CANACCORD Genuity
Wealth Management

LEPOIDEVIN
GROUP

November 2007

Managing Expectations, The Credit Crunch Worsens, A Tale of Two Yield-Curves

Up 200 points, down 200 points: the global stock markets have been tremendously volatile; and I get the sense that the vast majority of investors remain frustrated with their investment returns year-to-date. Just recently, for example, the stock markets achieved all-time-high levels only to fall back again. So what might be considered a decent return this year?

Looking at the major stock market indices (to Nov 12) reveal that Toronto Stock Exchange (TSE) comes out on top with a gain of 696 points or 5.4%. I would suggest that the TSE is not in fact a good benchmark as the index is 75% weighted to just the three sectors of financial companies, oil and gas, and materials (gold and other commodities). Concentrating on just three sectors is not prudent portfolio diversification and could cause large losses if one of these sectors were to experience a steep decline.

The US stock market as measured by the Dow Jones Industrial Average is up 4.2% year-to-date; but to a Canadian Investor, with the Canadian Dollar up 20.7%, that means a loss of 16.5%. Moreover, the Value Line Index, which measures all US traded stocks, is down 23.4% in Canadian Dollars.

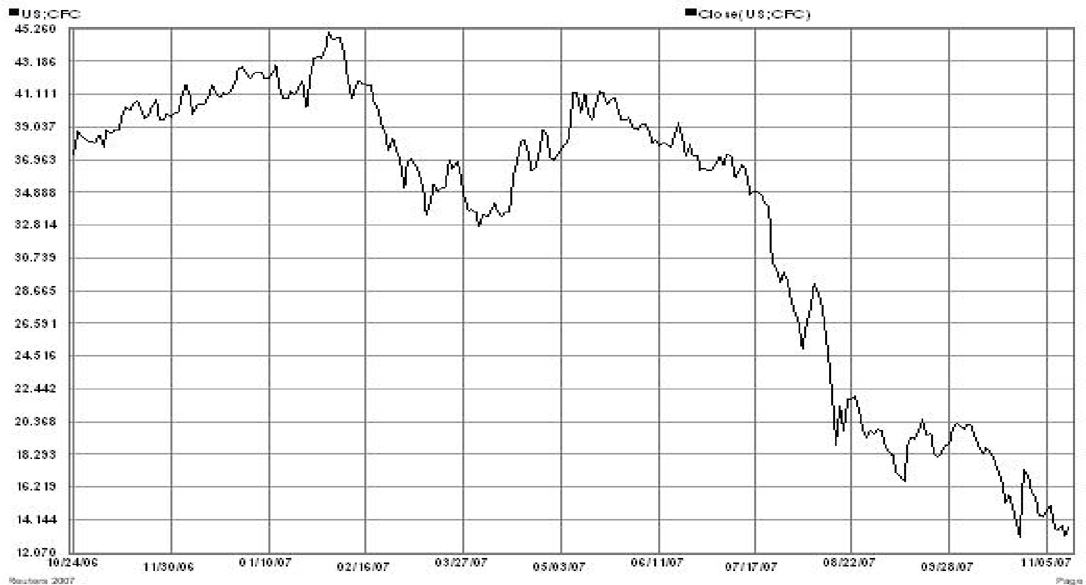
So where are the returns? Perhaps in Europe? European stocks as measured by the Dow Jones Europe Index are down 14.0% in Canadian Dollars this year. Japan? Down 26.1%.

Are people making money in bonds? The benchmark long-term Government of Canada bond is down 3.1% so far this year, bringing the total return with interest to 0.6%. Wait… Gold. That must be it. Actually, gold has risen from $741 to $773 in Canadian Dollars so far this year for a 4.3% gain.

