

August 2007



Credit Crunch

“As I try to walk through what happened there – and could a lot of this have been foreseen... nobody saw this coming.”

Anthony Mizilo, CEO Countrywide Financial

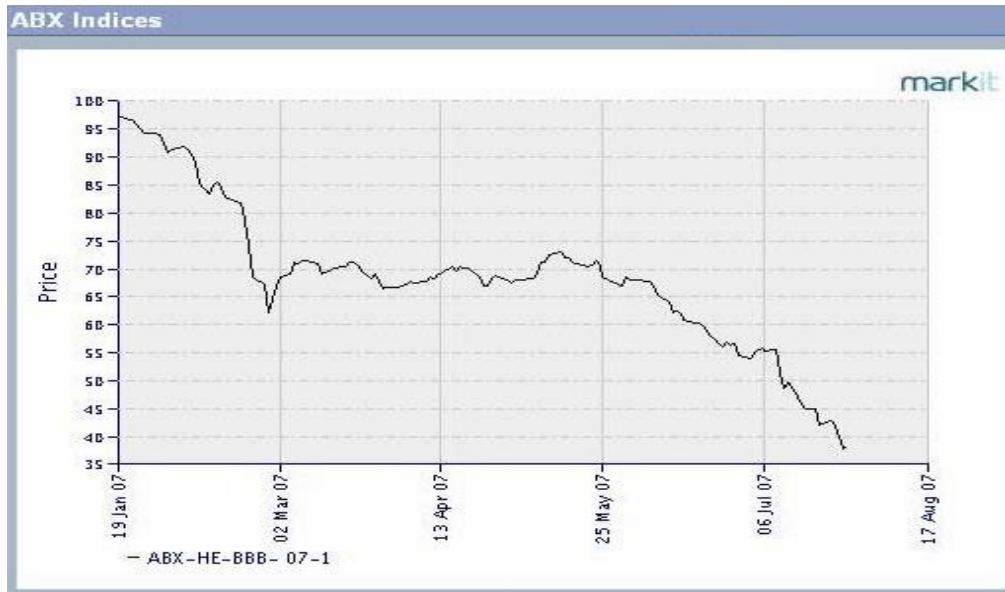
The preceding quote is from a conference call following the announcement that America’s largest home-loan lender saw profits fall by a third because of growing delinquencies - not only from risky subprime borrowers, but also from some credit-worthy borrowers.

Too bad Mr. Mizilo did not subscribe to The LePoidevin Letter. In past letters, I have warned that inverted yield-curves had preceded every recession for more than 100 years and that yield-curve inversions tended to lead economic downturns by 6 to 9 months.

Profit margins at banks are greatest when long-term interest rates exceed short-term interest rates (a normal yield-curve). As the US yield-curve flattened and US short-term interest rates rose, profit margins per each dollar of loans began to fall. But rather than curtail lending, Mr. Mizilo and his competitors at other lending institutions wanted to maintain their bonuses; and so decided that the only way to meet Wall Street’s growth expectations was by pushing even more loans out the door. No down payment, negative-amortization and no verification of income became common practices. About 50% of all mortgage originations in 2005-2006 had such lax policies.

Most mortgages get pooled together into something called Mortgage-Backed Security. Each pool typically contains thousands of individual mortgages; so a normal delinquency rate of 1 or 2 percent would have a minimal effect on the pool as a whole. Furthermore, when real-estate prices were rising, any foreclosed houses could be sold for more than their mortgage value, meaning no loss to the mortgage pool.

Below is a chart of the price of BBB credit-rated mortgage-backed securities, which hold primarily subprime mortgages, but whose pools were nonetheless considered “investment grade” by the rating agencies. The chart illustrates that the BBB mortgages are now trading at 38 cents on the dollar.



