CANACCORD Genuity
Wealth Management

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The Dow over the Long Run
Banks Tighten Lending

Although the bear market of 2000 to 2002 felt very painful to many investors it pales in comparison to markets in the period from 1965 to 1982.

As the chart illustrates, the Dow Jones Industrial lost roughly 75% of its value between '65 and '82. Conversely, after adjusting for inflation, the market increased almost 10 fold from 1982 to 1999. The trend lines have thus appreciated close to 2% per annum real return.

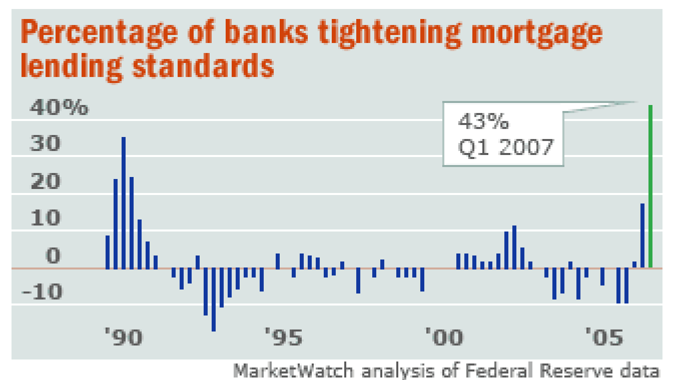
Recently the media celebrated a new high for the Dow Jones Industrial average. One must realize, however, that just getting your money back eight years later is not keeping pace with inflation. The index remains 15% below that of 1999 after the inflation-adjustment.

The two characteristics of markets at the top of the trading band are high valuations and broad participation of the investing public. Conversely, when markets are at the bottom of the trading band, stocks are historically cheap and the investing public tends to have thrown in the towel as far as stock market investments.

In my most recent letter I asked whether the yield curve indicator was still valid. I argued that short-term interest rates being higher than longer-term interest rates would eat into bank profits and curtail bank lending.

By March of this year, however, the US banking industry had changed. Banks pool mortgages and resell them in the form of Mortgage Backed Securities. Investors buying these pools have a high degree of confidence in the cash flows as there may be thousands of mortgages per pool, so only a small number of delinquencies is expected. Furthermore, banks could pool the riskiest pools, known as sub-prime mortgages, and could get high credit-ratings based on the diversification of the mortgages. The February statistics revealed that more than 13.5% of US sub-prime mortgages were delinquent on their monthly payments; and the price of sub-prime pools plunged in the aftermarket. For example, a Washington Mutual pool recently changed hands at 66 cents on the dollar. In other words, for banks to issue sub-prime debt, the yield on these instruments would now have to be in excess of 19%. Needless to say, almost all banks have stopped lending to this riskier category of borrowers. There are at present 74 US mortgage lenders who have shut their doors and gone bankrupt. Though 40% of mortgages issued last year required little or no income verification, that is changing quickly. Last year mortgage originations and lines of credit totaled 1 trillion dollars. A report by Fred Hickey's The High-Tech Strategest, suggests that the recent collapse in sub-prime mortgages will cause a loss in spending power of more than half a trillion dollars in mortgage cash-out money.

US consumer spending has not fallen since 1991. Consumer spending has in recent times been fuelled by cheap and easy money; but that too has changed. Though the US consumer has been the primary driver of world economic growth, ("accounting for almost 20% of the global economy", according to David Rosenburg, chief economist at Merrill Lynch), if the US consumer spending slows significantly the global economy is in trouble.



2

Chart 2 shows the percentage of banks that are tightening their lending standards. The primary driver of the economic expansion since 2001, consumer spending, has been driven by loose lending standards and a consequence explosion in consumer debt. The more that house prices rose, the more people felt that they could tap into the "equity" in their homes.

I have argued that in past cycles, the yield curve inversion (short term interest rates above long term rates) would cut into the profit of lending, and thereby reduce loans and slow economic activity. So is this time any different? The only differences are that household indebtedness is at an all time record high and housing is coming down from the biggest bubble in history. Since 71% of the US economy is driven by consumer spending, now that US house prices continue to decline and banks intend to tighten lending, I cannot see a positive outcome.

US GDP has already slowed from 4.8% to just 0.6% in the first quarter of 2007. If lending standards are further tightened next quarter, this number could drop to close to 0%. Further evidence of weak economic activity recently came from UPS, which blamed “sluggish” US economic activity for its drop in earnings. Wal-Mart has been struggling for months, citing a “tough sales environment”. Even Target, which has been stealing market share from Wal-Mart said, “We now expect comparable store sales for the full month to be much weaker than our initial plan.” Home Depot reported that some store sales had fallen 6.6% year over year. Auto sales have also slowed – GM reporting “mortgaged industry meltdown for weak sales”; Ford stating “this month is terrible”; and Nissan saying “the consumer seems to be frozen”.

For now, North American stock markets continue to power to new highs. Given the weakness in the economy one would think that a risk premium would begin to filter back into the markets. The probability of recession is certainly not zero. In the nine recessions since 1950, markets lost between 30 to 50% of their value. The stock markets seem to be celebrating bad economic news, perhaps in the hope that interest rates will be lowered and the consumer will therefore go on another borrowing spree. Unfortunately, since the role of the central banks is primarily to protect against inflation, and since inflation has been accelerating recently, I doubt any rate cuts are imminent. In fact, in Canada a rate rise could be in the cards. Recent inflation data showed the 12 month inflation rate at 2.3%, just slightly above the 2% target rate. However, this is skewed by last year’s data: annualizing the inflation rate from Jan 1 to the end of April shows inflation running at 5.6%.

The bulls argue that there is just too much money chasing stocks and too much momentum in the market for there to be any meaningful decline. And, indeed, the Dow just recently finished a run where stocks rose in 19 out of 21 days. The last time that occurred, however, was July 1929 – not a particularly good correspondence for stocks. Another 19 of 21 up day run occurred in Japan in December, 1989, which corresponded to the market’s peak, after which there occurred an 82% decline.

RECENT INVESTMENT IDEAS

I continue to avoid fixed rate government bonds, as higher long term interest rates could provide a negative yearly return. The Quebec Real Return bonds maturing in 2013 look attractive, with a 2% real yield. I have also recently suggested taking advantage of the decline in some corporate bonds by purchasing Telus 10 year bonds, yielding approximately 6% and Bell Canada 9 year bonds yielding 6.3%.

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On the stock side, I continue to focus on avoiding exposure to the US consumer. I am currently accumulating Thompson Corp and Kingsway Financial.

Sincerely,

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