

E.Q Trendwatch™

That '70's show again: US \$ down, commodities up

In September, the US Federal Reserve, concerned about the growing impact of the US housing recessions, stepped in to buoy confidence with a .5% cut in the overnight lending rate.

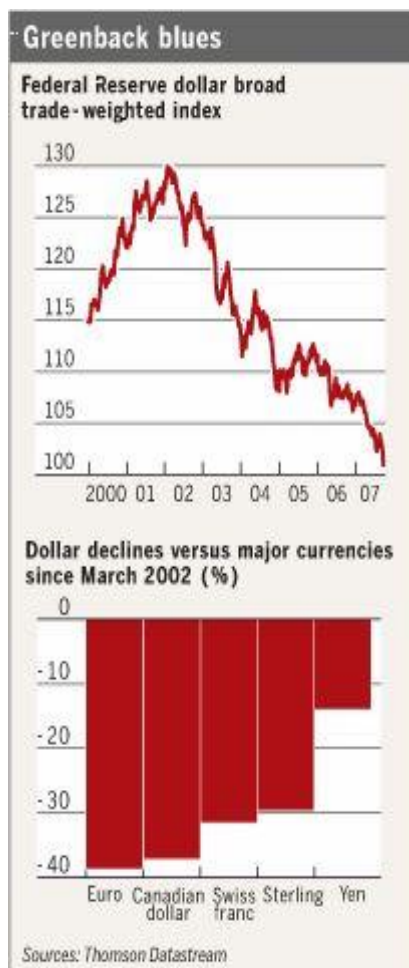
The inevitable fallout has been the US\$ dropping in value against other world currencies to levels not seen since the 1970's.

The '70's presented several themes reminiscent of present times with a US-led war abroad, soaring commodity and energy costs, rising inflation, and a falling US dollar.

For foreign investors, who have already lost heavily in US investments over the past 5 years, the Fed cutting rates was just one more nail in the coffin.

For US citizens, their dropping dollar brings inflation and loss of purchasing power since imports cost more: lumber, plywood, and natural gas from Canada, medical devices from Germany, machine tools from Italy. As the dollar continues to slide, Middle East and Russian oil is likely to be priced in euros rather than dollars and thus energy bills will continue to rise. When China seriously revalues – which it has to do as the dollar drops – every big-box retailer in America will be charging more.

Although American exports do better when the dollar drops, most Americans get poorer. And although Canadians can buy more in the US, our biggest trading partner finds our exports more expensive, and is thus able to buy less from us.



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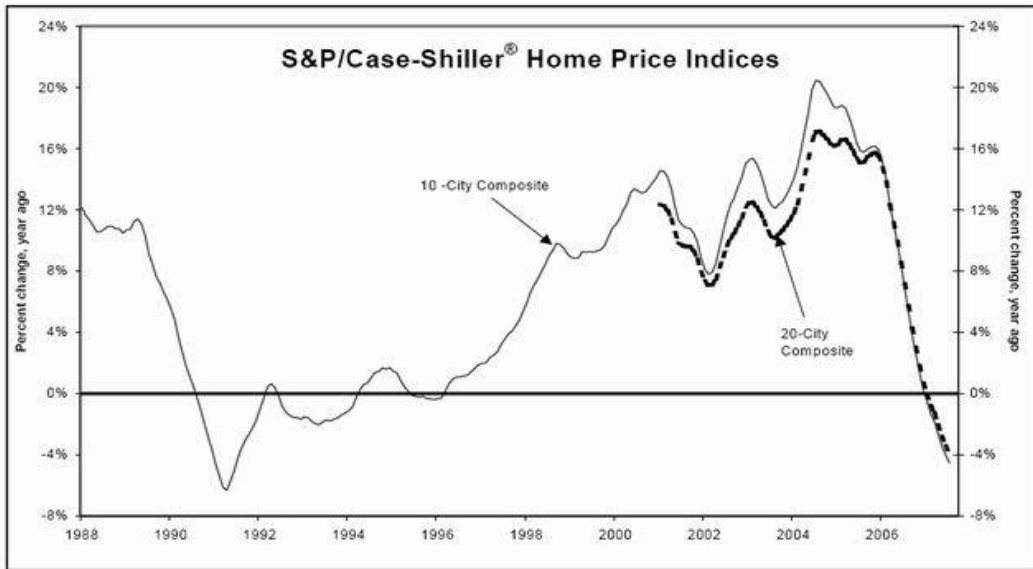


