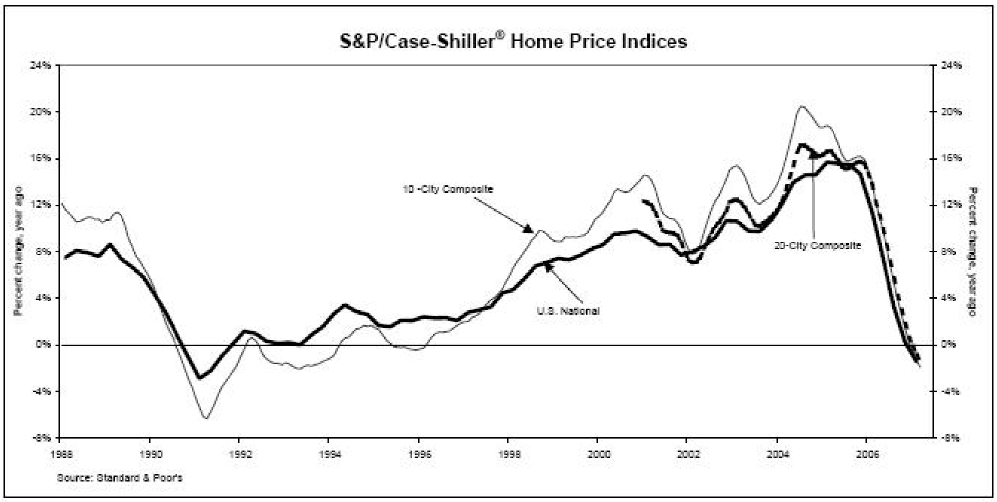
Real life needs active management MAY 31, 2007. ISSUE 5

E.Q Trendwatch™

Spring brings no signs of warming to US realty markets



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On May 29, we received the next instalment in the S&P/Case-Shiller Home price Index for the US, showing year over year declines in property values. We note that this Index comes to us with a two-month lag so we are only now seeing the data to the end of March 2007. And the picture is ugly with no bottom yet in sight. As at March the National composite is within a percent of where it bottomed in the 1990-91 recession and so far we still have no indication that the market is yet turning around. The trend in April and May is likely to look worse by the time we receive the data at the end of June and July.

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Why do we care again about what house prices are doing in America? Lets review the relationship with rising house prices and mortgage equity withdrawals (MEW) that have provided the support for the majority of GDP growth in North America (and around the world) since the last economic cycle peak in the year 2000. Recall that 80% of what Canada sells goes to US consumers.

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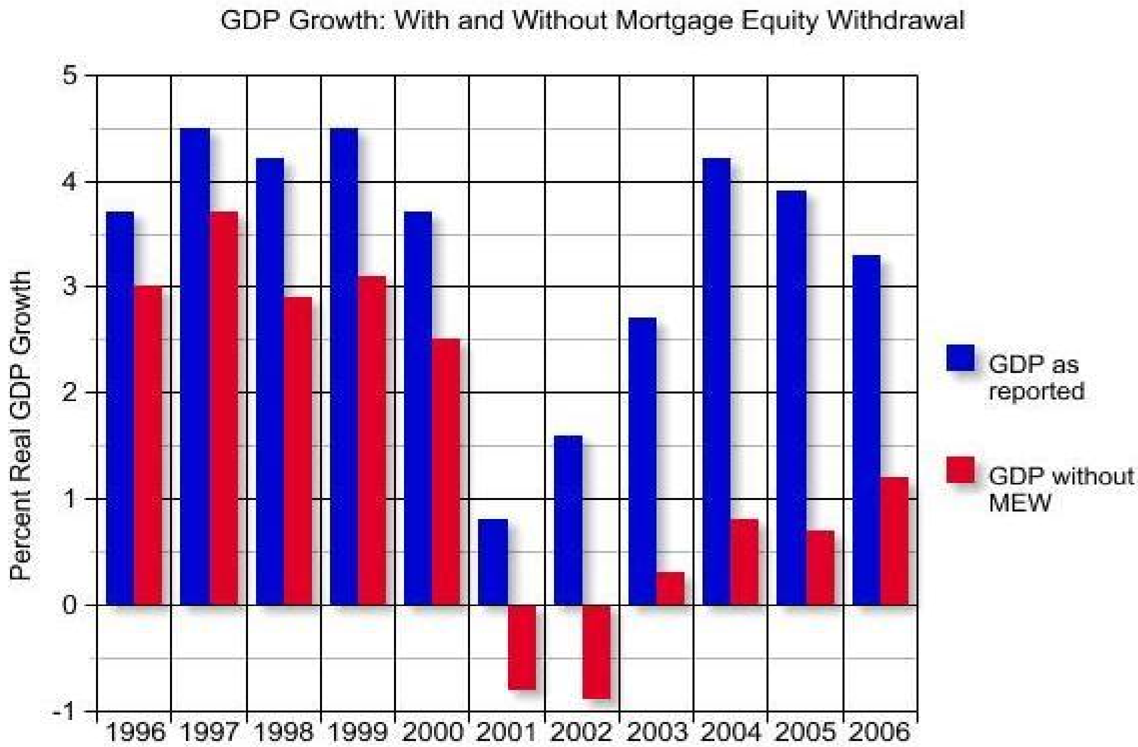

