

Why is US Housing Important?

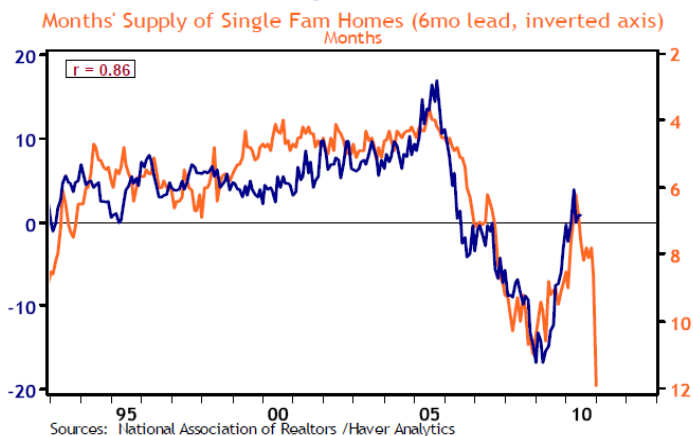
The run up in house prices prior to the crack in 2007 resulted in euphoria. Refinancing was common as homeowners increased their mortgage as their house price increased. Typically, the new mortgage was done at lower interest rates. Homeowners used this cash to purchase boats, vacations, renovations and so on. One word which could have been used to describe these individuals was confident.

At its peak in the fourth quarter of 2005, residential construction constituted 6.3% of US GDP. Today, the opposite is true. Residential construction made up 2.7% of GDP in the first quarter of 2010. To put this in perspective, a decline of 3% in GDP usually constitutes a major recession. This is a reduction of 3.6% just in residential construction!

Today, homeowners would like to refinance their mortgages to take advantage of lower rates; however, according to Gary Shilling, "About 35%-40% of all borrowers with 30 year fixed rate mortgages ...could cut them by one full percentage point by refinancing. The problem is their houses are worth less than the mortgage which makes refinancing impossible."

United States home sales in July sank to a record low. The homebuyer tax credits brought forward individuals that were in the market to buy a home, but now the expiration has resulted in a significant drop in activity. The inventory of unsold homes has risen to a level that could supply US housing demand for 12 months without building another home. By this measure, today's housing supply glut is higher than the previous peak recorded during this financial crisis. RBC Capital markets did some research on the correlation between the month's supply of single-family homes and median sales price. As displayed in the chart below, there is potentially a risk of another severe correction in prices. Coincidentally, RBC's analysis comes to the same conclusion as Gary Shilling's estimate of approximately another 20% decline in house prices.

Median Sales Price: Existing 1-Family Homes
% Change - Year to Year



Declining house prices have reduced confidence, and the ability to spend therefore affecting all companies that sell products to the United States. These would include Canadian companies since we are the most integrated country with the United States, but it also affects the imports into the United States from other areas of the world. Commodities are an input into many of these products. As has been mentioned in the press at length, China is the biggest purchaser of commodities in the world. If China is exporting goods to the US consumer, commodity consumption should decline. We continue to be concerned about these issues, which results in our continued under exposure to the commodity areas within our Funds.

Inside the Fund

Bay Street analysts have come into the office and made the statement: "Company XYZ is a niche player and therefore is not as good of a company as Company ABC that is a national player. We have heard this statement in respect to investments such as Metro (vs. Loblaws), Industrial Alliance (vs. Manulife) and National Bank (versus the other big banks). Our response to the niche argument is that if you can satisfy your customers profitably, you will be successful in any size market. Investing in these 'niche players' listed above has helped in protecting capital in down markets and has provided good returns in our Funds.

National Bank, primarily a niche player in Quebec, reported this week as did Royal Bank, Bank of Montreal and CIBC. National Bank delivered impressive numbers in comparison to its peers. It saw an increase in its loan portfolio and due to lower funding costs provided an increase in net interest income. This assisted in offsetting weakness in its trading revenue, which was weak at National and the other banks as well. The provision for credit losses (a reserve for potential loan defaults) was down to \$28 million from \$36 million in the previous quarter and \$46 million in the third quarter of 2009. The tier one capital ratio (a measure of the bank's solvency) is at 13.7%, which is up substantially from 10.5% in the third quarter of 2009. Investors have been concerned that new Basel rules will hurt the capital ratios of all banks. Louis Vachon, National's CEO, confirmed these new rules would reduce the ratio by 2.50% still providing a high level of comfort since the regulator, OSFI, requires 7%. These strong results have pushed the payout ratio to the bottom end of National Bank's range of 40-50% signalling that once the capital rules are confirmed National Bank should continue to increase its dividend.