

“A Banker is a fellow who lends you his umbrella when the sun is shining, but wants it back the minute it begins to rain.”

-Mark Twain

Canada

-The TSX had a tremendous run from March 9th low to June 11th high of 41.3% and remains YTD up 14.3% as of July 2

- Canada's median home sale price passed pre-recession highs by posting a new record high in May 2009 – \$ 319, 757

- BRIC nations held summit in early June to discuss the status of US currency as world reserve currency

- Rumbblings of Americans looking to put their assets outside of US. Canada presents itself as a good option

- Madoff sentenced to 150 years in prison...because it is a federal case and sentence he has no chance of early release

- GM bankruptcy on June 1st

Many economies currently have very little to be optimistic about, while Canada's economy is at least facing a tug of war between the benefits of a stronger banking/financial sector and greater exposure to cyclical energy and commodity markets. Canada should be expected to continue to benefit from its well-capitalized banking and financial system. It does not insulate us from the global economic contraction, but it should put us in a much better position to deal with it. Canada may be more vulnerable than most countries around the world to the weakness in commodity prices, these declines are the equivalent of a global tax cut (particularly the oil price) and very beneficial to large importers such as Europe, the United States, Japan and China (see China at end of this commentary). However, Canadian home sales numbers have certainly prompted some optimism in this country. Home sale numbers were up almost 18% in June from the same period last year and prices were up 3.6%.

But the picture is not as rosy in the United States, where the collapse of the housing market is considered one of the key causes of the worldwide recession. The most recent Case-Shiller index numbers – a broad and detailed look at house prices in 20 U.S. cities – showed prices down 18.1% in April from a year earlier. That is an improvement from earlier in 2009, but still discouraging. The bottom line is that house prices are key to an economic recovery because when prices go up, homeowners tend to spend more of their disposable income, as they feel richer. Higher prices also add strength to credit markets and there are likely to be fewer market-destabilizing defaults if prices are not falling.

The U.S. housing bubble was one for the ages. We have all heard stories of one kind or another...

There was the glass cutter who earned \$5,000 per month, pretax. Washington Mutual gave him a \$615,000 home loan with payments of \$3,600 per month.

There was a house - a shack, really - that appraised for \$132,000 and got a mortgage of \$103,000. The owner hadn't worked in 13 years. Upon foreclosure, a neighbor bought the house and paid \$18,000 just to tear the thing down.

- On June 11 PM Harper announced that "a fully 80% of our plan's funding has been committed" ...and that "3,000 individual projects across the country are now getting underway - no small feat in only 72 days."

- As a percentage of personal disposable income, household income is at a 4.5 year low in Canada compared to a 16.5 year low in US.

- Canada's rate of contraction while still high at 5.4% is still well below the record for a quarter that was set in the '82 recession.

-62% of all jobs losses in Canada since October 2008 were in Ontario-But the GTA has not suffered as badly as the rest of the province

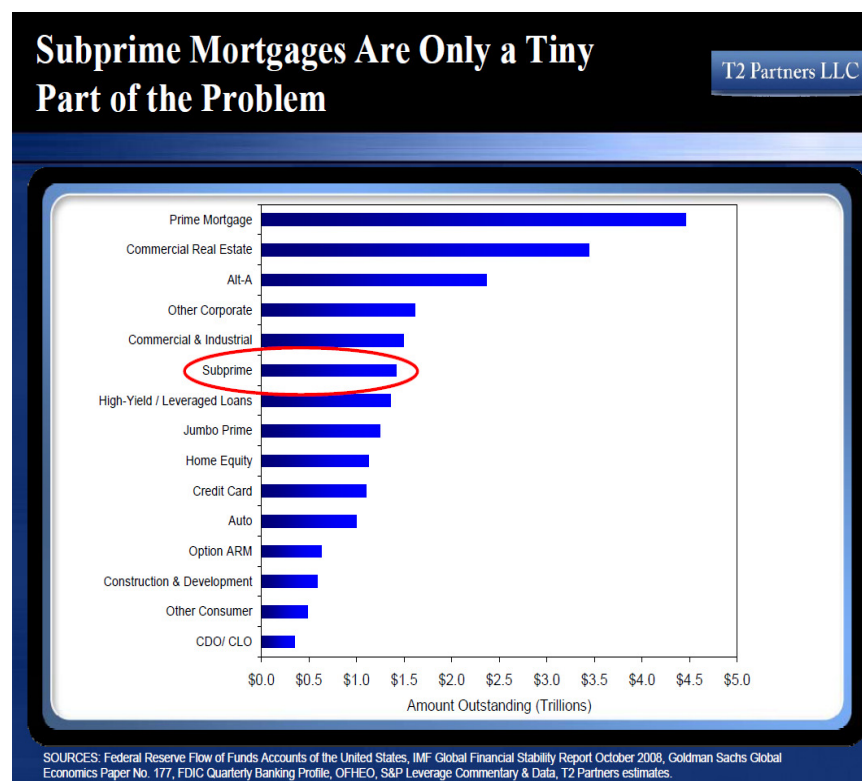
-Canadian dollar gained 2.7% over the period from May1-June 30 trading at 86 cents on June 30th after having reached a high of almost 93 cents on June 2

