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## The Angle

Issue 3 - Sept 20 2007

Welcome to the third issue of The Angle. In this issue I will be trying to explain the "sub-prime blues" as well as looking at the year to date performance of primary investment assets & markets, but first some Ark Finance news.

### Team News

We welcome Mary Sherlock to the team. Mary will be focused on the administration of financial services. Mary has previously worked for Royal Liver Assurance and has held a number of administrative roles in both the UK and Ireland.

We sadly say goodbye to Lisa Fagan who returns to complete her degree later this month.

### Morton on Newstalk

Morton was recently a guest on Newstalk's Down To Business show. The discussion centered on the "Wealth of the Nation" report, published by Bank of Ireland. You can hear a recording of the discussion on our web site news store section, or by following this link. >>

<http://www.arkfinance.ie/download/?guid=62e3c3c8-6cdf-4a63-9976-7b7bc849b538>



### 2007 The Story so far

**Equities** – Based on historical stock market trends, there was a view that equity markets would return to normal levels of volatility this year. The continuous uninterrupted Bull Run, which commenced in March 2003, had to face periods of volatility at some stage.

Despite regaining much of the lost ground in quarter 2 this year, primary global markets have seen a period of downward movement during the summer. It could be argued that this is not "normal" volatility, as markets lost double digit % value over a few weeks, on the backdrop of continued strong corporate earnings growth.

### Subprime Blues -

Many headlines pinpoint sub prime lending in the US as being the key issue, but it's more complex than that. Certainly poor sub prime lending by US banks was the catalyst for the downward movement in markets. But there are many non financial companies out there producing strong earnings growth which have seen their share price decrease.

The core issue; is that Banks had loosened their purse strings across the board and have let their lending standards slip in the chase for profits. Once seen as the epitome of risk adversity and cautiousness, Banks globally had been increasing their risk appetite. They are not that hungry any longer.



As can be seen from the table below, of sub-prime mortgage data (source IMF); there has been an increase in interest only mortgages and mortgages issued with low levels of documentation (such as income certification). These mortgages have been issued to applicants with poor credit history and who have not been able to secure a mortgage from a prime (main) lender. Yet remarkably the sub-prime bank's underwriters have been more flexible with the lending criteria than the prime lenders, who are lending to quality applicants.

### Underwriting Standards in Subprime Home-Purchase Loans

	ARM Share	Interest-Only ARM Share	Low- No- Doc Share	Debt Payments-to- Income Ratio	Average Loan-to- Value Ratio
2001	73.8%	0.0%	28.5%	39.7	84.04
2002	80.0%	2.3%	38.6%	40.1	84.42
2003	80.1%	8.6%	42.8%	40.5	86.09
2004	89.4%	27.2%	45.2%	41.2	84.86
2005	93.3%	37.8%	50.7%	41.8	83.24
2006	91.3%	22.8%	50.8%	42.4	83.35

*... due to a relaxation of credit standards, particularly in issuance of interest-only adjustable rate mortgages and mortgages with little documentation.*

Sub-prime mortgages have higher interest rates and can be very profitable for the lender, if the level of defaults experienced is within an acceptable level. Through poor underwriting, banks who lend into this market are now exposed. One of the key issues facing global equity markets is that nobody really knows, or is telling, how exposed these banks are and worse still, which banks are exposed.

Many of the mortgage books from US sub-prime banks have been resold (known as securitisation) across the globe to investors. These products have been resold to investors through other banks, or through hedge funds. Some of these investors have invested with borrowed money, banking on the margin between the return on the security and the interest rate on the borrowed equity. Now many of these investments are worthless.

Banks have pulled back on lending, notably to each other. This has caused a reduction in the amount of credit (money) available for lending purposes. If growing companies have difficulty gaining credit from banks, they cannot grow. An example would be the take over of another company, which has been a large contributor to equity markets growth, particularly in Europe. The central banks in the US, Euro land and the UK have stepped in recently to provide Banks with credit, such as Northern Rock in the UK. These measures do not occur often and coupled with the pause in the ECB increase in base rates and the 0.5% reduction in the US Fed rates, underlines the seriousness of the situation.

