

## An Unhappy Anniversary

This Sunday marks the one year anniversary of the beginning of the US Federal Reserve's rate reduction program in response to the global credit crisis. On August 17, 2007, the Fed delivered their first of seven rate cuts to alleviate pressure on the US banking system.

Ned Davis, an independent research firm, reviewed US credit characteristics to see if an improvement has occurred. The conclusion is simply, NO! As an example, the spread between Baa/Aaa bond yields, a measure of the risk premium required by investors, is currently at a 50 year high!

According to David Rosenberg of Merrill Lynch, three events are needed to improve the credit crisis and prevent further economic damage. Firstly, the savings rate in the US must increase. Currently, the savings rate is 2.6%, down from the level in late '80s of 8%. Secondly, the housing inventory in the US needs to be reduced. Thirdly, the amount of debt held by consumers must be reduced.

The events needed above are applicable to Canada and the US. The logical way to increase the savings rate is to reduce the debt level of consumers. Consumers in Canada and the US are saddled with more debt than ever before. In both countries the ratio of debt to household disposable income is 130%, an all time high. Lenders in both countries are forcing a reduction in debt by increasing their lending standards. The biggest debt on a consumer balance sheet is typically a mortgage. There are, however, only three ways to reduce the housing related debt of the consumer, the sale of the house, the abandonment of the house, or the sale of assets to pare down the mortgage

Mr. Rosenberg points out consumers have \$4 trillion worth of consumer durable assets which could be sold to pay down debt. Debt reduction and the reduced interest payments on that debt provide two of the three events mentioned by Mr. Rosenberg to end this crisis. Obviously, with a cascade of assets hitting the markets, the value of the \$4 trillion will also deflate. The deflation boom continues.

This credit situation will be resolved, but this will not occur in one month or in one quarter. It was built over six years. The resolution has been a year in the making and will continue to correct itself. In light of this, we have been strengthening the portfolio by increasing weights to businesses with low debt levels and more regulated operations. Leon's, an example of one of these businesses, follows.

## Inside the Fund

Leon's furniture reported strong second quarter earnings this week. The recent slowdown in the Canadian housing market has not slowed down Leon's.

At the beginning of the year, Leon's acquired Appliance Canada Limited, which distributes appliances to home builders and landlords. This may seem like poor timing for an acquisition with this type of exposure. The benefits to Leon's, however, are numerous. Consolidating the distribution network and increased buying power should help reduce their overall costs for delivering product to their stores. Over the years Leon's has done an excellent job of creating high returns on their equity. This acquisition increases the equity base in which they generate these healthy returns.

Leon's is an excellent example of a high quality holding, which should succeed within a slower operating environment. Most retailers lease their retail space or have a combination of leases and owned properties. Leon's owns all of their properties outright and carries zero corporate debt. Leon's stated in their latest press release:

"In the second quarter we saw good sales growth compared to the prior year. Although our sales continue to be strong, we are concerned about a general slow down in the economy."

A slowdown results in lower profits and lower cash flow. Any company without debt has fewer fixed costs such as interest payments and therefore the greatest flexibility. Other Canadian retailers are scaling back their expansion and store renovation program while Leon's has continued to renovate and build new stores. They will continue to do what they have always done, pay an increasing dividend and continually invest in their business.