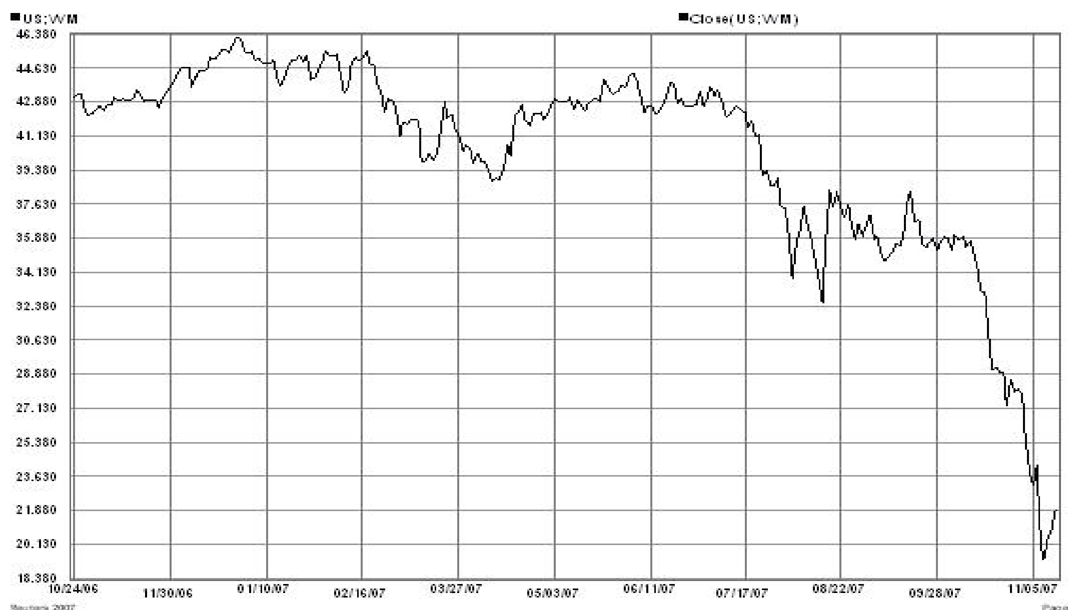
If you are up this year you are doing well. Anytime you can maintain your wealth and have your currency gain 15% to 20% against most major currencies, your international wealth has increased by a tremendous amount.

Investors who are up this year likely listened to previous warnings of the LePoidevin Letter regarding the yield-curve and avoided the financial sector. Large losses in US mortgage lending, of course, have produced steep declines in US banks.

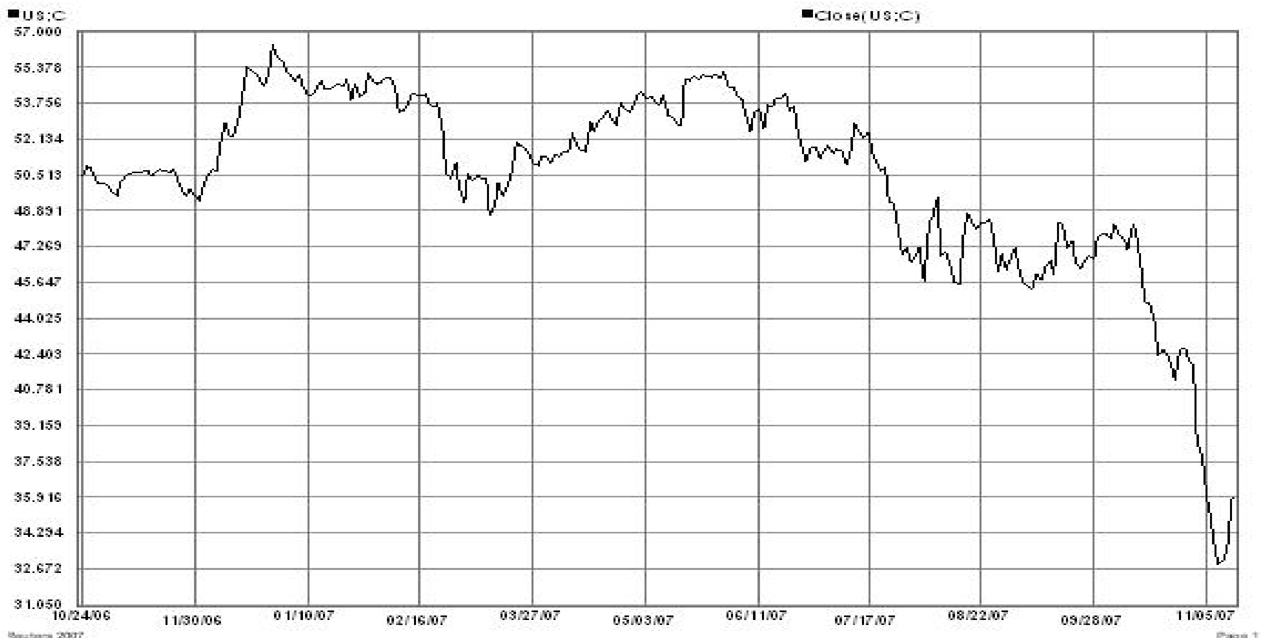
1. Countrywide Financial – The largest mortgage lender in the US. Year-to-date – 69%.