The problem now is one of uncertainty and until the passing of time with no more major "sub-prime" bad news, markets will remain jumpy. The worse case scenario is that continued uncertainty and the lack of credit, will be a cause for a period of recession in global economies.

I certainly feel that there are real equity bargains out there, especially established companies who are cash rich and can fund much of their own expansion. I would hope that the worst is over and that markets can regain the earlier growth seen this year, however it would appear that the US economy could be facing a recessionary period.



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**Europe** – The overall Europe S&P350 market index is flat on a year to date basis. Although markets have been troubled year to date, the Irish index [ISEQ] is considerably behind other European markets showing a year to date value loss of -16.9%, this in contrast to a 27% annual return in 2006. The German [DAX] is showing a strong year to date return of 13% despite loosing ground during the last few turbulent months. The UK FTSE100 is up 1.1% in local currency terms.

I would continue to hold a positive view on European stock markets in general. As, I stated in May's edition, I would continue to hold a "reduce" exposure to the Irish stock market. The ISEQ index is primarily made up of the large financial stocks (BOI, AIB, Irish Life) which have experienced a double hit from the slowdown in mortgage sales / construction activity and the global "credit crunch" as it has become known. But there are still some nuggets on the Irish market which may provide value at current valuations, notably; Anglo, C&C and IAWS. These companies have capacity to continue to grow earnings in international operational markets and are not dependant on the Irish economy for continued earnings growth.

Market	Index	Year to Date Return 31.12.06 to 14.09.07		1 Week Return 07.09.07 to 14.09.07	
		Local Currency %	Euro %	Local Currency %	Euro %
US	S&P 500	4.7	-0.4	2.1	1.5
US	NASDAQ	7.7	2.5	1.4	0.8
Europe	FT/S&P Europe Ex. U.K.	2.4	2.4	1.1	1.1
Ireland	ISEQ	-16.9	-16.9	-4.5	-4.5
UK	FTSE 100	1.1	-1.3	1.6	-0.1
Japan	Topix	-8.1	-9.6	-0.8	-2.9
Hong Kong	Hang Seng	24.7	18.6	3.8	3.2
Australia	S&P/ASX 200	11.2	13.0	0.5	1.6
Bonds	Merrill Lynch Euro over 5 year Govt.	0.3	0.3	-0.2	-0.2

**USA** – The US S&P 500 index has returned 4.7% year to date growth in USD. However for euro investors who are fully exposed to foreign exchange movements, this translates into a loss of -0.4% in euro terms. In general I would continue to minimize short term exposure to USD equity investment, unless the foreign exchange exposure is hedged. The dollar will continue to depreciate against the euro if the fed is on a downward rates movement without reciprocation by the ECB. On today's FX markets the USD/Euro FX rate has now breached the 1.4 USD/Euro level and FX futures prices support that being a year end position.



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**ASIA** – [China's SSE \(Shanghai Composite Index\)](#) breached the 5,000 mark in late August and is up 95% on a year to date basis (no, I did not leave out the decimal place – ninety five per cent!). While earlier in May I highlighted concerns of a bubble in the Shanghai market, I certainly think the valuations of stocks on the SSE would indicate a correction should be expected, P/E ratios of 45 are now the average, some stocks at a P/E ratio of 100 plus!



Yes, that economy is growing fast and yes there are reasons to believe that there will be strong earnings growth in the years ahead, but the valuations of some stocks is now reaching stratospheric levels. Many university students have walked away from attending lectures to day trade, banking on trade tips for choosing their daily bets. There may be more to run on the Chinese stock markets, but the prices are not for the faint hearted as there is a long way to fall if there is a market correction. I think a safer way to invest in the continued growth of the Chinese economy is to look at established global brands which are introducing their products for sale in China. Therefore you are investing in a euro denominated company which is managing the risks associated with expanding into the Chinese marketplace.

