BMO Nesbitt Burns

BMO Nesbitt Burns Ltée/Ltd.
Tour McGill College
1501 avenue McGill College, Bureau 3000
Montréal, QC H3A 3M8

Tél: (514) 282-5810
Téléc: (514) 282-5883
1-800-363-6732

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Website: www.pierremorin.com

Nothing "subprime" about gold

A couple of years ago, we had worries about the expanding US debt and deficit, as well as the lack of consumer savings. We talked about risks related to the speculative real estate bubble in the US, stating at that time that it could possibly be the catalyst of the next major recession or worse, depression (reference newsletter #32 page 2 and 3). We highlighted the effects of a falling US dollar on inflation and the resulting impact of a shrinking US market weight on the MSCI World index, which stood at a peak of 58% in 2000 but is now down to less than 48% today (newsletter #35 page 2). We also had concerns about the fast growing popularity of hedge funds which, as you well know, make extensive use of leverage to enhance performance (newsletter #37 page2). Although these worries tend to reappear cyclically, they usually come in sequence, and in the past we have seemed to overcome them; not necessarily without pain, but avoiding worst case scenarios.

The difference this time (and I hate to say this) is that it seems that our worries are all converging at once, thus creating a snowball effect and increasing exponentially the probability of a real financial disaster. In this newsletter, I will attempt to explain in lay terms what has happened in a financial world that has been hit by the subprime loan crisis.

The root of the problem is the combination of two factors, namely greed and greed: the greed of real estate speculators and the greed of financial advisors (i.e. mortgage lenders, investment bankers, etc.).

The real estate boom that started in 1997 really picked up steam in 2001(after 9/11) thanks to the sharp drop in interest rates designed to help bolster consumer confidence. The bursting of the technology bubble also got investors to realign their risk tolerance in favor of real estate. As demand for real estate grew so did prices, until the situation eventually became a self-feeding spiral. It is argued today that easy money (low interest rates) has been available for too long.

As the demand for real estate loans kept rising, mortgage lenders became more and more aggressive. Some were prepared to lend up to 110% of the value of a house, at a variable rate, discounted for the first year (this is also called a teaser), requiring interest repayments only (no capital), on a pre-approved basis (no credit check), regardless of employment.

In the US, these practices became the norm, based on faith in an everlasting real estate boom. Here is an example of a $200,000 house.

	Loan	Rate		Capital/Bal.	Monthly payment Interest only
Year 1	$210,000	2%	(teaser)	$216,300	$350.00
Year 2	$216,300	5%		$216,300	$910.00
Year 3	$216,300	8%	(?)	$216,300	$1,425.00

After Year 1, the only effect of the teaser rate was to increase your new debt balance, since the 3% discount was added back to the loan balance. If interest rates had not increased at all, the interest-only mortgage payments have almost tripled in one year. If, as it happened, mortgage rates go up to, say, 8%, your mortgage payments (interest only) have now quadrupled to over $1,400 a month.

But wait, there's more! The actual value of the property has decreased by 5% to 10%! You now owe $216,300 on a house that is only worth $180,000 to $190,000 !

Chart 1

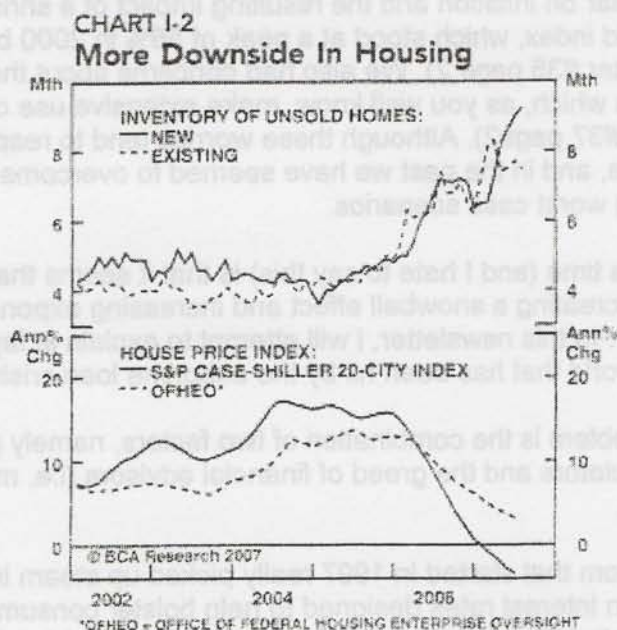


Chart 1 indicates the inventory of both new and existing homes has risen sharply. This has led to declining house prices in leading U.S. cities as evidenced by the decline in the Case-Shiller Home Price Index. Some speculators cannot financially support either the higher payments or the increased debt level, so they have been forced to foreclose. In July alone, there were 800,000 foreclosures in the US. Subprime mortgages are defaulting at unprecedented rates, a situation which is directly impacting financial markets.

