Real life needs active management MARCH 31, 2007. ISSUE 3

E.Q Trendwatch™

The world reluctantly awakes

Source: The Big Picture

Cory Venable CIM, FCSI, CMT
Technical Market Analyst

Danielle Park LL.B., CFP, CFA
Portfolio Manager

Venable Park Investment Counsel Inc.

Venable Park Investment Counsel Inc.
VIIP
www.venablepark.com

33 Clapperton St.
Barrie ON L4M 3E6
Tel: (705) 792-3991
Toll Free: 866-792-3991
Fax: (705) 792-3992

No you are not imagining things. The business media and U.S regulators are this month "aghast" at the reckless lending practices of the past three years which are now coming to light. Since December there are now 44 mortgage lenders in the US that have officially filed for bankruptcy. Unfortunately for many, this is only the tip of this iceberg.

For our clients of course, this story is old news. We have been chattering away about these looming storms for over a year now. The only thing shocking to us in all this is how long it is taking the mainstream to catch on and wake up. We have been waiting for the opportunities that will inevitably come out of all the unravelling now underway.

The broker-dealer stocks (JP Morgan, Goldman, Lehman Bros etc.) have been steadily losing value over all of this, down about 9% on the group year to date. (sorry but if you ask us, it couldn't happen to a more deserving bunch-a-fellas). Each day more data comes to light as to what a large role Wall Street has played (once again) in enabling and encouraging the credit bubble that is now beginning to bust around the world. In layman terms: over the past three years when interest rates were abnormally low, the broker-dealers funneled billions of dollars to smaller mortgage and loan companies who then earned commissions brokering this money (1.6 trillion dollars worth) for sub-prime loans to people who could not afford them. The same broker-dealers then bought back these mortgage portfolios and "securitized" them meaning they re-packaged low-grade debt into investment pools that they then sold to investors as AAA debt. As one commentator observed this week, "in another era we would have called this loan-sharking".

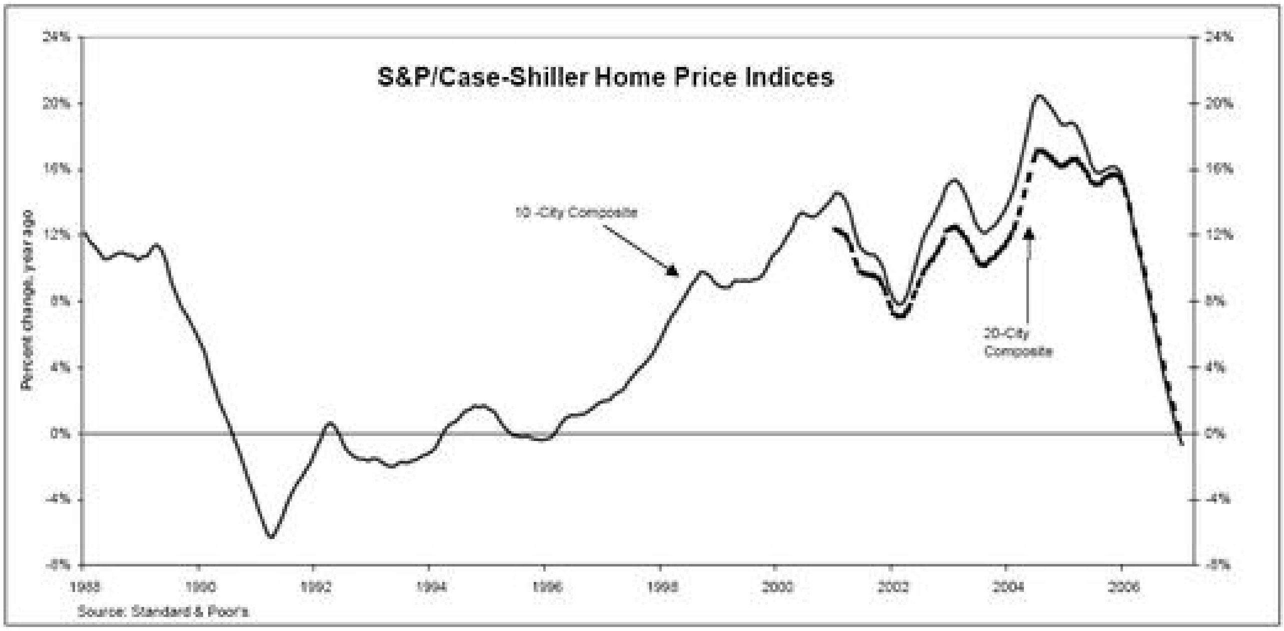
The broker-dealers have made staggering fees underwriting all of this product, making their earnings the best ever in history. The mortgage brokers have been highly profitable too. But here's the catch. The broker-dealers had a term in their carefully crafted agreements--if a certain percentage of the loans in these pools started to go bad, then the mortgage brokers were to buy the mortgages back off the Wall Street wizards. The wave of defaults began to swell in late 2006 as housing prices were in decline and mortgage rates headed up. By this January, people were walking into their mortgage broker offices and literally throwing their keys at them. With no money to buy back the loans as promised, the mortgage brokers are simply going bankrupt—one every other day so far in '07. Wall Street is now trying to smooth things over with investors left holding, now clearly sub-prime bonds.