America, it seems, just went crazy - borrowers, lenders, nearly everybody. These anecdotes and others are told in a new book titled More Mortgage Meltdown by money managers Whitney Tilson and Glenn Tongue. We recently attended a Value Investing Conference put on by these two in California. This is an annual event that had stark differences from this year to the Spring of 2008.

But what caused the mania and how we got there is less to the point than what happens from here. Even so, the stories are amazing...

"If the problems in the mortgage market were limited to subprime loans, then the carnage would be mostly behind us," the authors note. Subprime loans were the riskiest mortgage loans. Prime loans, by contrast, were made to borrowers who made a substantial down payment and had good credit history.

The subprime borrowers were the first to fail...but they certainly will not be the last. The chart below shows the other mortgage markets, most of which are only now beginning to show signs of distress.



- From an Interview with Warren Buffet...
 "We got way overleveraged in the financial arena. The American public got overleveraged too. We do need to address institutions where the wrong incentives are in place so that their personal incentives are at real variance with what our national incentives should be. We need something to make sure we don't get into the situation again that we were in last September. And leverage is a big key to it.

-on the stock market,
 "Well, I think it's attractive over the next ten years compared to alternatives. If your alternative is buying some fixed-dollar investment, I think inflation will eat away at that. I think it's almost certain over a ten-year period that equities will do better than fixed-dollar investments. So, if people are keeping their money in cash and getting virtually nothing for it they may feel comfortable, but it will be very expensive for them over time."

The first thing to jump out at you is that subprime is about a \$1.5 trillion market - not anywhere near the largest of the risky loan categories. There are other layers here.

Subprime is only one slice of low-grade bologna. It sits at the bottom. Alt-A is the next riskiest slice of mortgages above subprime. Alt-A are mortgages to people who are better credit risks than subprime, but still not prime. Documentation is still spotty as far as verifying income, and loan-to-value ratios are high. Plus, about a quarter of these mortgages went to non-owner-occupied homes - which were subject to even greater speculation.

The scary thing is that this mortgage market is 150% bigger than subprime. Unlike subprime, Alt-A loans typically have five-year resets - meaning, the interest rates adjust to higher rates. The Alt-A reset surge does not really get started until 2010. It continues through 2012.

You will also see something called "option ARMs" on that chart. Even though the option Arm market is much smaller than the subprime market, it is also much riskier. An "option ARM" is a loan that allows the borrower to pay less than the total amount due from month to month. Whatever amount the borrower does not pay is added to the total loan amount...up to a pre-determined limit.

Obviously, loans like these are very easy to satisfy initially, but can become difficult or impossible if the borrower has been making token payments for a long time. What is worse, these loans usually offered ultra-low teaser rates at inception, then re-set to higher fixed rates later on. The reset surge for these loans only starts in 2010.

You will also see something called "jumbo prime." These are big loans - on average about \$750,000. These were common in the most inflated bubble states, such as California and Florida, and were often made to poor credit risks. This is a market of \$1-1.5 trillion - about as big as subprime.

Then there are home equity lines, which you will see just below jumbo prime. In calendar 2007, Tilson and Tongue explain, home equity lines funded "30% of new car purchases in California and 20% in Florida." These loans are second loans, behind all the garbage I mentioned

- Unfortunately the Euro-zone economies continue to contract and many indicators point to a deep recession.