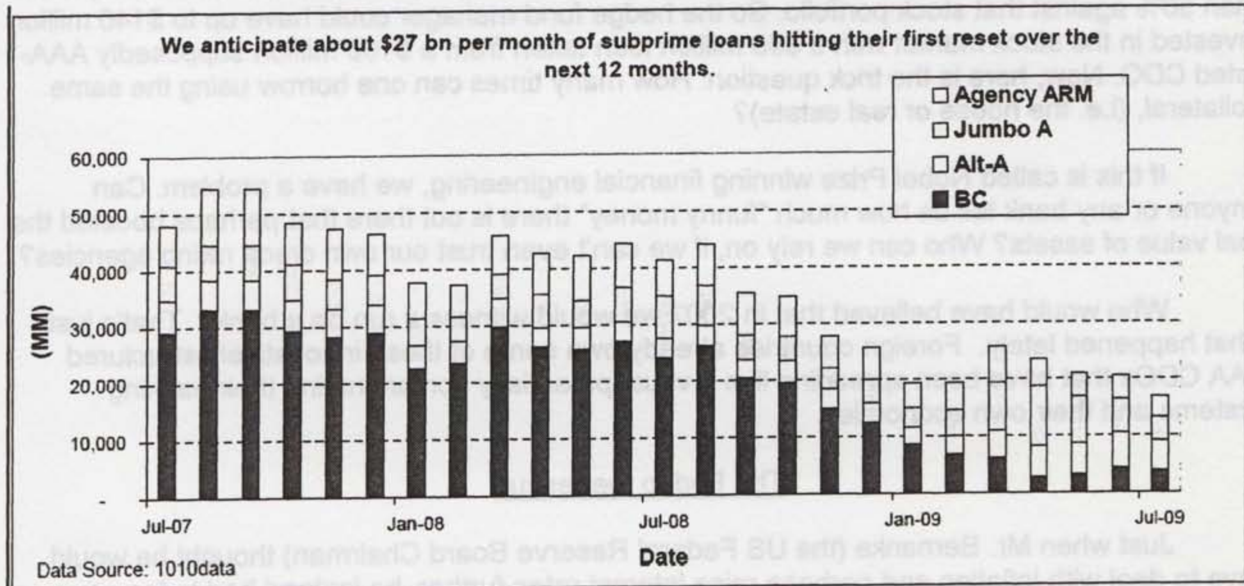
According to John Mauldin's August newsletter entitled "The panic of 2007", 47% of 2006 mortgage loans included some of these new features and therefore were based on top-of-cycle real estate prices. Given that most of these teaser loans get to reset the terms sometime between 12 to 24 months after they were granted, the downward spiral could get worse before it gets better.

The second level of this major problem is that some of these mortgage lenders found themselves uncovered, given the lost value of the real estate collateral. These "subprime" lenders started to feel the pinch last winter. The increasing amount of bad loans caused an internal liquidity crunch and attracted "vultures" to the rescue. High profile investment bankers (IBs) such as Bear Stearns, Merrill Lynch, Morgan Stanley and company were attracted in an attempt to bail out those desperate institutions, bailouts they financed by issuing what are called collateral debt obligations (CDO) which carried the credit rating of the issuer (usually AAA). The IBs worked out the debt structure with the credit agencies (i.e. Standard & Poor's, Moody's and Fitch who collect fees for such evaluation) in order to meet the minimum requirements to maintain a AAA rating for the newly issued CDO. For the most part, the assets of the bailed out

institutions provided the collateral behind the CDOs. In other words, it appears that the bad real estate portfolio was being used a second time as collateral, this time backing the newly issued CDOs...

John Mauldin** provides the following chart, produced by RBS Greenwich, which shows the amount of mortgages hitting the reset button in the next two years.