The biggest holders of these low-quality securities? Public and private pension plans that were desperate to find high-yielding investments. Who will pay the ultimate price for the losses that will follow? The poor unaware, nameless pension holders. As always there will be lots of lawsuits and finger pointing, but it will be little people left bearing the brunt of the damage.

The other inevitable fallout is that millions of homes will now be coming back onto the market over the next couple of years through foreclosure. Lehman Bros and Bear Sterns have a base case scenario that calls for subprime national defaults of $200 to $250 billion over the next two years. This would translate into 1-2 million residential-unit defaults. The next 22 months will see nearly $1 trillion in adjustable-rate mortgages resetting at significantly higher interest rates, with $650 billion of this in subprime.

So great has been the over-building this cycle, that in February there were already 8.1 months of housing supply for sale in the US. This is a record being the highest inventory since the last great real estate recession of 1990-1991. The U.S housing market will play a critical role in shaping the investment landscape for some time to come as the already large supply builds even larger from ongoing cancellation of new home orders, increasing foreclosures and speculators who will now start to dump real estate back on to the market.

Everyone is starting to see again what many learned and forgot in 1990 and the stock market bubble of 2000-- buying things on credit, with a little or no money down, is a bad idea once prices start dropping. The chart below is the latest update to the Case-Shiller home price index. It shows that US home prices have now been in recession for over a year. As of February, prices across the country are now officially negative on a year over year basis.



In a recent Barron's article, Robert Shiller projected that average US home prices should fall a further 20-30% over the next 5+ years to correct for the over-valuations currently in the marketplace.

This has been a worldwide asset bubble where reckless credit has been widely at play. At the stockbrokerages, the following charts shows that margin loans are now at higher levels than at the peak of the last market bubble in 2000.

Credit contagion is spreading to other sectors of the economy. Many people will remain in denial for a while longer. In a recent US poll homeowners were asked if they believed home prices were too high nationally, the majority agreed and said they were. When asked if they thought this applied to their own property value, the majority said no that they thought their homes were fairly priced. (Not in my backyard.)

It seems that we Canadians may be suffering from the same myopia as we watch things unfold in the US. Could our home values become somewhat over-valued after the last few years as well?

Recent growth in the Canadian economy has come almost exclusively out of the boom-bust oil towns in the west. It seems the mania there has developed all of the common symptoms of over-consumption. A Canadian contributor to a March 25, 2007 US housing blog offered this snap-shot on Alberta:

> *"…up here in Alberta, the oil boom has driven housing costs through the roof five times over. However, the hidden peril is that due to the labor crunch, a lot of slipshod work in plumbing, drywall, framing and other trades has slipped through the inspections, even (especially!) in the multi-million dollar homes that I work with. I have seen construction deficiencies that would curl your hair. Already, smart shoppers are looking for pre-2002 homes, knowing that the houses that have been tossed up in the past five years are total [garbage]. Right now, buyers are agreeing to drop conditions to make the sale, including dropping the inspection. But in a couple of years it will really [stink] to have a two million dollar mortgage in Calgary and need half-a-million in repairs before you're going to be able to list it."*

Could our Canadian broker/banks also be at risk of valuation contraction as this story plays out? In a report last week Desjardin Securities warned that our Canadian banks are vulnerable and reminded us that, during the last credit contagion in 1998, conservative Canadian bank shares lost 30-40% of their value. Meanwhile during this market cycle Canadian investors have fallen as madly in love with their banks as they did with Nortel in the last.

If the downturn now proceeds in earnest, the stock market should decline accordingly over the coming months. Typically stock prices will bottom about 6 months before the economic data starts to turn up again. We will be following all of this very closely for our advantageous entry point. We will keep you updated as the story unfolds.

New Associate joins the Venable Park team

We are pleased to announce the addition of Susan Featherston this month as a new Associate Portfolio Manager with our firm. Susan comes to us after several years as a research analyst with another investment counsel firm. Her focus will be on helping us to service cottage country clients north of the Barrie area. We are very happy to have Susan on board.

BUSINESS NEWS NETWORK TELEVISION (Channel 49 on Cable)

For those that are interested, **Cory** will be the **guest Technical Analyst on *The Chart Room,* Friday May 4, at 3:40pm,** and **Danielle** will be the **guest Portfolio Manager on *The Street* at 9:20am on Tuesday April 24.** The clips can also be viewed for the week following the appearances on the ROB website at http://www.robtv.com/shows/past_archive under past video archive for the date and time in question as well as through a link on our web home page at www.venablepark.com.