[India's BSE – Sensex index](#) is now up 11% on a year to date basis. The Indian economy is on track to grow by 9% this year the medium term outlook for the economy there is positive. I like the steady growth in the Indian economy over the last several years and the more realistic stock valuations. Exposure to this market is possible through a specialist managed fund or an ETF such as the MSCI India Index Fund (INP).

The established Asian markets [Japan Topix](#) is down -8.1% on year to date basis and the [Hong Kong - Hang Seng](#) is up 24.7% LC year to date. This validates my view; that the Hong Kong market was the market of growth for 2007, given its direct links to the Chinese mainland economy.

The Australian market is up a healthy 11.2% LC year to date. Although not a market that attracts much interest from European or US investors, Australia is certainly a market which appears to be reaping gains on the growth of the Asian economies.

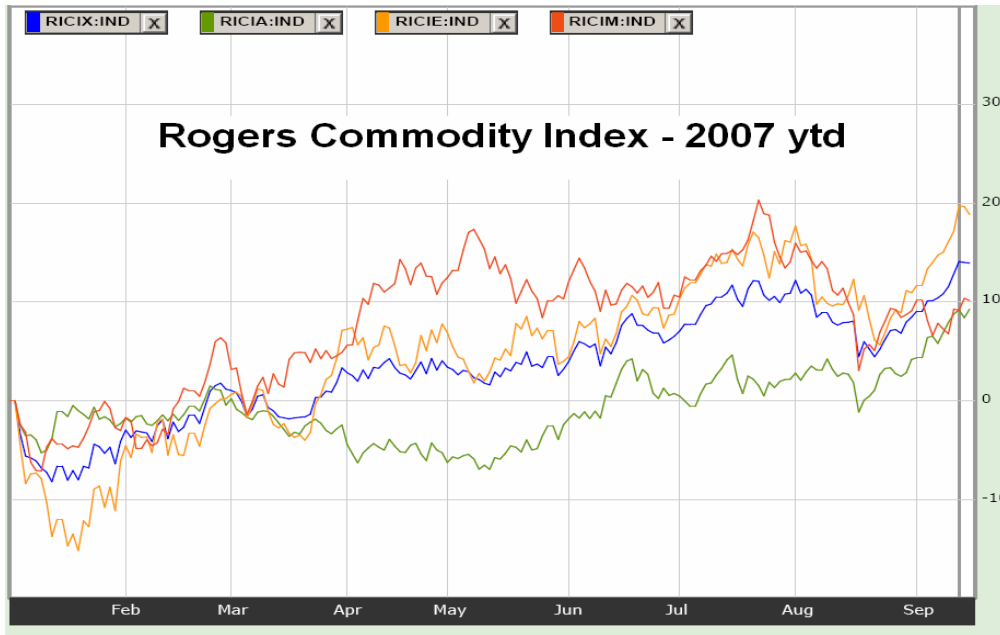
I would continue to take a positive medium to long term view of Asian market growth. The Indian market and the Hong Kong market, in particular being my picks.



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**Commodities** – The overall Rogers Commodities Index (blue line in graph below) is up 17.9% year to date to close on Sept 14<sup>th</sup>.



The chart above shows that the sub-index with the most year to date gains (26.2%) is the **energy index** (RICIE – orange line); which is made up of oil, refined oil products and natural gas. Brent oil is now priced over \$76 a barrel, in January it was traded at as low as \$51 a barrel. US crude oil has just breached the \$80 a barrel level with some analysts expecting a year end price of \$85 or above.