Chart 2



Given the very high number of mortgage resets in the months to come, significant new cash will be needed at a time when the AAA ratings become questionable. According to RBS Greenwich, an estimated $27 billion per month will need to be refinanced or reset over the next year. Furthermore, JP Morgan now expects average house prices to fall between 7.5% to 15% by the end of 2008, while Goldman Sacks think a drop of 15% to 30% over the next few years is quite probable.

In recent weeks, we have witnessed a rush for quality (i.e. Government issued debt only) as a consequence of a lack of confidence in the rating agencies and a lack of transparency regarding the so-called CDOs. It was published that many Canadian publicly-traded companies had bought CDOs and similar commercial paper for short-term investment with their running cash flows. Air Transat, for example, has announced that more than half of its $150 million cash flow had been invested in CDOs and/or similar commercial paper, for the short-term only, but the issuer could not meet the deadline even though it was a AAA rated paper!

Fortunately, Air Transat has a very strong cash flow and does not depend on it for major payments of any kind. I am quite sure, though, that other companies out there might be in an awkward financial position, especially if they were counting on these liquidities to settle recent acquisitions.

The National Bank is the only bank that has officially revealed that some of these CDOs and the like were sold to small businesses through its retail network. The other significant buyers of those papers, also called mortgage-backed and asset-backed securities, are the increasingly popular hedge funds. These funds found the higher-yielding AAA papers very attractive since they could borrow up to 90% against them, given their AAA rating.

To sum the situation up, hedge funds borrowed 90% against paper that uses as collateral a bankrupt mortgage lender which, in turn, holds a real estate portfolio that is worth less than the loans held by people who cannot repay them! But it doesn't stop there! Because of the aggressive nature of hedge fund managers, who are driven only by performance, the 90% loan they were able to get using the "AAA rated" CDO as collateral, was invested in the stock market, through investment houses… and yes, one can margin (or borrow for investment) more than 50% against that stock portfolio. So the hedge fund manager could have up to $140 million invested in the stock market with a $90 million loan taken from a $100 million supposedly AAA-rated CDO. Now, here is the trick question: How many times can one borrow using the same collateral, (i.e. the house or real estate)?

If this is called Nobel Prize winning financial engineering, we have a problem. Can anyone or any bank tell us how much "funny money" there is out there that perhaps boosted the real value of assets? Who can we rely on, if we can't even trust our own credit rating agencies?

Who would have believed that in 2007 we would witness a run on a bank? That's just what happened lately. Foreign countries already own some of these innovatively-structured AAA CDOs that have been spreading like a virus, potentially contaminating their banking systems and their own economies.

The Fed to the rescue

Just when Mr. Bernanke (the US Federal Reserve Board Chairman) thought he would have to deal with inflation and perhaps raise interest rates further, he instead had to face a severe cash crunch and was forced to choose reflation, the lesser of two evils. Interest rates dropped 50 basis points (1/2%), most probably the first of several similar moves to come. To increase liquidities seems to be a relatively easy task. However, when you are already running chronic budget and commercial deficits, and the economy is relatively weak with a currency that is in a multi-year slump the solution to print more money becomes questionable. One must remember there are way fewer buyers of low interest debt in a weakening currency.

Japan and China, the two largest owners of US treasuries with over a trillion dollars each, are unlikely at this point to buy new US treasuries as their value decreases with the US dollar. It would be worse if they became sellers, heaven forbid! A higher rate of interest might attract some buyers, but will that be enough? Remember that a higher rate could be disastrous for the domestic economy. It seems to me inevitable that the yield curve will steepen over the next few years, which means interest rates are likely to go up for the longer term bonds but perhaps remain low for short-term paper.

The other effects of Mr. Bernanke's lowering of the Fed fund rate on September 18th are the dilution of dollars and the resulting consequence of inflation. Given more than 70% of consumer goods in the US are imported, a lower dollar means these goods will cost more in US dollars, leading to inflation. The highly-indebted consumer may not be able to sustain this pace for very long, and that may lead to a build-up in inventories, followed by layoffs that would slow

consumption even further. Once you set foot in such a spiral, things can get ugly (think recession).

