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Wealth Management

LEPOIDEVIN GROUP

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LePoidevin Letter

History in the Making

The events of the past two weeks have been the equivalent of a run on the banks. While the U.S. didn't experience mass withdrawals at local branches, as they did in the 1930s, the capital markets were literally seizing up as never before.

First, the government sponsored entities Fannie Mae and Freddie Mac were taken over by the U.S. government. These giant institutions had been created to expand home ownership in the U.S. As delinquencies on mortgages surged, profits turned to losses; and now the U.S. government is on the hook for $5 trillion of mortgages. The stock markets celebrated the move, even though the likely cost to the taxpayer is at least $200 billion.

Just a few days later, employees at the century-old Lehman Brothers learned that the highly leveraged company, having bet heavily on mortgages and commercial real estate, had filed for bankruptcy. This time, there is no government bail-out.

No bail-out? Shares in financial companies went into free fall. More importantly, access to capital at many of the U.S.'s largest institutions simply dried up. Credit won't be extended, even at 10% or 20%.

Merrill Lynch, a firm founded 158 years ago, was forced to sell itself to the Bank of America. AIG, the world's largest insurance company, which many of the world's largest banks had exposures to, including many Canadian banks and life insurance companies, was also facing insolvency. So once again, the U.S. government provided $85 billion to buy the firm.

Still, the capital markets were frozen. Banks were not lending to one another; and many large institutions would not place money at any bank, no matter what its rating. The demand for government guaranteed Treasury Bills was so high that the yield went negative; i.e., when the Treasury Bill matured in 30 days, you would get less money than you put in—a situation not seen since 1932.

With the threat of two more failures by Morgan Stanley & Goldman Sachs, details of a massive U.S. bailout started to emerge on Thursday, September 18th. The U.S. would create a superfund of $700 billion to buy up depressed assets from U.S. financial institutions. Furthermore, the U.S., Europe and Canada would ban short-selling of financial firms. It's true, stocks were forced higher after the news, but let's be clear: companies like Lehman Brothers went broke not because of short-sellers, but because of bad bets in the mortgage market that were leveraged by up to sixty to one.

The total so far…$700 billion superfund, $200 billion Fannie and Freddie, $85 billion AIG and the $29 billion to guarantee Bear Stearns several months ago…one trillion and counting. With the U.S. credit markets frozen, something needed to be done. Unfortunately, this bailout will do little to turn around the massive oversupply of houses for sale. Consumer spending had been running at or above 100% of GDP for the previous four years. Consumer spending accounts for 70 % of the U.S. economy, and such free-wheeling high spending has been fostered by easy credit, driven in turn by rising real estate prices.

Sparing the investment firms and large banks from imminent collapse will do little to turn around the economy, as banks will likely continue to be defensive for an extended period of time. The U.S. government will likely call the new debt an off-balance-sheet item, and it will not be reported in the 2009 official deficit. However, all of these bail-outs need to be paid for. Therefore, the U.S. will be issuing well over $1 trillion in new bonds over the next year.

This is an experiment with a very uncertain outcome. The U.S. debt is being financed almost entirely by foreign investors. Whether they have an appetite for another $1 trillion is yet to be seen. If the bonds cannot be sold, the interest rate paid to finance the debt may have to move higher to attract new buyers, which would further damage the housing market. Currencies will likely move violently no matter who wins the U.S. election. And taxes will most certainly have to be raised, which will put a further damper on spending and housing.

I do not believe that there is an easy solution to the unwinding of the largest debt bubble in history. Consumers simply stopped saving; many of them viewed their house price appreciation as their retirement growth plan. In future, consumer spending will likely decrease from 100% of U.S. incomes to its long-term average of about 92%, or an 8% savings rate. Average house sizes have been growing steadily for two decades. I believe that the new trends will be to smaller houses, to driving smaller cars, and generally to living more frugally. While the U.S. housing market was the first to implode, the entire Western World has similarly been experiencing elevated levels of consumer spending driven by easy credit and soaring house prices.

I have seen quite a few articles recently proclaiming that there is no real estate bubble in Canada, and therefore Canadians need not worry. Looking at the hard data, however, suggests otherwise.

