

The Moskowitz Minute: A Mid-year Economic Report

*In this first installment of **The Moskowitz Minute**, we provide a backdrop to the US "sub-prime mortgage crisis", review economic conditions in the US and Canada and provide an outlook on market trends. Stay tuned for future "Minutes"...*

Dear Fellow Investors,

As the escalating turmoil in the US residential sub-prime mortgage market weighs heavily on global credit markets, the financial system as a whole, and on the minds of many of our investors, we have prepared the following report to put to ease some of these concerns.

The much publicized US mortgage melt-down hit "prime-time" in August 2007 and despite being limited to a risky segment of the residential mortgage market, it has had a pervasive and dramatic impact on global credit markets. While Moskowitz Capital Management has never (*and will never*) participate in such mortgage transactions, we have been a net beneficiary of the crisis as it has forced US-based competition to exit our markets.

Let's take a closer look at how the mess unfolded and where things stand in Canada's real estate markets today...

"Free Fall" in the US Housing Market

Mortgage delinquencies, foreclosures, and frozen credit markets have led to the worst price erosion in the US housing market since the Great Depression. The crisis seemingly deepens by the day. Indeed, the *S&P Case-Shiller index*, shown in Table 1, demonstrates what has been a "free fall" in US home prices since early 2006, a full eight months *before* the well publicized "sub-prime meltdown".

How did we Get Here?

"Financial engineering", aggressive lending practices, and old-fashioned "greed" south of the border brought front-stage a previously obscure and risky asset class of "mortgage-backed securities" (MBS) that was in turn sliced and diced and sold to unassuming investors globally. Underlying these securities were dubious quality sub-prime mortgages written during an era of extremely lax underwriting standards to borrowers with little and sometimes no equity. The question of a borrower's creditworthiness became irrelevant in the "fast money" underwriting process, as lenders turned a blind eye to repayment capacity. At the same time, a prolonged era of depressed interest rates together with a political agenda to increase home ownership, allowed "easy money" to fuel an unprecedented US housing bubble. And like any positive feedback loop, these unsustainable lofty home prices, in turn, further encouraged high risk lending against residential real estate. "*All ships rise with a rising tide,*" was the saying of the day. But just like the Tulip craze (1630's), the railroad bonanza (1870's), the last gold bubble (1979), the tech bubble (2000); all asset bubbles eventually burst. In the case of the US housing market, the burst had dire consequences on the world's financial markets. The wide dispersion of these sub-prime mortgage backed securities has resulted in a *contagion* inflicting global financial markets and sinking such esteemed US institutions as Bear Stearns, Fannie and Freddie Mac, and most recently, Merrill Lynch, Lehman Brothers and AIG. The sub-prime graveyard seems to be expanding by the day....



Cooling over Canada's Housing Boom

As the US housing market languishes, the Canadian market has seemed invincible. The continued strength in the domestic economy and real estate market has been largely due to our economy's dependence on energy and resources, a strong dollar, and "Canadian-style" financial engineering that increased affordability for home buyers through new financing options, such as "no money-down mortgages" and extended amortization periods.

However by May, 2008, the real estate market began to cool with inflation rates near flat at 1.1% from a robust 8.6% at the beginning of the year and 11% in the banner year 2007. The cooling effect has hit hardest those markets that experienced the sharpest price increases (i.e. Calgary and Edmonton). In these regions, a major correction has seen over-inflated home prices fall dramatically; with MLS sales down 33% and 29% respectively as at April, 2008.

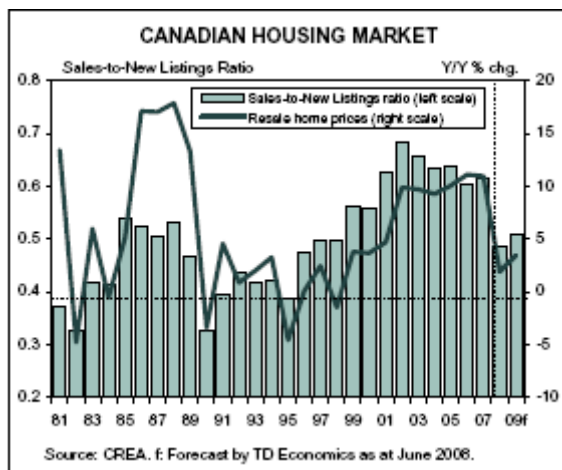


Table 2: Canadian Housing Market, www.td.com/economics

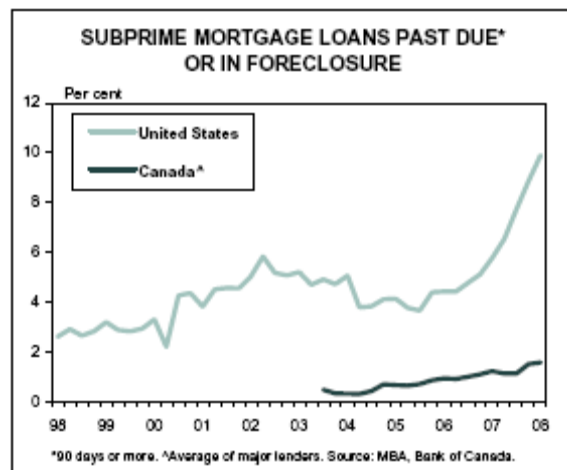


Table 3: Subprime Lending in Canada, www.td.com/economics

Despite recent cooling, participants in Canada's real estate market can be rest assured that a US-style bust is unlikely here (see Table 3 above). This is due, in part, to less speculative buying, more conservative financing and less use of financial leverage in Canada. Many of the schemes and incentives that stoked the sub-prime fire in the US, such as the adjustable rate mortgages (ARMs) with their rock-bottom initial "teaser" rates, never took hold here. It seems, Canadian banks may just muddle through this mess with their shirts still on their backs.