US inflation and the US dollar

As explained above, the devaluation of the US dollar stimulates inflation, at least locally. The simple fact that all commodities (metals, food and agro-output) are priced in US dollars also means that they (most commodities) become cheaper to foreign buyers as their own currency strengthens. In other words, it takes less of their own currency to buy one dollar, therefore commodities become more affordable and this, consequently, stimulates foreign demand. As demand increases, prices follow suit. This is of particular importance given the Asian appetite for most commodities such as energy, agriculture, materials, precious metals, etc. Everyone knows the price of all these commodities has been rising for the past few years and they are not about to pull back. Although most commodities mentioned above have risen in price, gold has been a laggard… it has "only" tripled in price compared to zinc, copper, nickel, corn, wheat, etc. Those commodities have quadrupled or better in price. Gold stocks have underperformed base metal stocks because gold prices have underperformed other metals. The cost of operating a mine – be it gold, uranium, zinc, copper or nickel – Is similar, but gold revenues have not grown as fast as other metals and that is reflected in earnings. Things may be different in the months to come as gold prices may well outperform other base metals given the US's weakening currency and the slowing of its economy (leading to less domestic base metal consumption and the increased risk of inflation and/or financial crisis.)

Chart 3

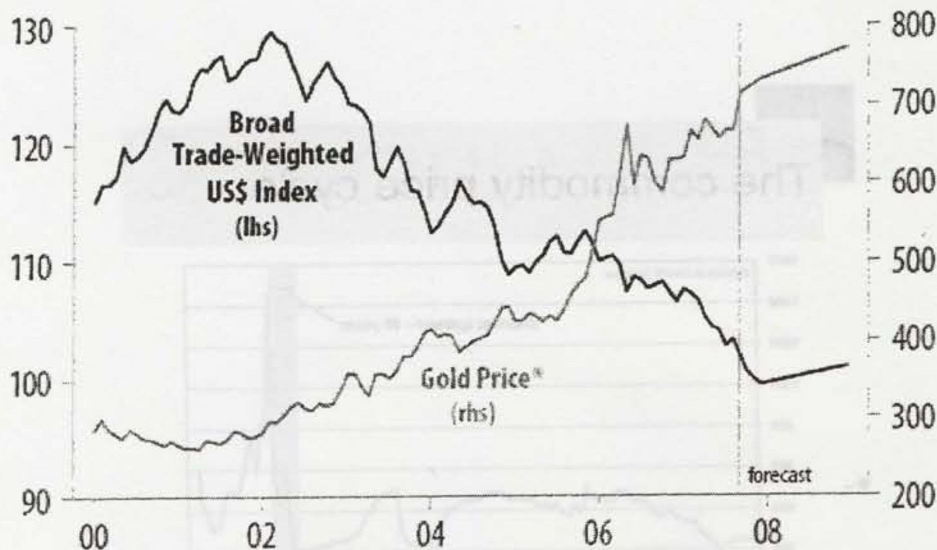
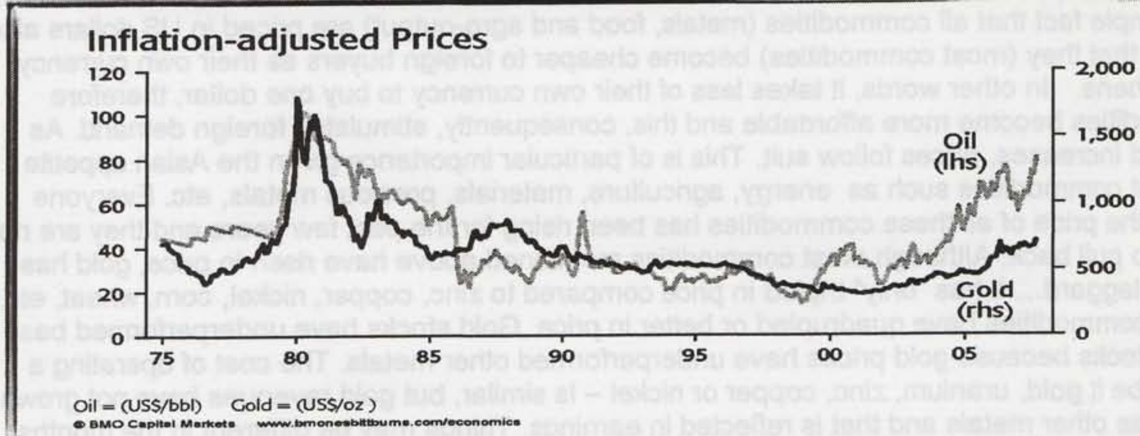