-The overall Euro-zone also suffers from a number of problems that will hold back individual economies to different degrees.

- The pullout of U.S. troops in Iraq is underway. The U.S. has left security details within major Iraqi cities to the Iraqi forces. But the U.S, on the same day of their withdrawal from Iraqi cities, launched the single biggest military operation in Afghanistan since the Russian invasion of 1979. Afghanistan, on that point, has been in a constant state of conflict since 1979.

- At the International Economic Forum of the Americas in early June the main topic of conversation was the lack credit flowing... chief US economist for Goldman Sachs, Jan Hatzius, had a simple statement-“Lack of demand.”

above. That means that many home equity loans will be a total loss for the lenders, as housing prices have collapsed and can't even support the junk loans in first position, much less junior liens like home equity lines.

We will not go into all of these loan categories, but we think you get the picture. All together, these “other” loan categories total more than \$5 trillion – or more than three times sub-prime. Even worse, issuance peaked during the peak bubble years of 2005, 2006 and 2007.

Through March of 2009, U.S. banks had taken only \$1.1 trillion in write-downs to date. Even the most conservative estimates put total credit losses at \$2.2 trillion. Tilson and Tongue make a convincing case that the losses will be far worse than that - more like \$3.8 trillion. And these numbers seem only to grow over time.

So we think Tilson and Tongue will be closer to the mark. It may well be even more than that when it is all said and done. The fallout from all of this is that the banks will have to raise a lot more capital. They have raised only \$1 trillion so far - yes, “only.” Given the high leverage in the banking sector, they may yet need to raise at least another \$1 trillion. We do not see how that is possible in today's market. Where is the money going to come from?

The margin for error is extremely small.

As banks' assets got riskier - with subprime, Alt-A and all the rest – the banks actually borrowed more to hold these assets. The typical bank has only 4 cents of tangible equity for every dollar of assets. That means a 4% drop in asset value wipes out the equity - making the bank insolvent. The U.S. banking system is vastly undercapitalized. Throughout the 1990s, banks operated on leverage of about 16-to-1. Today, they operate on 25-to-one leverage...or higher!

And this, then, answers the great fundamental question that seems to baffle so many market commentators. Why are the banks not lending? People point to the trillions of dollars the government pumped into the economy, including on bank balance sheets.

The answer is that the bankers know they will need the money to cover losses from their toxic loan portfolios. The U.S. banks are clearly not lending. Banks are cutting lines of credit to consumers - and to businesses, too. New loans in various business categories are down

- North Korea has continued its belligerence by continuing to test fire missiles that have the range to reach US and Canadian territory. This has forced S. Korea to remain on an ever heightening state of alert

- Canada teetered in the brink of another election only to have the Liberals lose their gumption and continue to back the minority government

- Manhattan Real Estate prices dropped for the first time this past quarter since 2002

- Big US banks still hold toxic assets on their books but interest is picking of potential buyers

-Obama's stimulus package (\$787 billion) is expected to create 5 million jobs by the end of 2010 and into 2011. To date only 5% of this money has been spent

-10 U.S. banks begin to pay back TARP loans

60-80% from where they were a year ago.

It is hard to imagine any economic recovery when the banking system has such gaping funding holes it needs to fill. As it is, banks are failing and the losses are severe - on average, the losses amount to more than 40% of assets. The data coming in on foreclosure recoveries are bleak. In California, recovery is often less than 35 cents on the dollar, which means a loss of 65 cents on the dollar. It is not supposed to happen like this. If this crisis is anything like previous cycles, we have got a long way to go on bank failures.

The seemingly never-ending decline in U.S. home prices and construction should soon be coming to an end as supply and demand are rapidly coming into balance.

The dramatic misallocation of capital to real estate in the 2002-2006 periods in particular caused massive distortions in the U.S. and global economy, and an unprecedented bust in all things related to homes. The most accurate data on housing suggests that approximately 2.5 million more homes were constructed during the 2002-2006 period than could be absorbed by population growth and new household formation. Speculators filled the gap with catastrophic results when home prices began to fall. But while everyone has been focused on the current housing downturn, the seeds of recovery are already taking place. Since 2006, the U.S. population has grown by an additional 8.1 million people. The typical household size in the U.S. is 2.5 per home, and home ownership has averaged around 67%. So, demand for new homes since 2006 has increased by about 2.2 million, and is continuing to grow. Meanwhile, the supply of new homes has been reduced to record lows and is now at about 500,000 homes per year (the prior low was 790,000 homes in 1991).