In fact, the US situation has forced Canadian government and regulators to reign in aggressive lending practices. Indeed, the Canadian Government's CMHC (Canadian Mortgage Housing Corp.), an institution akin to Freddie and Fannie Mac, has declared it will no longer accept mortgage insurance applications for 40-year amortizations or 100 per cent loan-to-value mortgages after October 15, 2008. Such efforts to clean up Canadian underwriting practices in residential mortgages may add insult to an already injured market by disqualifying a large number of prospective home buyers.

Regional Strength in Atlantic Canada

The Maritimes' real estate market has benefited dramatically from the growing oil and gas industry, which is newly employing the farmers and fishermen who were ready to pick up their families and head West. The record-setting high price of crude oil has fuelled continued investment into technology, exploration and drilling across Canada and particularly in Atlantic Canada. Promising regions include offshore Newfoundland, and Nova Scotia. In New Brunswick, the Liberal provincial government has boldly announced its intent to become self-sufficient by 2026 (equalization payments are now 25% of total revenue) by moving to an unbeatable flat tax

system that aims to make the province irresistible to investment. Moreover, there is 15 billion in capital projects in the pipeline which includes expansion of the Irving refinery, already one of the

largest in the world. Halifax ranks in the top three housing markets in Canada based on activity, with a sales-to-new-listings ration above 0.6, making it still a Seller's market. And so petro-dollars and capital expansion projects will not only serve to fuel the Atlantic regional economy, but will also provide downside protection to Atlantic Canada's real estate markets.

EXISTING HOME SALES					
Per cent change					
	2005	2006	2007	2008F	2009F
CANADA	5.0	0.0	7.6	-14.8	3.0
ex Alta	3.7	-2.0	9.7	-10.8	2.8
N. & L.	-1.7	10.2	28.4	13.4	-2.2
P.E.I.	-3.4	3.0	18.6	-8.6	0.3
N.S.	23.1	-3.3	12.1	-5.3	1.6
N.B.	14.3	4.2	14.5	-7.2	3.8
Quebec	2.0	2.6	10.8	-4.5	3.6
Ontario	-0.2	-1.1	9.5	-12.5	5.7
Manitoba	5.5	2.0	7.0	-4.4	4.0
Sask.	1.7	10.0	31.9	15.2	-3.1
Alberta	14.6	12.9	-3.9	-40.2	4.6
B.C.	10.3	-9.1	6.4	-17.4	-3.0

F: Forecast by TD Economics as at June 2008
Source: Canadian Real Estate Association

Table 4: Percent change in existing home sales across Canada as at June 2008 illustrates regional leadership in Atlantic Canada
www.td.com/economics

Outlook for Canada's Real Estate Market

While expert consensus anticipates a low single-digit gain in home prices across the country (TD bank calling for 2%), regional trends will contrast sharply. Previous price appreciation in Alberta has made homes unaffordable. And as additional new housing inventory comes to market, Alberta's major markets will see further weakness. Saskatchewan and Newfoundland are expected to continue to buck the national cooling trend, posting double digit gains through this year.

Moskowitz Capital Management's strong performance through mid 2008 continues *despite* and in part *because of* the US housing crisis. We have long held the belief that through these turbulent markets, taking the position as a **mortgage lender**, provides downside protection in a contraction. While we first made the case for mortgage lending in 2005 on our web site (see below), today's market turmoil only reinforces our position. With cautious optimism, we anticipate economic trends in Canada's real estate market to remain favourable for *our type of lending* into the foreseeable future.

Sincerely,
MOSKOWITZ CAPITAL MANAGEMENT INC.

Brian J. Moskowitz

Why lend against real estate as opposed to owning real estate?

Conventional real estate investment involves direct ownership of property, and personal financing from a bank where one assumes the liability. Investing in a first mortgage positions you as the lender, not the borrower, and provides you with the security of being in a first position against the value of the property.

This offers downside protection in a market with falling real estate values. Should real estate values drop, the mortgage investment would *not* be impaired. For example, a first mortgage worth \$600,000 is secured against a property valued at \$1,000,000. If the market drops by 20%, the margin of safety is reduced but the mortgage's yield remains unchanged. In other words, the borrower's mortgage payment remains the same. On the other hand, direct ownership of real estate in a market that drops 20%, would expose the owner to loses of 50% of his equity upon the sale of the property. Therefore, if one wants to participate in the real estate market but desires protection from the potential for future price declines, invest as a lender not an owner.

<http://www.moskowitzcapital.com/investors.shtml> (2005)