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**Metals** – The metals sub-index (RICIM – red line) has continued to grow, with an increase of 12.9% since the start of the year. There have been significant changes in base metal prices since May. These include, Nickel which was up 59% on a YTD basis in May, now down -13% on a year to date basis. Prices of Zinc continue to fall, now down -35% from the opening price in January. The price of Aluminum is also down -18% compared to a year to date gain of 34% back in May. Reasons you ask? Firstly, it is due to the slowdown in US house building, which consumes a lot of byproducts of these metals. Secondly the Sub-prime blues! Investors have sold off holdings in commodities to cover losses in investments associated with sub-prime mortgages. Thirdly, the concerns related to a global recession which would see a slowdown in economic activity and in parallel a slowdown in demand for base metal products.

Lead is now up 84% on a year to date basis, this is down in part to a drop in stocks of the metal which is currently held and increasing Chinese consumption.

<b>Metal Price Trends 2007</b>				
		<b>Latest Price</b>	<b>Opening 2007</b>	<b>Movement YTD</b>
<b>Nickel</b>	\$ / t	29,210	33,550	-13%
<b>Zinc</b>	\$ / t	2,766	4,259	-35%
<b>Tin</b>	\$ / t	14,975	11,620	29%
<b>Lead</b>	\$ / t	3,181	1,725	84%
<b>Copper</b>	\$ / t	7,540	6,201	22%
<b>Aluminium</b>	\$ / t	2,316	2,830	-18%
<b>Silver</b>	\$ / oz	13	13	0%
<b>Palladium</b>	\$ / oz	337	332	2%
<b>Gold</b>	\$ / oz	723	640	13%
<b>Platinum</b>	\$ / oz	1,312	1,136	15%
<b>Uranium</b>	\$ / lb	85	72	18%

On precious metal prices, the only significant movement has been a drop in price of Palladium, which peaked at \$382 in April, is now down 12% off that year to date high point. Although categorised as a precious metal, Palladium is an industrial metal and is open to price volatility levels similar to base metals.

**Uranium** which private investors cannot buy for obvious reasons is now priced at \$85 a lb, down from a high of €135 in July. Prices rose dramatically over the last 12 months as there were incidents at two mines which will delay the production from those two sources. One of those mines belongs to a stock in my own portfolio - Cameco (Cigar Lake), which hurt the stock price. It would appear that the problems with those mines are being sorted and they will reach production phase sooner than was first expected. So, price reaction (pardon the pun) upwards, following this bad news on the supply side, has now eased. I hold the long term view that nuclear energy will form a large part of the energy source for the future and prices will regain. Apart from this view, there are a number of nuclear reactors which will soon require decommissioning and new plants constructed, so even standing still there is an ongoing demand for uranium.



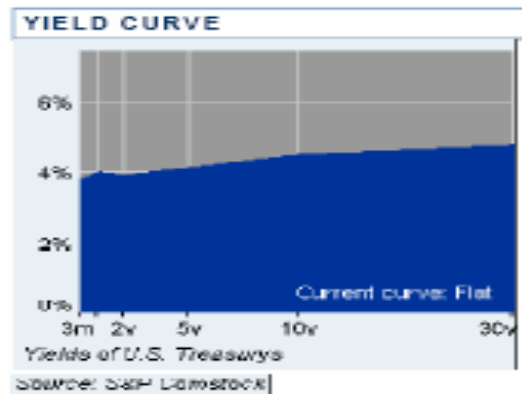
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**Bonds** – With the recent uncertainty in equity markets the bond market has attracted inward movement of funds, reducing short term bond yields (increasing prices). Year to date the Merrill Lynch Euro government bond index is showing a year to date return of 0.3% this may increase depending on where investors funds flow over the coming months.

The US Treasury Bond yield curve is now flattening. The difference in yields between short term (4%) and long term (4.8%) treasury bonds, has reduced, which according to analysts could point to a period of recession and lower interest rates. The news of August US house starts being the lowest in 12 years would support this view.