The U.S. economic downturn has also dampened new household formation among the key 25-39 age groups, many of whom are renting or have temporarily moved back with their parents or extended family. Inevitably, inventories will continue to drop as they have from the highs of last year, but it will take an additional several months or more to restore inventories back to normal levels. The U.S. banks, of course, are making things more difficult by dumping foreclosed homes onto the market and refusing credit to all but the least risky. Fortunately, Freddie and Fannie Mae are providing much-needed financing, and in the meantime, home affordability is extremely attractive in much of the U.S. As consumer confidence slowly

-Jim Balsillie's failure to buy the Phoenix Coyotes was an interesting lesson in US anti-Trust versus bankruptcy laws

- Since its lows early this decade, gold is up 300%, 194% and 180% respectively against the U.S. dollar, the Euro and Swiss Franc.

- The U.S. economy continues to face some formidable challenges, but given the unprecedented stimulus that has been applied, it should be one of the first economies to post positive growth numbers.

- Even the Federal Reserve has recently offered glimpses of optimism indicating it no longer views deflation as a threat and offered the first hints that it may be contemplating removing some stimulus from the marketplace

rebounds, housing demand may well be one of the first areas to recover and may also represent a once-in-a-generation opportunity to buy homes at a reasonable price in almost all parts of the U.S.

How do we invest in this environment? For starters, continue to avoid U.S. banks and leveraged financial institutions in general. And do not expect the banks to start lending so freely again anytime soon. That means you should also avoid businesses that depend on regular access to credit to grow - such as real estate investment trusts. We would also say that the housing market is not due for any recovery anytime soon. There is still enormous inventory to work through. So homebuilding stocks and related investments also face stiff head winds.

At the right price, we might buy almost anything else. But investing is hard enough without also taking on problems as big as the ones we have outlined here. There are plenty of other great places to fish.

End of the American Era?

With its slumping economy, mountains of debt, ungodly deficits and overseas entanglements, many observers believe the end of the American era is at hand. Not so, according to George Friedman, founder of STRATFOR, a global intelligence company. In his latest book, The Next 100 Years, Friedman argues America's power on the world stage will actually increase in the 21st Century for three major reasons:

- The immense size of the U.S. economy: The current crisis is painful and America's deficits are shocking on an absolute basis but are "trivial" relative to the country's net worth, which Friedman estimates is about \$340 trillion.
- The unrivaled dominance of the U.S. Navy: Even in the digital age, control of the high seas is paramount in geopolitics.
- The ability of the U.S. to absorb immigrants, both culturally and in terms of the nation's relatively low population density.

This last point is controversial, considering the nation's current anti-immigration mood and worries about ongoing job losses. But the global population is shrinking, especially in the developed world, and Friedman foresees labor shortages leading to competition for immigrants in the next 20-30 years. America's ability to attract and

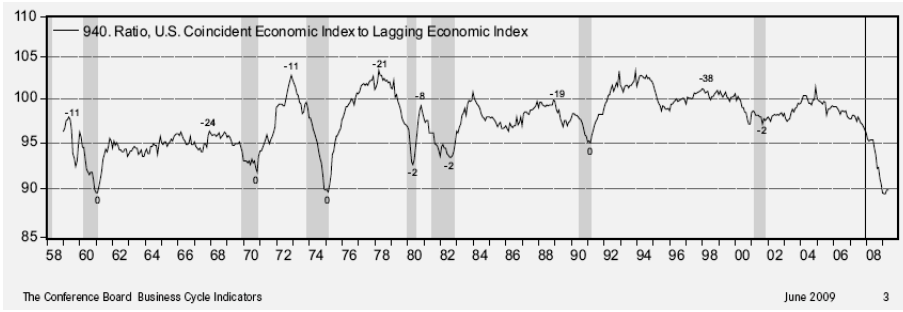
-The \$50 billion plus fiscal deficit would not normally be positive for the loonie, but with long term fundamentals in its favor, we look for it to continue to appreciate over time.

