REAL LIFE NEEDS ACTIVE MANAGEMENT

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Market Timing

Greenspan's "conundrum" confirms our view on interest-sensitives

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This past March, the head US central banker Mr. Greenspan, again illustrated the power of his spoken word by using the term "conundrum" during his testimony before the Senate Banking committee. Greenspan was referring to the low yields on the US 10 year Treasury, caused by overly exuberant buying pressure on the 10 year issues which has driven prices up and yields down to 40 year lows. This subtle language during his testimony was akin to a 2x4 over the head of bond traders who had been unwilling to acknowledge the increased risks of their long bond positions (ie. as inflation picks up, bond prices should decline).

To the average investor the word conundrum may seem harmless enough, but when we look at what has happened to income investments since the word was uttered, harmless does not apply. Investor's interest sensitive assets such as long maturity bonds and income trusts have been hit with double digit declines in a matter of weeks (bad for them, good for those of us who are no longer holding them)

As an example: Riocan, currently 24.89% of the iUnits capped Reit Index Fund, is one of the largest income trusts in the Canadian market. In just the last 7 weeks, the combination of the rising yield on the ten-year US treasury and Greenspan's conundrum comment have eroded all of the gains made in Riocan's unit price since February 2004. For some time now, our work has suggested that the income trust area and long bonds are extremely over-priced and due for a pullback. It appears that this pullback is now underway.

On the behaviour side, the concern for the extremely high prices of income-oriented assets is really just recognition of what occurs to the price of an asset when investors begin to leave with increasing haste (recall Nortel). One of the evident dynamics of high price levels is a tendency for greater downside price velocity usually to the underside of fundamental value. , ie. prices tend to fall much faster than they rise. The once rational and deliberate investor becomes irrational, using emotionally based motives like fear of loss. The resulting declines can be shocking, especially in the fixed income category, which people often think of as their "safer" money. Each decline in this sector brings us one step closer to our patiently awaited buying opportunity.

Since our own analysis took us out of the broad stock market indices in February 2005, we welcome market declines while in the safety of Tbills and short bonds and are hopeful that an ensuing decline may get prices down to a point where we can be excited about buying some good value. Double digit declines from current market levels are certainly not out of the question. Declines have been quickening in recent weeks, with the S&P 500 and the NASDAQ now showing negative returns in the first quarter of 2005, the TSE and the International Index about flat. How long the market will decline is of course an unknown. Several of the world's best Market Analysts are suggesting more volatility with the bias toward lower prices. Mr. Buffett continues to say he cannot find anything of value to buy at current prices.

We are currently investigating some new US Bear market ETF's, that are structured to profit from declining markets, more on this to follow as we complete our research.

Oil will be the wild card in market strategist calls on stock price levels from here, as oil is the input cost with the greatest volatility of late. But oil can be a double-edged sword, lower prices serve to fuel consumption and inflation fears whose containment may need more than "measured pace" rate hikes from the Federal Reserve. This would be negative for both stock and bond prices, which will again present some opportunities for us. If oil increases from here, its drag on the economy will be an ongoing tax, leading to lower earnings and likely cheaper stock prices. Often sustained high oil prices have historically been one of the catalysts to economic downturn, which again may present some excellent buying opportunities at lower prices.

Looking back over the past three years, we now see that the Dow 30 index which holds several of the world's largest oil and resource companies is back at the level it had reached in December 2003. Most of the gains experienced in the broad market averages occurred during the fall and winter of 2002 and the entire year of 2003. Since then they have been literally marking time caught in a tight trading range. It appears likely that this range will soon break one way or the other and investors must be ready for it, either to stay on the sidelines until prices move lower, or to get back on board should the range finally make some serious upward headway in a breakout.

Avoiding the need to take on the risk of individual company investments, ETF's afford us cost effective exposure to specific bond categories both government and corporate, Canada and the US; as well as equity units targeting broad market indices, individual sectors and countries around the world.

There is a complete list of our equity and fixed income universe on our web site for anyone interested in seeing it. We regularly update this list as new exchange traded units become available or begin trading with sufficient liquidity for us to utilize them in our system.

No Housing Bubble??

There continues to be a lot of speculation as to whether realty markets have been experiencing a financial bubble that is increasingly at risk. It is of course a characteristic of bubbles that no one can confirm that they exist until after they have burst. However, several commentators have been increasingly vocal of late regarding what they see as a financial disaster waiting to happen. In his recent newsletter on MSN Money, "The Fed sees Bubbles—and keeps them secret (March 14, 2005), Bill Fleckenstein criticizes the US Federal Reserve for not taking on the role of warning consumers. This has been a complaint that we and others have shared through time. John Kenneth Galbraith sites this criticism in his various works including "The Great Crash" and "A short History of Financial Euphoria" wherein he comments that there should be some responsibility on the part of the very influential government policy makers to be more vocal in warning consumers of dangerous behaviours they may be engaging in. Governments certainly do this in other areas of its citizens' health and welfare. Unfortunately the fact of the matter is, there is a great deal of lobby pressure from banks and business leaders to restrain the Federal bank leaders from being too cautionary and throwing a wet blanket on a financial party, especially since borrowing to invest (the bankers' mainstay) plays a huge role in fuelling a financial bubble. Thus laisser-faire prevails.

So it is not surprising perhaps that Greenspan argued as recently as October 2004 before the America's Community Bankers Annual Convention that for a variety of reasons, real estate cannot experience a bubble. This will no doubt seem a bizarre comment to anyone who remembers first hand previous real estate bubbles and the damage they inflicted to the economy as a whole.

