Venable Park are ahead of this story, and have been diligently watching it unfold (and yes we admit it has taken a seemingly long time to come to a crisis). But we are ready to take advantage of the lower prices, better values and higher yields when the correction presents itself.

Enjoy the summer. Best wishes to you and your family from your humble and devoted analysts….

Juggling Dynamite available in fine book stores everywhere



Danielle's new book is now available in Canada with release in the US scheduled for September. *Complimentary copies of the book were mailed to all our clients April 27.*

Discount prices are available on line at http://amazon.ca and http://www.chapters.indigo.ca

Daily articles and commentary can also be viewed on the book blog at www.jugglingdynamite.com.

www.jugglingdynamite.com

Praise for Juggling Dynamite:

"Park manages to not only explain finances well for the average person, she also manages to entertain and educate, while cutting through the clutter of information she knows that every investor faces."

-Toronto Sun