Source: Ritzholt Research

The ability to continue refinancing and withdrawing equity from real estate has been considerably diminished in 2007 by three main elements: rising interest rates, falling liquidity as over 70 US lenders have gone bankrupt and others tighten lending standards; and falling home prices that reduce the consumer's ability to borrow further against home equity. So we have to be concerned with how the economy will fair over the next few quarters.

When one objectively weighs the data for the past few years, the surprise is not really that things are slowing now, the surprise is that they have been able to go so far so long on so much borrowed money.

We have recently been reading an insightful book called "The Go-Go Years" by John Brooks which is a fascinating look (ok, you have to like this stuff for it to be fascinating) at the credit driven mania of 1962 through 1969 which in retrospect came to be dubbed the "go-go years." The correction following this period of over-exuberance was characteristically painful, as from the start of 1969 through to May 1970 stocks on the New York Stock Exchange lost over half of their value. The overhang from this period resulted in a secular bear trading range that lasted all the way up until 1982.

The good news is that during the 1966 to 1982 secular bear cycle there were many opportunities to make money in capital markets but only a very defensive timing strategy garnered positive results. Those that were perpetually invested in equities did not fare well. There have been many cycles of increased credit liquidity over the years and they have all finished in exhaustion in the end. In comparing the losses of 1969-70 to 1929, author John Brooks (writing in 1973) offers

Karl Marx's famous observation that history repeats itself the first time as a tragedy and the second time as a farce. Having been through this cycle several times now since 1970, most recently in 2000-2002, it seems that the masses are now poised to repeat hard lessons once again.

This week Ray Dalio of Bridgewater Associates that manages about 160 billion for clients that include central banks and foreign governments was interviewed in Barron's. Interestingly he too saw parallels between present times and the late 60's (our emphasis highlights added):

> ***"Our situation today is a modern-day version of the time before the Bretton Woods break-up. It is very much analogous to 1968, '69, and '70****, a period in which we had large imbalances, a fixed exchange rate, and Japan and Germany bought our bonds, and then there was a rebalancing. China today is similar to Japan then, in transition from being an emerging economy, except it is about eight times as large. The imbalances are only going to increase, and there'll need to be an adjustment for that. This will lead to depreciation in the value of the dollar relative to emerging countries' currencies, particularly those in Asia . It is going to mean the Fed's trade-off between inflation and growth is going to be more acute in the next couple of years."*
>
> ***"We haven't had negative performance or positive performance for about the last 18 months or so. We haven't made money and we haven't lost money.*** *There are always times when you are saying the world around you is doing things you think you don't want to participate in and, in fact, you want to bet against****. In fact, 1998 and '99 were very much like that for us, and we made a lot of money when the stock market broke in the 2000-2002-time period.*** *The biggest mistake in investing is almost implicit in your question. The biggest mistake in investing is believing the last three years is representative of what the next three years is going to be like. The most common mistake in the investment profession is to say, oh, it hasn't been good for me for the last 18 months and therefore I need to change what I'm doing. The real question is whether your judgment is sound or poor. "*
>
> *"Hedge funds and private-equity firms today are like the dot-coms in 2000: Ask for money and you'll get it. They bid up the prices of everything. The amount of money flowing is almost out of control, and it's making everything overvalued. A client of mine said* ***it's like there are 11,000 planes in the sky and only 100 good pilots -- an accident is bound to happen.*** *Just like the dot-com bust, the winners and losers will be sorted out but the technological advances won't stop. There is a greater differentiation of managers now than ever before. "*

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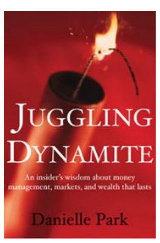

Danielle's new book is now available in Canada with release in the US scheduled for September. *Complimentary copies of the book were mailed to all our clients April 27.*

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.

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 July 13, at 3:40pm,** and **Danielle** will be the **guest Portfolio Manager on *The Street* at 9:20am on Tues June 26.** The clips can also be viewed for the week following the appearances on the BNN website at http://www.bnn.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.