Chart 4

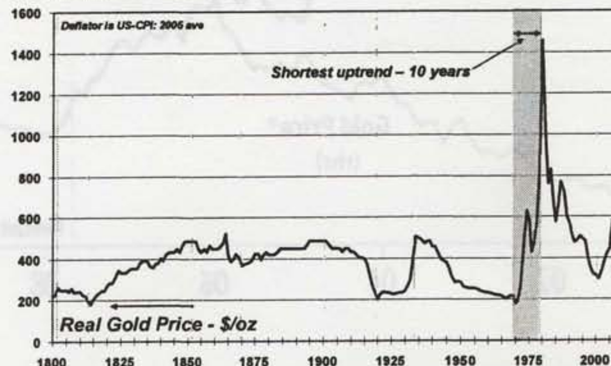


For those who worry about gold being too expensive, you probably also worried that oil prices had reached too high a price at $40.00.

Oil and gold prices reached a three month average price of $40.00 and $650/oz, respectively, in the 1980's, which should translate into approximately $100 and $1,700/oz today, adjusted for inflation. This leaves a lot of upside for gold prices.

Those who worry about the gold cycle should note that the shortest cycle of them all lasted 10 years, between 1970 and 1980. We are now in the sixth year of the current cycle (Chart 5).

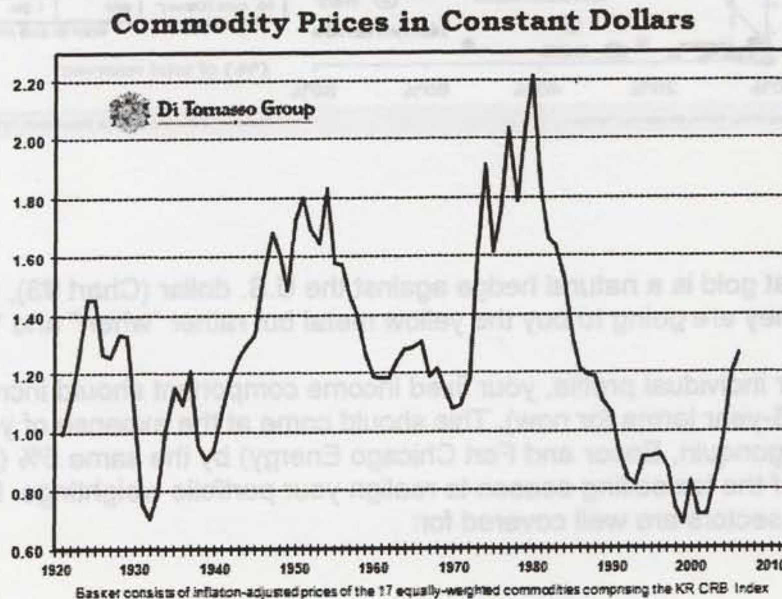
Chart 5



The last newsletter highlighted the three special ingredients to ensure the return of inflation, namely the combination of higher energy and food prices and excessive monetary creation. Who would have thought that six months later, despite rising fuel and agricultural goods prices, we would witness a sharp drop in interest rates, increasing liquidity, and a US currency devaluation?

Although most of us would think that commodity prices have reached their limits, in real dollar terms, history suggests that there is a lot of room for growth before our purchasing power reaches the level of erosion attained in the 1970/1980's (Chart 6).