At the peak of the U.S. housing bubble, the median house price peaked in the spring of 2007 at just short of $260,000 U.S. Whereas, at the peak of the Canadian real estate cycle, prices peaked in the spring of 2008 at $338,000 CDN; or in fact 30% higher than the earlier U.S. peak. Moreover, Canadians are less able to afford such high house prices, as Canadian incomes average 22% lower than U.S. incomes.

I often hear how conservative Canadian banks are, and have been, in their lending practices. Conservative? Until recently, the most common mortgage had been a 40-year amortization with little or no money down.

A recent true story of a former National Bank Financial employee illustrates what I think will be a common Canadian tale. The employee, I will call him Steve, bought 2 houses in Calgary for speculative purposes. The down-payments were $30,000 for each $620,000 new house. Steve borrowed some and used some savings. When he put both houses on the market, one sold for a nice $10,000 profit. Not bad for an investment of $30,000. The second property, however, never sold, so it was rented out. But the renter soon skipped town and Steve now has to cover the $3600 monthly mortgage. Trouble is, Steve only made $3000 per month before taxes. A Calgary realtor has told Steve that he would be lucky to get $550,000 today. So after agent fees, Steve is down $100,000. And since he doesn't have that kind of money, the bank is going to lose on this one.

I asked Steve how in the world he got a nearly $600,000 mortgage? He told me, "Simple, I lied about my income". That was last year. Canadian lending institutions were incredibly lax in their lending standards; but now that they have witnessed the U.S. fallout, standards are tightening dramatically. The more real-estate prices weaken, the tighter lending standards will get.

Few saw the U.S. housing bubble developing, despite several clear signs. Even when the sub-prime market began to collapse, few thought it would spread to middle-class neighbourhoods.

The following chart shows house prices in the major centers in Canada.

*SFD Prices	VANC	CALG	EDMO	TORO	OTTA	MONT
Prices at Peak	$771,321	$505,920	$426,028	$398,687	$298,336	$242,000
Prices Now (AUG'08)	$737,985	$440,625	$369,190	$364,886	$280,806	$231,000
Months since Peak	4	13	15	4	2	9
$ Plunge from Peak	-$33,336	-$65,295	-$56,838	-$33,801	-$17,530	-$11,000
$ Plunge Annualized	-$100,008	-$60,272	-$45,470	-$101,403	-$105,180	-$14,667
% Plunge from Peak	-4.5%	-14.8%	-15.4%	-9.3%	-6.2%	-4.8%
% Plunge Annualized[1]	-13.6%	-13.7%	-12.3%	-27.8%	-37.5%	-6.3%

The lesson of the U.S. experience is – as the housing market goes, so go the lending institutions. If I am correct that Canadian real-estate prices will follow U.S. ones, but 20 to 40% lower, then Canadian bank shares would likely drop in value, just as the large U.S. banks have done in the past 12 months.

[1] Ripley, Brian. "Canada Real Estate Equity Losses Increase". Canadian Real Estate Price Charts. 9 September,2008. (www.Canadian-housing-price-charts.235.ca)

Investors who recognize the Canadian housing bubble before it deflates can go a long way to protect their portfolios.

Personally, I have elected to sell short Canada's largest sub-prime lender, believing they will have trouble surviving in a deflating housing market. I have also bought puts on some Canadian banks. Let me be clear: this is speculation on my part, and I would only recommend it to investors who have a clear understanding of the risks. Investors who believe that Canadian banks will decline could also purchase an ultra-short position, which would rise in price if financials should fall, but would fall in value if financials rose.

I think the next 12 to 24 months will be extremely dangerous for investors; but they will also create opportunities. Diversification is paramount at this point. Being 100% in cash risks losing purchasing power. On the other hand, the stock market averages have been heading lower on a global basis. Throughout the crisis, stocks such as Coca-Cola, McDonald's, Johnson & Johnson and Wal-Mart have not only held up well, they actually increased in value. Many preferred shares also offer very good value. Real Return Inflation-indexed bonds may be a good fall-back in times of uncertainty, although I favour shorter maturities. The price of TIP's (U.S. version of real return bonds) is starting to look very attractive.

Are the back-to-back 300 point advances in the Dow Jones Industrial Average on September 18th and 19th a sign that the stock markets have bottomed? Consider that in the bull market of October 2002 to October 2007, there were no 300 point advances in any one day, yet that happened 12 times in the market decline of 2000 to 2002. This was the 7th and 8th 300 point-plus advance in the current bear market decline.

Sincerely,

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