History reminds anyone who will heed it that the interest rates of the past 5 years have been artificially and intentionally low. This artificial condition was brought on by governments all around the world in order to stimulate the economy out of the slow down which flowed from the stock markets' crash of 2000, the negative effects of the 9/11 attacks and the US led war thereafter. Consumers have been lulled into an artificial sense of security in borrowing higher and higher levels of debt, simply because record low rates have allowed them to make the relatively modest interest payments. Variable rate debt puts the borrower at the highest risk of solvency problems in a rising rate environment, and yet consumers all over the world have been taking it on with great fervour over the past few years. Here are some of the US stats, which are similar to the habits of many Canadians and Europeans as well:

- Variable rate loans increased to 27% of the $6.64 trillion single-family mortgage obligations by the first quarter of 2004, this trend has been continuing to increase over the past year.
- Borrowing on variable home equity lines of credit has increased by more than 20% annually for the past three years and now totals $359 billion.
- The amount owed on credit cards (mostly adjustable) has nearly doubled since 1995 to $739 billion. This is the case notwithstanding the fact that consumers have repeatedly refinanced their homes in the past few years to pay off credit cards. Spending habits have ensured that the debts just keep growing back.
- Adjustables tend to be far more popular among borrowers getting jumbo loans (330K+ for 2004), with 52% of jumbo borrowers opting for adjustables in 2002 versus 14% of lower loan borrowers. This means higher end properties are at a higher default risk as rates increase.
- Some lenders are offering “monthly adjustable” mortgages with introductory rates as low as 1.25%. The second-month rate could increase as much as 3% and continue to rise monthly after that.

Source: Freddie MacWeekly Mortgage Market Survey

> “The kind of maniacal behaviour that we saw then [in early 2000] and which we are now seeing in real estate tends to come at the end of a speculative mania. It is almost always coincident with rising supply, which helps to satiate the inflated demand. As I have pointed out, the true danger in the real estate bubble is that folks are often speculating with more than 100% leverage [borrowed funds]. When it all ends (and though we don’t have a timeline for exactly when that will be), the banking system and other financial entities will be left with bad assets, which will severely impact the economy…Today’s housing bubble is a consequence of policies designed to ameliorate the effects of the bursting of the stock market bubble.”
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> *(Fleckenstein,” The Fed Sees Bubbles—and keeps them secret”, MSN Money, March 14, 2005)*

“The Federal Reserve and the federal government are pulling out all the stops to regenerate growth in the economy,” Northern Trust economist Kasriel said. “If that growth comes, rates are likely to keep drifting higher.” Even if economic growth begins to stall from here, thanks to high-energy costs and other negatives, massive trade and budget deficits could cause foreign investors to demand higher interest rates to risk investing in US dollars. The rest of the world is advancing us [the US] $1.5 billion a day so we can party with it: buy bigger houses, buy bigger cars, buy cruise missiles,” Kasriel says. “At some point they may start to wonder how we’re going to pay them back.” The result will be a demand for higher rates of interest in order to compensate them for the increased credit risk of an over-extended country.

<u>RISK MANAGEMENT STRATEGIES</u>

So we should be approaching new real estate purchases at this point with some caution. We should perhaps consider fixed rate mortgages if we have benefited from floating rates in the past. We should also realize that when the stock market crashed in early 2000, it crashed all over the world. And when interest rates were slashed to stimulate economic recovery after the crash, they were slashed all over the world, not just in North American. The boom in real estate values has been a phenomenon all over the developed globe. Even in developing countries, foreign investors have been able to bid up real estate values as they bring investment dollars abroad courtesy of low rates and higher property values to lever back home. In a lot of vacation destinations and islands, visitors have only been able to buy and build vacation homes, by borrowing against their over-valued properties at home. If a rate crunch comes in North America and Europe, many may be forced to divest themselves of real estate all over in order to lower their leverage. As in any market, more sellers than buyers will lead to lower prices.

As with any asset, if recent experience has been one of extraordinary gains in value, more than double digit over the past few years, we should approach this trend with great caution, and realize that reversion to the mean will require values to decline in order to restore long term rates of reasonable growth. (recall the tech bubble of the late '90's)

US Housing Market Stats *(source: National Assoc. of Realtors survey)*

- Average US home prices measured from Q4 of 2003 to Q4 of 2004 rose a robust 11.2%, the biggest annual gain since 1979.
- Nearly half –48% of the metropolitan areas surveyed showed a double-digit rise in home prices, only 4 posted modest declines.
- The top highest areas of year over year increase were: West Palm Beach, FLA, a jump of 34%; Riverside-San Bernardino, California, up 34.7%; Reno, Nevada, up 39%; Las Vegas, up 34%; San Diego, California, up 30% and Sarasota, FLA, up 27%. (In one year!!)

Canadian Housing Market Stats *(source: Bank of Canada)*

- Cdn home (new and resale) prices averaged a less than 1% per year over year increase from Q1 1993 through Q1 1999.
- From the stock market crash of 2000 to Q1 2005, slashed interest rates prompted the annual home increase to average 4.67% year over year.
- Over the past 3 years to Jan 2005, average Cdn home resale prices averaged an increase of 6.96% year over year.
- In 2004, Winnipeg (+9.5%) posted the largest 1-year increase in new home prices, followed by St. Catherines—Niagara (+9.3%), St. John's (+7.6%), Ottawa-Gatineau (+7.1%). Saskatoon (+6.9%) and Victoria (+6.9%).

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