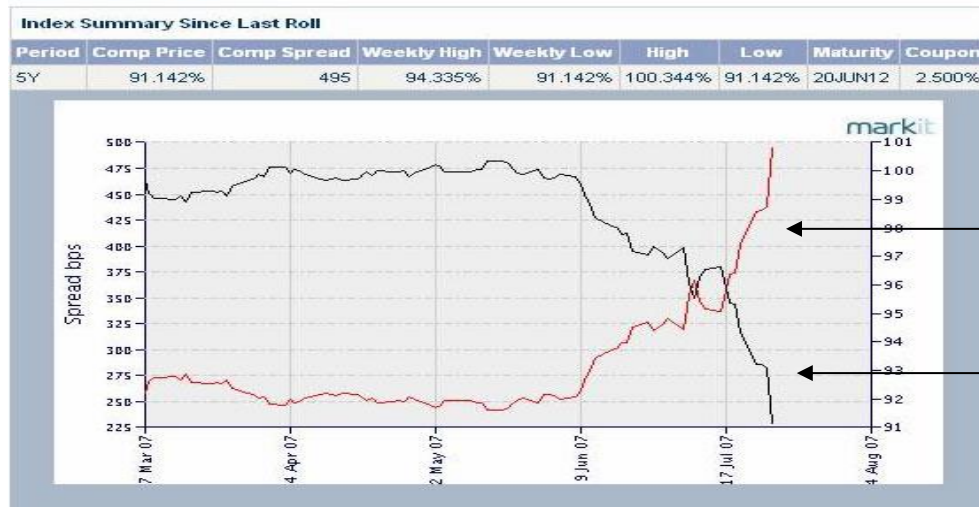
1

Now that the 2005-2006 pools are trading at such a deep discount, how can any new pools be issued? The answer is that they can't. Banks either have to curtail lending or take all the risk involved in issuing a mortgage upon themselves. As a result, the US has gone from no income-verification to requiring very stringent proof of financial assets and income. Wachovia Securities just announced a rate increase from 6.625% to 8% on their long-term mortgage rates to compensate for extra risk.

The consensus view among leading economists, and the US Federal Reserve Board, has been that these problems were isolated and would not spread from the subprime market to other credit markets. The consensus is wrong.

The next chart shows the price averages of US junk-bond issues, and the yield-differential between these junk-bonds and US government bonds. As recently as early June, the yield-differential stood at 250 basis points (a basis point is 1/100 of one percent) though it now stands at 500 basis points.

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One ramification of this widening of credit-spreads is that leveraged buyouts tend to use the high-yield or junk-bond market to finance these deals. As a result, as many as 40 bond offerings have been cancelled in the past 4 weeks, including the Chrysler bonds which Cerberus Capital had intended on using to finance its purchase of Chrysler.

What we all want to know, of course, is whether the worst is over. The Federal Funds rate (US overnight rate) to 10-year bond-yield is still inverted by 75 basis points. Furthermore, one of the main problems of the US mortgage market has been the popularity of the “2/28 mortgage”. This form of mortgage permitted the borrower to pay a low teaser rate for the first 2 years, thereby allowing the principal on the loan to grow. The rate would then be reset for the remaining 28 years. Unfortunately, many borrowers with this type of loan are now faced with a mortgage debt bigger than the value of their homes. More than 13% of these borrowers are now delinquent on their payments. And the problem could get a great deal worse.

As the following chart illustrates, in recent months about \$35 billion worth of these 2/28 adjustable mortgages have come up for rate re-adjustment. This number jumps to over \$50 billion from August to December, peaking at \$110 billion by March 2008.

Jan '07	\$22
February	\$25
March	\$35
April	\$37
May	\$36
June	\$42
July	\$43
August	\$52
September	\$58
October	\$55
November	\$52
December	\$58
Jan 2008	\$80
February	\$88
March	\$110
April	\$92
May	\$76
June	\$75
July	\$50
August	\$35
September	\$26
October	\$20
November	\$15
December	\$17

3

The US consumer's spending makes up about 70% of the US economy. Easy lending has created an unprecedented 3 years of negative savings; i.e. spending more than one takes in. The US is in the process of moving from the easiest lending standards in US history to one of the tightest. The US economy will start to feel the effects of tight lending over the next few months if it has not done so already.

I continue to recommend avoiding exposure to banks. And yes, we have a debt bubble in Canada too, but in this country, banks have not yet tightened their lending standards. I would also avoid exposure to consumer discretionary spending. Consumer spending will likely slow much more than economists are currently forecasting.

In an ironic twist, there are some positive or bullish effects from the housing crisis. Normally, at this late stage in the economic cycle, the central banks are forced to raise interest rates to cool down the economy and to slow economic growth. The housing slowdown, however, will likely mean that the US will not raise rates, but in fact will start cutting rates in late '07 or early '08. In Canada, the Bank of Canada will likely raise rates by one or two more steps (0.25% to 0.5%), but will be able to stop there as the US slowdown will cool the Canadian economy as well.

This scenario will likely be bullish for gold, as lower US interest rates will be negative for the US dollar. Another method of profiting from a decline in the US dollar would be to have exposure to the Japanese Yen. (The Canadian dollar has appreciated almost 100% against the yen over the past 10 years!)

As far as stocks are concerned, international dividend-paying stocks such as Johnson & Johnson, Merck, Coca Cola, Anheuser-Busch, or Thomson Corp. have no exposure to the US

housing or the lending industries. The stock market weakness could therefore present some useful buying opportunities.

The stock market has finally acknowledged the problems of lax lending and the consequent tightening of credit conditions. In past years, the stock market has tended to bottom in either September or October, which could prove to be an excellent entry point to add to blue chip stocks.

As far as bonds are concerned, I am still cautious. Even though US interest rates will likely fall, the longer-term outlook of a weak US dollar is inflationary. For this reason, I have been recommending 3 and 5 year GIC's, which I can purchase close to or above 5%.

Sincerely,



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