

Easy come! Easy go!

That's what we can say about 2007's stock market returns. As all of you have heard or read in the news media stocks have dropped quite sharply over the last several days of January. In just a few days, the TSX has dropped more than 1,500 points or 11.4%, wiping out all of 2007's gains. As of this writing, Canada's main equity market was at the lowest closing level since November 2006.

The reasons for this sell off are many and varied. U.S. housing values have collapsed and resulted in a significant loss in personal net worth. As a result, consumer confidence has started to fade. Recent economic indicators have begun to wane including rising U.S. unemployment coupled with rising prices for food and energy. North American auto sales have begun to weaken and U.S. retailers have reported disappointing holiday sales.

Several U.S. financial institutions have reported serious setbacks. Losses on bad investments and loans have so far totaled more than \$100 billion. Some have turned to foreign investors to remain liquid and solvent. More losses are expected and as a result banks have tightened lending standards to consumers.

The above noted concerns have raised worries among investors that the U.S. economy is headed for recession. These fears have been further stoked by weak fourth quarter earnings at prominent companies and more importantly their cautious outlook for 2008. The possibility of faltering earnings in a weakening environment coupled with a whiff of inflation has put market participants in a skittish mood. As a result, investors that were recently very optimistic are now frightened.

We view economic contractions as a very normal part of the business cycle and welcome such times as an opportunity to purchase excellent businesses at very attractive prices.

However, the current situation gives us more cause for concern about future economic conditions than is usually the case. As we have often discussed in our previous newsletters (archived at www.patientcapital.com) the total amount of debt in the American economy has increased dramatically over the last several years. As the charts below illustrate, (all courtesy of The Chartstore.com) total debt and more importantly total debt as a percentage of GDP are at all time highs.

Chart 1

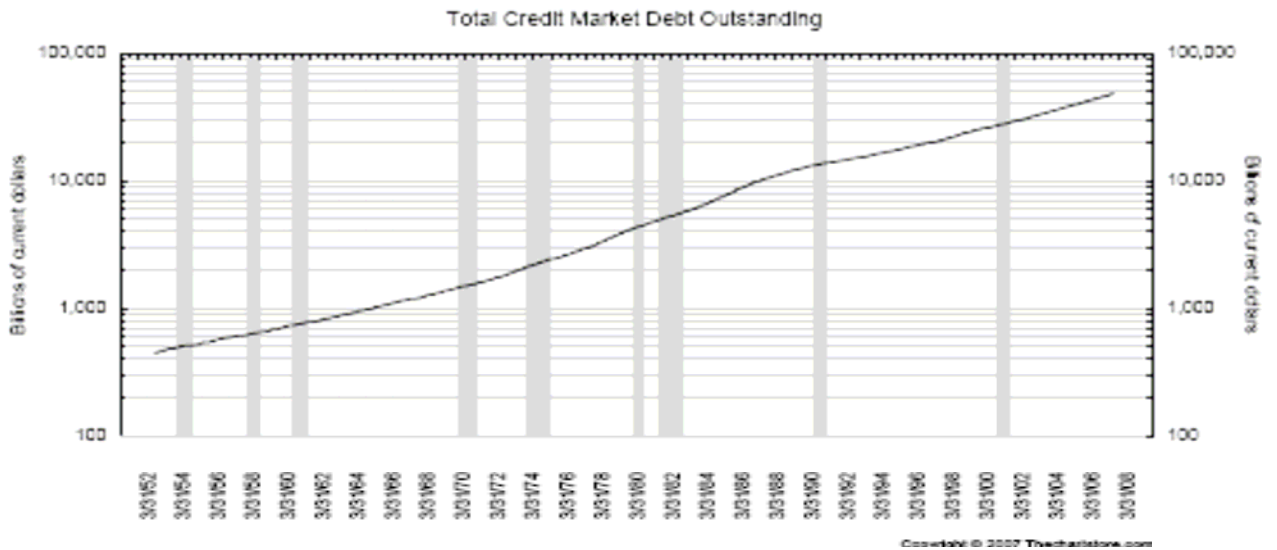
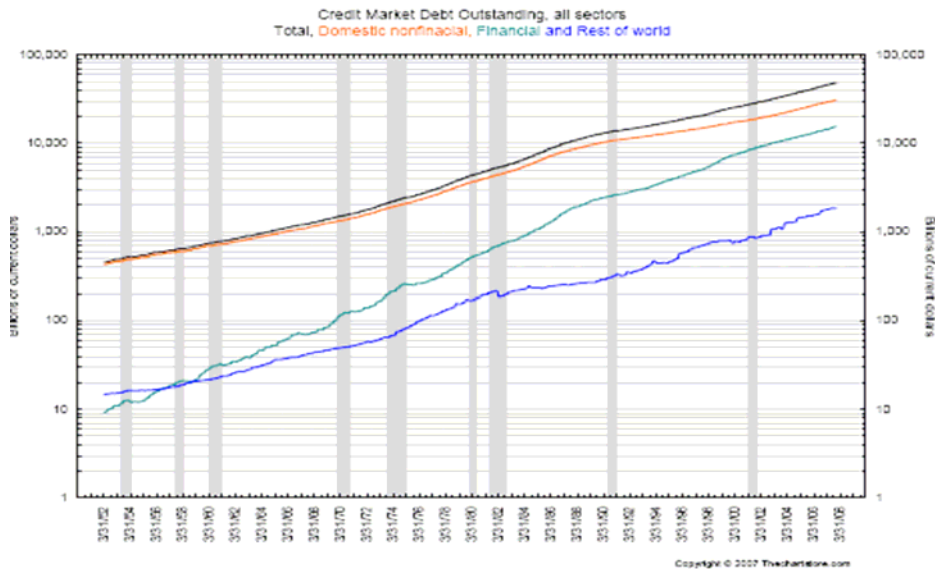


