

PERSPECTIVES

An exclusive report from TD Waterhouse Private Investment Counsel Inc.

U.S. Sub-Prime Lending and Your Portfolio

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Over the past month, North American stock markets have been hard hit, falling sharply from record highs recorded in mid-July. The TSX Composite has, at the time of writing, fallen about 15% from its July 19 peak while the U.S. Standard & Poors 500 Index has slipped 13%. Both markets are down slightly for the year to date though well above levels of only a few years ago. Chart 1 provides some perspective.

Sub-Prime Loans – A Primer

The principal culprit for stock markets' queasiness is the well-publicized sub-prime lending in the U.S. Exactly what are sub-prime loans and why have they become a problem? Let's explain.

In the wake of 9/11, the U.S. Federal Reserve (the "Fed") was worried about a possible deep recession or depression. To stimulate the economy and ward off such an event, the Fed cut short-term interest rates to 1% (see Chart 2), the lowest level in half a century. These ultra-low interest rates touched off a housing boom, as low mortgage rates stimulated demand for houses and home prices rose sharply in response to rising demand.

With credit cheap and plentiful and

home buyers clamouring to get in on the action, some U.S. mortgage lenders adopted looser lending practices. Some mortgages were granted with little or no money down, interest-only mortgages became more common and loans were granted to less creditworthy borrowers.

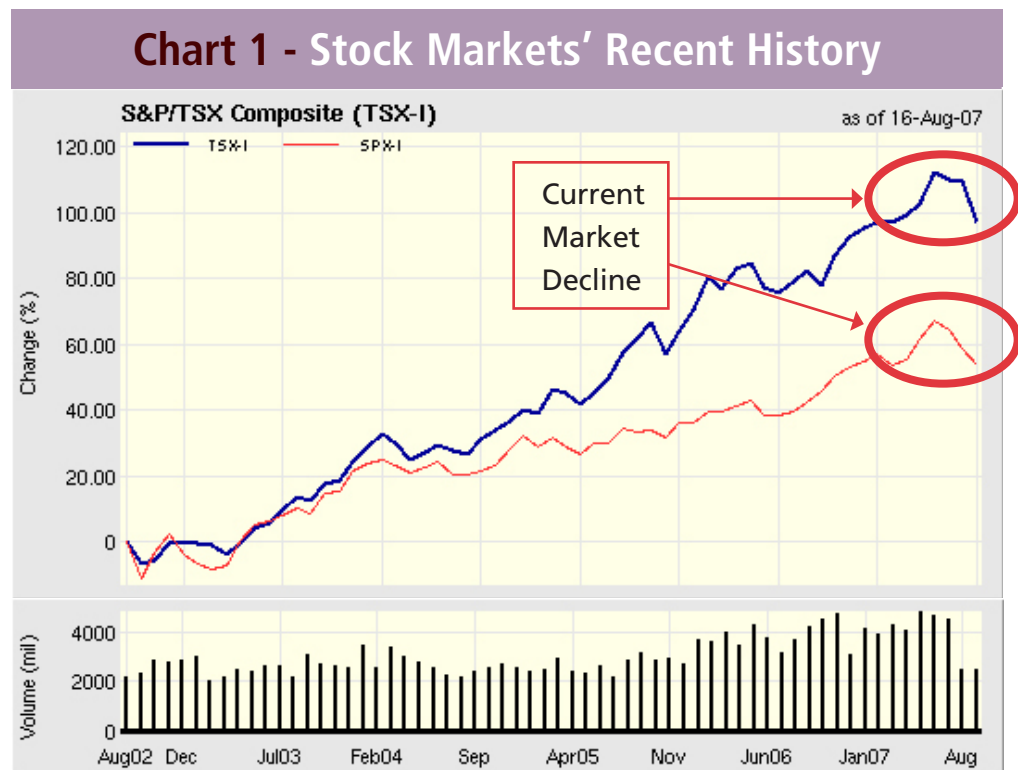
These lower quality or "sub-prime" loans amounted to 20 – 25% of all U.S. mortgages granted in 2005 – 2006 and currently represent roughly 10% of

outstanding mortgages in the United States.