Chart 6

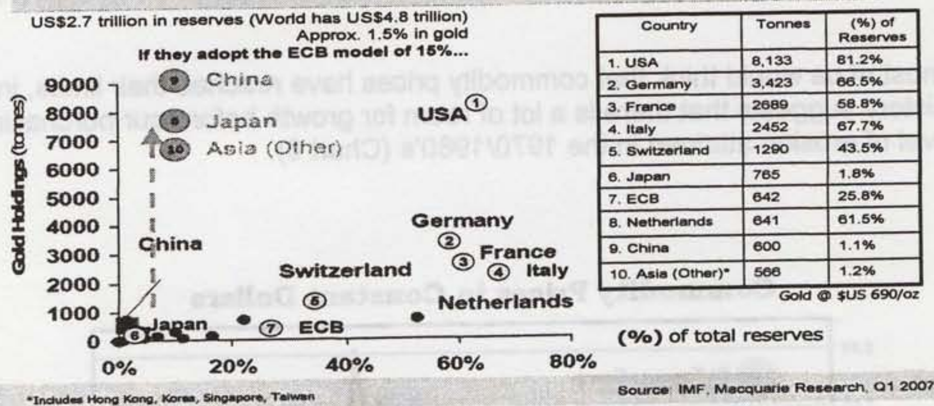


2007 saw food commodity prices sky rocket despite the fact that it was a very productive year for agricultural crops in North America. Hopefully, we will avoid major droughts in the coming years! But what if we do experience bad weather at a time when excess capacity is no longer available?

Conclusion: GOLD

We cannot and should not be blind to reality. Your best hedge remains gold and other commodities. However we believe your fixed income component, although it does not pay much, should expand as the cycle extends to its limits. As mentioned earlier, Japan and China are the largest holders of U.S. treasuries, but they own very little gold as a percentage of their reserves (Chart #7).

Holdings at Central Banks



Country	Tonnes	(%) of Reserves
1. USA	8,133	81.2%
2. Germany	3,423	66.5%
3. France	2689	58.8%
4. Italy	2452	67.7%
5. Switzerland	1290	43.5%
6. Japan	765	1.8%
7. ECB	642	25.8%
8. Netherlands	641	61.5%
9. China	600	1.1%
10. Asia (Other)*	566	1.2%

Gold @ $US 690/oz

Chart 7

Given that gold is a natural hedge against the U.S. dollar (Chart #3), the question is probably not "if" they are going to buy the yellow metal but rather "when" and "how much".

Given your individual profile, your fixed income component should increase by roughly 5% (shorter than 5-year terms for now). This should come at the expense of your utility income trust exposure (Algonquin, Epcor and Fort Chicago Energy) by the same 5% (down from 15%). Take advantage of the tax selling season to realign your portfolio weightings. Make sure your inflation-sensitive sectors are well covered for:

6 to 8% Gold:	Barrick Gold, GoldCorp., Agnico Eagle Mines, Virginia Mines
6% Base Metals:	Teck Corporation, Sherritt Int'l, Uranium Participation Corp ,Quadra Mining
4% Agriculture:	Vittera "Saskatchewan Wheat Pool", Market Vectors-Agribusiness (exchange-traded fund or ETF)
8% to 10% Energy:	Suncor, Canadian Oil Sands, Petro-Canada, Imperial Oil, Crescent Point Energy

As for financial stocks, with an average exposure of 17%, we are underweighted in comparison to the TSX, which stands at 34%. However, we favor insurers over banks at this juncture, and we would be sellers of the National Bank. If one bank finds itself in a very nasty situation as a result of the subprime scandal, I believe the whole issue of Canadian bank mergers will be brought to the forefront once again. This time it may be received with much more openness on the part of both the public and the Government, if it means reassuring depositors. At that point, the BMO Bank of Montreal and the National Bank would be the most vulnerable merger targets.

Railroad stocks (Canadian National Railway and/or Canadian Pacific) are core holdings for any portfolio. As far as consumers stocks are concerned, we still favor Metro and Alimentation Couche-Tard and we also like Thompson Corp.

Note that we are of the view that the markets have become more volatile as of late, and that is typical of an extended cycle. The fact remains that we are in the midst of one of the longest economic expansions the world has ever known, led by the booming Asian economies that represent two and a half billion people. Opportunities will arise as the market corrects. In the longer term we believe the outlook remains positive which justifies maintaining a strategically balanced investment approach to your portfolio.

ASSET MIX OF MODEL PORTFOLIO

INCOME PORTFOLIO			BALANCED PORFOLIO	
March 2007	**Sept 2007**		**March 2007**	**Sept 2007**
15%	15%	CASH (CSB, QSB, T-BILLS)	10%	15%
40%	45%	FIXED INCOME (BONDS)	25%	25%
20%	15%	CONVERTIBLE DEBS. AND INCOME GENERATING SECURITIES	20%	15%
15%	15%	EQUITIES	35%	35%
10%	10%	FOREIGN	10%	10%