-Japan will be one of the last major economies to emerge from this current downturn.

- Iran is embroiled in civil strife after an election that returned Ahmadinejad to office with the support of the ruling Mullahs who have threatened crackdown on protestors

- China appears to be past the worst and may be entering a period of sustained recovery. Growth is bound to be reported in the range of 8.0 – 8.5% for this year, but our sources connected with the compilation of the data suggest that 7.5% may be more realistic

absorb those workers, especially relative to economic rivals like Germany and Japan, will thus be a key to its continued status as the world's leading power, he argues.



The chart above is the Ratio of Coincident to Lagging Indicators, as compiled by The Conference Board. We have long said that if we could have but one economic data point to watch each month from which to make our economic projections this one would be it for historically its ability to “find” the end of recessions is uncanny. Note that the Ratio turned up either “spot on” the month of the end of all of the recessions going back to the early 60’s, or it led the recession by two months. The Ratio turned up last month.

China

The resurgence of Developing Markets this year, excluding Japan, has reignited the decoupling theory – a belief that these economies can continue to grow strongly despite a sharp downturn in the developed world. These markets have greatly outperformed their developed world peers since the start of the year, accelerating since risk appetite began to improve in March. China appears to be past the worst and may be entering a period of sustained recovery. Growth is bound to be reported in the range of 8.0 – 8.5% for this year.

Wave of Liquidity Washing over China

Monetary policy only works if banks lend and a surefire way to make that happen is to make banking heads part of the body politic as is done in China. Loan growth continues at a rapid-fire pace, suggesting that U.S. domestic demand matters little to the growth trajectory of China’s economy in the near term. Bank lending in China doubled in the first half of the year over the same period in 2008. Construction activity has rebounded after authorities wrung the excesses from the property market in 2008 which was an unfortunately timed bout of

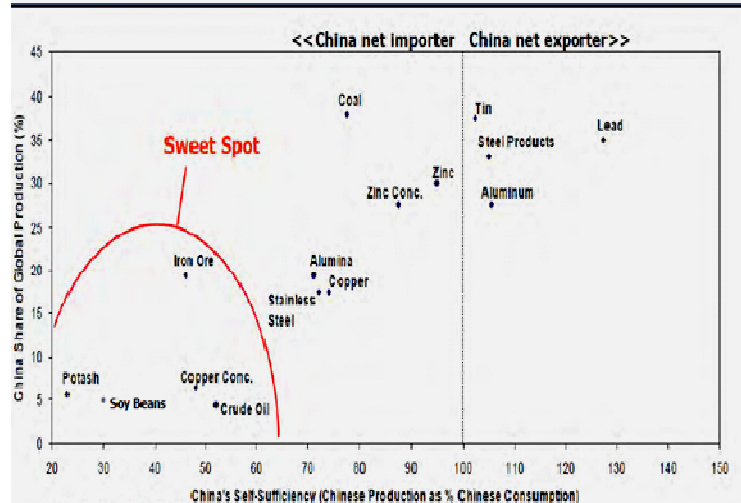
- Future rates of escalation in global demand growth for virtually all commodities are likely to be determined by non-OECD nations. Their current low consumption per capita and rising middle classes will vault them into a leadership role

-The 40th anniversary of the moon landing was celebrated this past week. A Blackberry has more computing power than all of NASA's computers in 1969

-Tom Watson's performance at the Open Championship was a run for the ages. We came to the conclusion his caddy should have told him to 'club down'

monetary tightening leading up to the global credit crisis. Housing inventories have declined substantially from over 20 months supply at the end of 2008 to a mere two months of supply. As a result, construction starts, comprised more than 80% of housing are up 11.9% in June over the previous year after being down 18.2% in May. That type of change in one month is massive given that these are year-over-year comparisons. Any chance for a rebound in exports to the United States, Europe and Japan will add marginally to the growth story that seems to be firmly in place. The wave of liquidity that is washing over the economy will continue to support an earnings rebound and the stock market. We will continue to hold and build positions in companies that benefit from China's demand for what it needs most. See chart below.

What China Needs Most



MacNicol & Associates Asset Management Inc.
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