Chart 2



Furthermore, this excessive credit expansion occurred in all areas of the economy; including non-financial credit, financial debt and global debt. Chart 3 shows the dramatic growth in debt across all areas.

Chart 3



All of this debt manifested itself in numerous ways. Consumers leveraged their homes through mortgages and sub-prime debt, purchased cars with auto loans and ran credit card balances to all time highs. Corporations leveraged themselves to buyback their own shares and buyout funds borrowed vast sums of money to take public companies private. Most troublesome of all, global financial institutions and hedge funds borrowed heavily to invest in exotic and complicated financial products that are now beginning to unravel.

It is this huge debt burden that deeply concerns us. Much of the debt that has been accumulated is unsustainable and unsound. As a result, a period of credit contraction and falling asset values will surely follow. It has been our observation that such contractions coupled with a large number of troubled financial entities can be very painful and have the potential to spiral out of control.

The above discussion and related concerns are now being given prominent attention by the popular media and market pundits. However, aggregate equity valuations do not reflect the risk that the current environment poses or the downbeat mood of many market participants. As the following graphs indicate, valuations are still far above their long term averages and nowhere near the valuations that existed at other times of financial stress.

Chart 4 graphs the total value of U.S. equities relative to GDP or the value of the entire economy. As we can see, equities are trading substantially above their long term average and higher than at any other period except for the tech bubble of the late 1990's.

Chart 4



Charts 5 and 6 also reinforce our view that equity markets are not “pricing in the risks” that have caused investors, central bankers and government officials to become quite nervous. The Dividend Yield of the S & P 500 is below its long term average and the P/E Ratio of the S & P 500 is above its historical average.

Chart 5

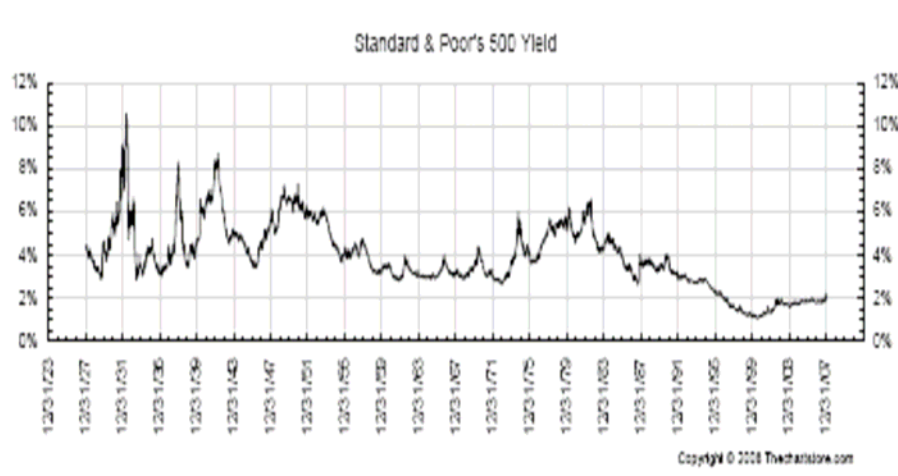


Chart 6



Valuation statistics for the TSX mirror their American counterpart. The TSX is also trading substantially above its long term value. The problem in Canada is exacerbated by the fact that the actual investable universe of Canadian equities is quite small and that the Canadian market is dominated by the commodity and financial sectors.

The recent market volatility has allowed us to deploy some of our large cash balances. We have added to existing holdings and invested in two new positions. Our patience, discipline and focus on purchasing very high quality businesses at exceptional valuations is literally starting to pay some very large dividends! We get quite excited when we think about the low risk high return possibilities that may come our way in this environment.

Mike Nadal resigned recently. Mike made significant contributions to PCM. He introduced PCM to many new people, helped to raise our level of client service and was instrumental in redesigning our website. We wish Mike all the best in his future endeavours.

Domenic Rinaldi will assume PCM's client service responsibilities. Domenic is a PCM partner, has worked with many of you in the past and knows your portfolios intimately. In order to free up some of Domenic's time we have hired another individual to take over some of Domenic's previous administrative responsibilities.

As we embark upon 2008 we would like to thank our many friends and associates for their encouragement and support during the past year. Most importantly, we would like to thank you, our clients for entrusting your capital to us. On all counts we are truly blessed.

We wish all of you and your families much happiness and health in 2008.

Vito Maida

January 2008