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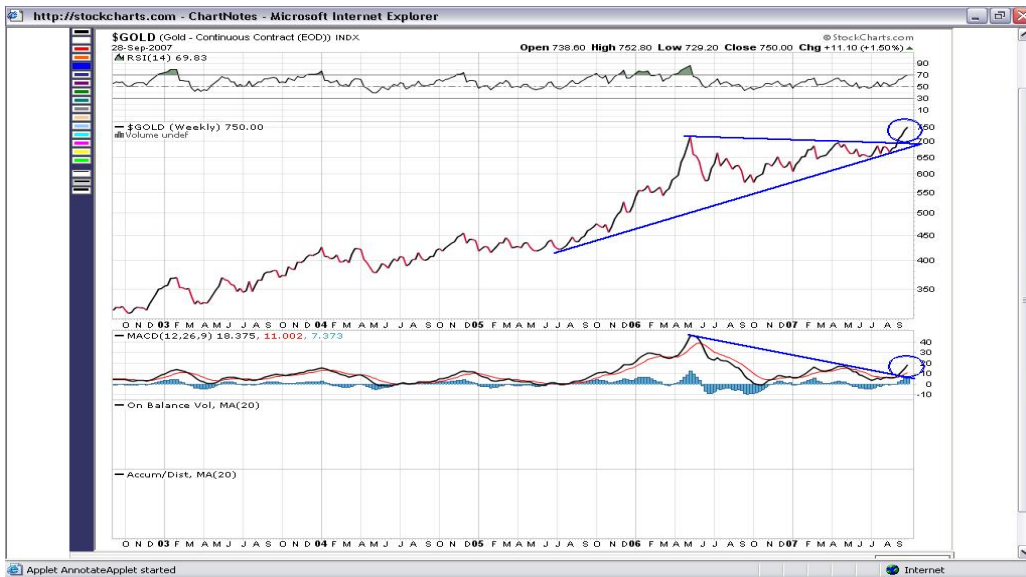
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So far the bottom of slowing consumption is not yet in sight. The latest home price index showed US housing prices continuing to accelerate down through the end of July. This index reports with a two month lag, and it is very likely that over the next couple of months, the previous cycle low of 1991 will be taken out.



The good side of this news, is that at VP we have not had US\$ holdings in our client accounts for over a year and the Gold and Energy Indices that we do hold have been increasing in response to the US\$ decline. We expect that while the US economy and its dollar continue to weaken, gold and other commodities should continue their ascent. The following chart shows the Gold Index over the past 5 years, and now staging another breakout to the upside.



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We believe that it takes courage to admit what we do not know. And we admit that we do not know how this housing recession plays out to the larger economy. So far the broad stock markets have continued to rally off of their August 16 lows, notwithstanding the weight of negative evidence. We have noted however that despite the price rally on the indices the market internals have been poor and with no convincing volume. The bullish argument for the recent stock market strength has been primarily that Fed rate cuts will rescue the economy from recession or significant slow-down, and that the global economy will “de-couple” from the US problems and continue to keep global growth on solid footing. We would like to believe that this will be the case however we also keep a close eye on facts over rhetoric and hope.

We agree that in the past stock markets have tended to rally after rate cuts, but in the past the Fed has generally cut rates *after* stock markets have already undergone a significant decline. This time, the Dow was only off some 5% from its cycle peak when the Feds stepped in. We know that in the last cycle, the US stock market peaked in March 2000 and declined more than 10% by the time the Feds began cutting rates in Q1 of 2001, only to see the S&P decline a further 35% before bottoming in the Fall of 2002. So it is very much uncertain that cutting now will avoid further economic and stock market declines over the next several months.

As for the ability of the rest of the world to de-couple from a slowing US economy, the jury is very much out on that issue as well. For one thing, it is not just the US that has experienced a housing bubble that is now bursting, this same phenomenon has played out in many countries all around the world with parts of the UK and Europe actually experiencing more irrational exuberance, and housing led consumption, than America. Lately, many of the analysts that were expounding the “de-coupling” argument have begun to retrace as evidenced in the following recent article from the UK Telegraph.

