

*“... buy when others are despondently selling and sell when others are greedily buying.”*

*John Templeton*

As we enter 2007 we are again witnessing a period when investors are greedily buying. The absence of fear and complacency towards risk truly astounds us. As is usually the case, the cause for optimism and complacency is rooted in sharply rising short term security prices.

Signs of excessive optimism; recklessness in our view abound:

- **The S & P 500, NASDAQ and TSX posted six month returns of 12.74%, 11.20% and 12.54% respectively. These unsustainable performance numbers translate into annualized gains of more than 20%;**
- **Shares of small capitalization companies are up sharply and have outperformed large capitalization equities by a substantial margin;**
- **Low quality and highly levered issues are priced at historical premiums; particularly when compared to their high quality peers;**
- **Junk bonds and complex, highly leveraged debt instruments abound and continue to proliferate;**
- **Emerging market equities are trading at historically high levels;**
- **REITS, once viewed as safe investments for conservative income oriented investors are now yielding less than ten year government notes;**

- **Equity markets have not experienced even a moderate decline in more than six months and volatility measures are at all time lows.**

**In addition, indicators such as investor sentiment, margin debt and advisor bullishness are all in record territory. Value Line’s market indicators are all signaling market tops.**

**Our favorite guidepost; the dividend yields of the major indices are all below their long term averages as illustrated below:**

	<b>Div. Yield</b>	<b>L.T. Avg.</b>
<b>TSX</b>	<b>2.4%</b>	<b>3.5%</b>
<b>S&amp;P 500</b>	<b>1.8%</b>	<b>3.5%</b>
<b>Dow Jones</b>	<b>2.1%</b>	<b>4.4%</b>

**Should the equity markets return to their historical average dividend yields, the losses to portfolios and heartache suffered by many would be significant.**

**We believe that the recent market run-up has been caused by two factors; the global liquidity glut that currently exists and the belief that the Federal Reserve has engineered the perfect economic scenario.**

**The huge amount of money sloshing around the global economy is unprecedented. The source of these funds is a combination of “petro-dollars” looking for a safe haven, central banks seeking diversity out of U.S. dollars and large pension funds hoping to meet their growing liabilities by chasing higher and riskier returns. The cumulative result of all of this capital searching for investments has resulted in the excesses that we discussed above. In our view, every asset class is now overpriced. Returns from current levels are not only**

likely to be very low but also very risky. Inevitably some event, usually random and unforeseen, will shut off the money spigot and this global liquidity will contract. When that event occurs; look out below!

Market participants believe that the Federal Reserve has engineered a “soft landing” for 2007; a perfect economy. Growth is expected to moderate to sustainable levels while interest rates and inflation are forecast to fall. In addition, this perfect scenario envisages corporate profitability that is expected to continue growing at a double digit rates and remain at record levels as a percentage of GDP.

In our view, this optimism is premature; significant risks are being overlooked. Both the housing and automotive sectors are experiencing serious declines. Companies in both industries are reporting steep declines in activity and profits. Historically a steep drop in these important drivers of economic activity has foreshadowed a significant slowdown in GDP growth.

Mortgage companies and sub-prime lenders are also reporting higher loan losses and delinquencies. The highly levered U.S. consumer is starting to show the strain of too much debt in the face of declining home values and a continuing negative savings rate. Should this condition spread to a wider number of Americans a slowdown will surely follow. Because the U.S. has been the engine of global growth the slowdown could turn into a global recession. Again, look out below!

In times like this it is understandable that people get excited. The feeling of optimism is reinforced by the “crowd.” It is easy to believe that trees do grow to the sky and that the sun always shines. But the history of financial markets shows us that it is precisely during these times that caution should prevail. Mr. Market always seems to show us that risk does exist; especially when it is least expected.

At PCM we have been cautious and conservative for some time. As we have discussed in past newsletters ([www.patientcapital.com](http://www.patientcapital.com)) the mathematics of investments dictate that the prudent approach prevails in the long run. Times like these make it more imperative than ever that we stay the course. To paraphrase the wise words of John Templeton ... “the time of maximum caution should be when optimism is greatest.”

In closing, may 2007 bring you and yours much happiness and health.

Vito Maida

January 30, 2007