## Property –

**Ireland – Residential** – According to the PTSB House price index, National house prices have reduced by 2.6% in the first 6 months of the year, with year on year price growth of 0.9% in June. Commuter belt prices have reduced 3.9% for the first six months of 2007 with 0.9% year on year growth to June. Interestingly Dublin prices are up 4.1% year on year to June.

Market activity continues to be slow, with prices continuing to soften. However there does not appear to be any panic in the market. No one is taking large drops in price just to close sales, but it would appear to be still a buyers market.

The good news for investors is that rents are increasing and that the supply of new property is slowing as developers cut back on the size and quantity of residential developments. Also as a result of central banks attempts to solve the "credit crunch", ECB rates are now looking to be at peak levels. I expect the next move in ECB base rates will be downwards. However prior to this, Bank lending rates will increase in the short term, as credit markets remain "squeezed". We know of at least one Irish bank who is reviewing their tracker and fixed rates on mortgage products. Such a move will not help the current market.

**Ireland – Commercial** – As one would expect in a period of economic uncertainty, there has been a reported slow down in commercial property investment activity in Ireland when compared to 2006. Dublin office letting activity has been very strong in 1H 2007. Industrial property values have stabilised, as have industrial yields. CBRE are forecasting 12% ungeared returns for commercial property in 2007.

Prime Yields	
Retail High Street	2.50%
Retail Shopping Centre	3.50%
Office	3.75%
Retail Warehouse	4.25%
Industrial	4.75%



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**UK – Residential** – The August Halifax UK House price index shows annual UK residential price inflation at 11.4 %, with a monthly national price increase of 0.4%. There has been a slow down in the rate of price growth nationally, this is due mainly to The Bank of England increase in the base rate to 5.75% in early July. Despite the slowdown in price appreciation, the annual figure still looks set to at least repeat the 9% price gain seen in 2006. Regionally Northern Ireland prices are up 46% annually to end of June. Newtownards Co. Down is the UK's top property hotspot, recording a 64% rise in prices over the past year!

**UK – Commercial** – Despite some very large deals lead by Irish investors – Quinlan Private (£700M London Docklands - 50% interest) BOI Private (£309M Liverpool – 50% interest) and Oregan Financial (£109M London City) which attracted funds from some of our own clients, demand for UK commercial property has softened. This is in part due to the higher costs of financing deals, but also the ongoing compression of yields. Investors are seeking prime properties, in prime locations with gilt tenants. London remains the most attractive location at present, with focus on property with redevelopment potential. CBRE are out looking a full year 10% ungeared return for UK commercial.

**Prime Yields**

Office (West End)	3.50%
Retail (High Street)	4.00%
Retail (Warehousing)	4.00%
Offices (City)	4.25%
Office (Provincial)	4.50%
Shopping Centres	4.75%
Industrial	5.00%

**IPD UK Monthly Index: End August 07**

	Property IPD	Equities FTSE All Share	Gilts FTSE 5-15 year
Total return % over the last			
12 months	9.9	11.8	0.9
6 months	3.2	4.2	0.7
3 months	0.8	-4.3	2.9
1 month	0.0	-0.3	1.8
Year to date:	4.6	3.7	1.1

The most recently published IPD UK commercial property index (to end of August 2007) shows a 12 month total (ungeared) return of 9.9%, with 4.6% total returns for year to date.



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**My revised 2007 investment asset split (not necessarily yours)**

<b>Equities –</b>	<b>50%</b>	5% Ire 10% UK 20% Europe (excl. UK & Ire) 15% Asia (excl. Japan)
<b>Property –</b>	<b>40%</b>	20% UK (Mixed Commercial) 20% Euro Property (EPRA Index)
<b>Commodities –</b>	<b>10%</b>	5% Uranium (Cameco) 5% Commodity Index

*Note: I have split property exposure between UK market and European property. I have reduced exposure to uranium and transferred 5% into a general commodities index (RICI).*

**By Morton Rennick - QFA ACMA**

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