Bottom line: We are watching for big value opportunities as this housing-led-slowdown continues to unfold.

Goldman Sachs tiptoeing into the bear camp By Ambrose Evans-Pritchard 28/09/2007

Goldman Sachs has abandoned its ultra-bullish view of the world economy, warning of a likely recession in Japan and mounting risks that US property slump could spread to parts of Europe.

In a new report, "The Global Economy Hits a Crunch", the US investment bank said it was no longer sure that Asia and Europe would be able to pick up the growth baton as America stumbled. It fears that turmoil is spreading beyond the debt markets to the factory floor.

"Much has changed since mid-July, when we wrote that 'the global economy continues to enjoy one of the strongest sustained expansion in modern history'. The mood in financial markets is clearly darker, and the economic data in the developed world is showing signs of wear," it said.

"Japan's recovery is tottering, with the chance of an outright recession having risen to nearly two in three," said the report, authored by chief economist Jim O'Neill.

It is an abrupt change of tack for the bank known as the "cheer leader" of the global boom. Until now Goldman has insisted that Asia and the developing world are strong enough to shrug off an American slowdown, allowing world growth to keep racing ahead without missing a step -- despite subprime woes.

Often overlooked, Japan remains the world's second biggest economy and top creditor with some \$3,000bn in net foreign

assets.

Output had already contracted an annual rate of 1.2pc in the second quarter before the credit crisis hit.

There has since been a surge in the yen as speculators unwind carry trade positions, leaving Japan's margin-trading housewives and grannies nursing big losses.

Wages have fallen for the last eight months in a row. They are now down 1.9pc from a year ago, threatening to pull the country back into deflation.

Goldman Sachs feared it was now "inevitable" that consumers would batten down the hatches for a while.

The bank said Europe is now so weak after a clutch of dire confidence surveys in Germany, Italy, France, and The Netherlands that any further rate rises by the European Central Bank are "off the table".

It expects the euro to fall back to \$1.35 against the dollar over the next year, and sterling to tumble to \$1.88 as the Bank of England pushes through three rate cuts.

The one bright spot is the 'BRIC' quartet of Brazil, Russia, India, and China, all still firing on four cylinders, if slowing slightly.

In a separate report, "Rising Risks to the Global Housing Market," it said that much of global system had succumbed to a property boom that is in some ways more stretched than in the US, with real (inflation-adjusted) house price rises of over 100pc in France, 60pc in Italy, 55pc in Canada, and 72pc in Australia since the late 1990s. The bubbles in Spain and Ireland have been more extreme.

"Such a widespread housing boom has little precedent in modern history. In those markets where prices have run up the most, and rental yields have fallen dramatically, the risks of a housing correction are likely to have increased materially," said the note, by Peter Berezin.

"The wealth effect for housing is about twice as large as for equities, with consumption falling by about two cents in the short run for every \$1 decline in home prices," he said.

He expects US house prices to drop 7pc in 2007 and another 7pc in 2008, as mortgage lenders shut off credit to chunks of the market. "The US is often a leading indicator for what happens in the rest of the world".

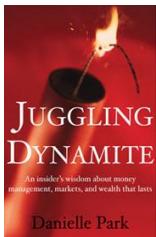
Mr Berezin said construction booms usually lead to housing busts lasting several years. Residential construction in the US reached 6.3pc of GDP at the peak of the bubble, the highest since the baby boom in the early 1950s.

In Spain, it has been even higher, averaging 8.7pc of GDP since 2003, and in Ireland it has exploded to 14.2pc, leaving a overhang of unsold property. House prices are already falling in Spain, where 98pc of mortgages are on floating rates that have roughly doubled since late 2005.

Property prices have dropped for the last four months in a row in Ireland.

Mr Berezin said the Goldman's "decoupling" thesis was based on the assumption that the US housing slump was a "country-specific-shock" that would not spill over into other economies. This was now in doubt.

"The spread of global credit risks has introduced a new potential transmission mechanism. If home prices in the key economies begin to fall, this will have an adverse effect on global growth," he said



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