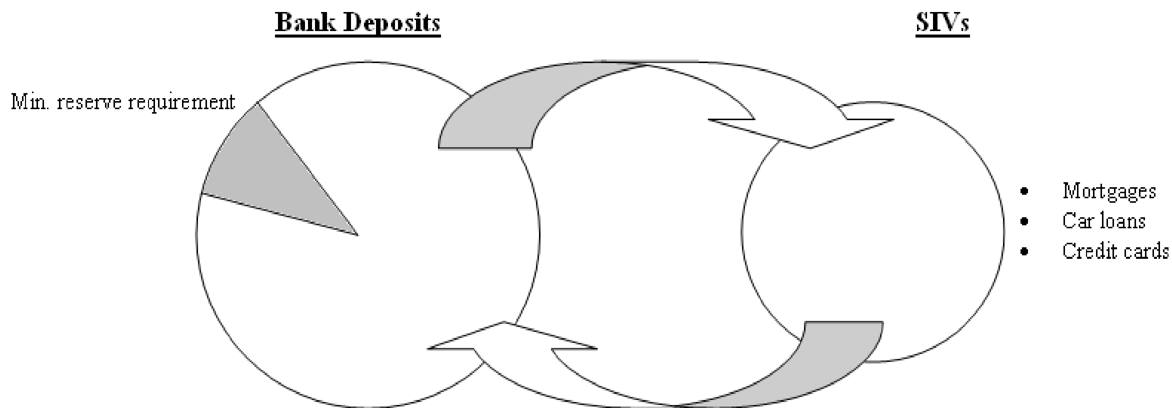
2. Washington Mutual – Largest savings and loan in the US. YTD – 54%.



3. Citibank – Largest bank in the US. YTD – 39%



Citibank recently forecasts roughly an $11 billion loss on lending losses related to Asset-Backed Commercial Paper (ABCP) or Structured Investment Vehicles (SIVs). The following chart illustrates the problem:



Banks loan out most of the deposits they hold. However, each bank is required to retain some deposits which they cannot loan out. These are referred to as the minimum reserve requirement. In the past few years, demand for loans has been so strong that banks were able to exceed their limits by selling pools of loans as commercial paper. Since August, 2007, in fact, when investors first really started to question sub-prime loans, banks have pulled $300 billion out of the Structured Investment Vehicle market, and have been forced

to acknowledge that these pools are in fact not worth full value. What is even more detrimental to the economy, the loans have to be brought back on to the books of the banks. This has lowered the banks' minimum reserve requirements, and forced them to sharply curtail lending. This means more bad news for housing; which, in turn, means more bad loans for banks. It is a downward spiral which has certainly not yet played itself out. Has Citibank bottomed, and does that reflect all the bad news? Maybe. But certainly it is one more bit of evidence for what I believe to be the next U.S. recession.

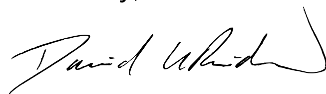
With Canada's largest bank down just 10% year-to-date, I would continue to avoid this sector. There is over $100 billion of Asset-Backed Commercial Paper in Canada, with very little of it having been written off. Moreover, as the Asset-Backed Commercial Paper market sinks, Canadian banks will be forced to bring loans back on their books, and hence to curtail their lending as well.

In past letters, I have often mentioned the only true predictor of the economic cycle - the yield-curve (a chart showing the difference between short- and long-term interest rates). An inverted yield-curve predicted the recessions of 1981, 1991 and 2001- and has predicted a coming recession for some time. I have suggested that the inverted yield-curve is important for two reasons. Firstly, an inversion inhibits bank lending (which is happening now); and secondly, an inversion promotes a flight to holding cash amongst investors, as they are rewarded with higher rates in the short term. With the recent collapse of Asset-Backed Commercial Paper and subsequent losses at banks, the cost of borrowing for these banks has increased. So the yield-curve is still inverted, and suggests further contraction in lending.

An interesting development has emerged in which investors have been pouring money into short-term US Treasury bonds, and pushing yields down to just 3.5%, thereby producing a positive sloped curve on the investment front. So there is little incentive to sell your blue-chip stock and exchange it for a 3.5% return. The stock market is, of course, a market of stocks. U.S. economic weakness has produced losses in consumer discretionary stocks and in financials, but other areas have held up well.

In my past letters, I have mentioned five stocks. Four are now higher, despite stock market weakness. If a company trades at less than 20 times earnings, has international sales, and can pass the "acid test" of how it would fare in a US recession, the recent stock market weakness should be viewed as an opportunity to purchase shares in it. I have previously suggested Johnson & Johnson, Merck, Coca Cola, Anheuser-Busch, and Thomson Corp. I am now adding Smithfield Foods, a major producer of beef and pork. The company is a key exporter, trades at a reasonable valuation, and has recently been under significant insider buying.

Sincerely,



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