COMMENTARY

August 13th, 2010

Dear clients and colleagues,

For those of you who read our comments regularly, you will know that we are not shy about expressing our views and opinions. Although we often profile companies held in the portfolio, at times, we also give our observations and views on the markets, regions, economic sectors, etc.

Lately, we often hear about a bubble in the Chinese real estate market, so today we decided to give our view on the residential real estate sector in Canada.

We believe that the residential real estate market in Canada is a bubble that will burst in the next 12 to 36 months. The consequences will be severe for Canadians and the Canadian economy.

Why are we so pessimistic? If we look at historical statistics and to the US, for many decades beginning after World War II, home ownership in the US stood at around 62%. Then in the early 1990s, it started rising and reached a peak of 69% in 2004. Prices peaked in 2006, and we know what happened after that. Today, home ownership stands at 67%, still much higher than the historical average, so the US market might have a ways more to fall, and the latest economic numbers on housing seem to confirm that. To put it another way, in 2004, 7 out of every 69 homeowners were perhaps not in a financial position to own their home. And the foreclosure rate, which currently stands at about 10%, backs this up. This has adverse consequences for the other 62 homeowners and the economy as a whole.

In Canada during that same period, home ownership was slightly lower than in the US but started increasing at about the same time. The difference is today in Canada homeownership continues to rise and is now exceeding 70%. Does it mean that about 8 out of 70 homeowners are not able to afford their home and they might run in trouble soon?

Naysayers often point to the fact that lending standards are much stricter in Canada, that we have no subprime or Alt-A mortgages or other sophisticated products. But who has not heard of someone getting a loan for a RRSP, rolling that RRSP into a HBP (Home Buyer Plan), then taking a CMHC insured loan, which essentially meant they bought a house with no cash down.

Every statistic that we see in Canada points to a consumer that is over-leveraged. Household debt is reaching record high levels, one of the highest in the developed world. Home affordability is also getting lower. Even if interest rates stay at their current low level, we think there is major trouble ahead.

To add anecdotal evidence on how stretched the Canadian consumer is, one only has look at all those interest free financing offers available for everything, even an $80 microwave…

Yesterday, we had a visit from the largest payday lender in Canada, which has 525 corporate branches across 9 provinces. A payday lender lends small amounts of money to consumers, the average loan is $468, the average loan duration is 31 days, and the average interest rate on a loan is around 20-23%.

Although convenience is often cited as a major factor for payday lending, one would probably think that this is the lender of last resort. Well, we were quite surprised to learn that 38% of their customers earn more than $50k per year, with over 9% earning more than $100k per year. This year the company will open 85 new branches across Canada compared to 31 in 2009 and 37 in 2007, a reflection of the strong demand.

So, we think there is trouble ahead and Canadians will probably learn the hard way that their house is a shelter and not an investment.

As investors, we believe in diversification, and if indeed the residential real estate market negatively affects the Canadian economy, assets outside Canada may provide a good offset.

Best regards,

Have a good week.

The Global Alpha Team.