The Current Problem

As U.S. short-term interest rates rose from mid-2004 until mid-2006, the resultant flattening of the yield curve and tighter credit conditions left sub-prime borrowers on the horns of a dilemma.

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Source: The Globe and Mail

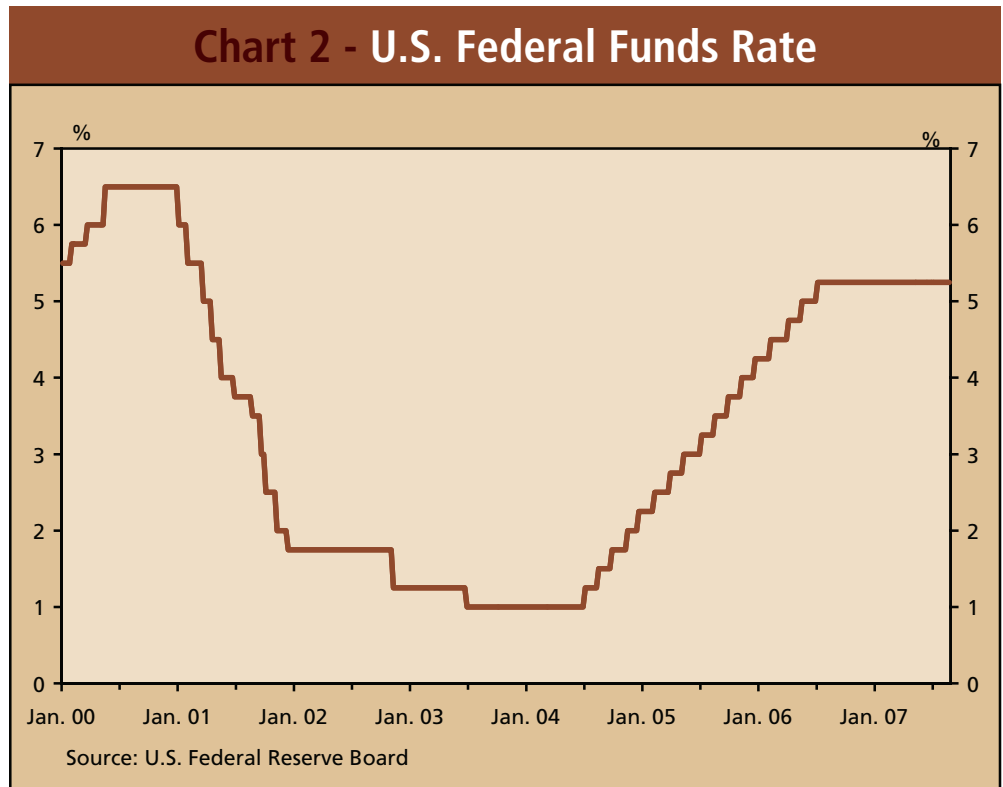
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Many such borrowers had taken out adjustable rate mortgages (ARM's) when rates were very low. As rates increased, the monthly mortgage payments of these borrowers increased and many have found it difficult to meet their payments. This has been compounded by the fact few sub-prime borrowers have much equity in their homes, so they were not in a position to re-finance and lower their payments.

The initial impact of these borrowers' difficulties has been an increase in sub-prime mortgage delinquencies, which have risen to a current 3 % versus half that earlier this decade (See Chart 3). Note this is an average figure for all sub-prime mortgages. Those granted most recently, in 2006, are generally weakest in terms of credit quality, with delinquency of 6.5%, a figure likely to rise further over the coming year. Not surprisingly, lenders such as Countrywide Financial, the largest American home mortgage lender, have suffered as they have had to write down these bad loans. There are, however, other less obvious casualties.

Most U.S. mortgage lenders do not keep the mortgages they originate on their books. Rather, they sell the mortgages to investment dealers, who package the mortgages as bonds, which are ultimately sold to investors. These bonds are typically called Collateralized Debt Obligations (CDO's) or Asset Backed Securities (ABS's). As the sub-prime mortgages held within these securities have declined in value, many investors have unwittingly found



themselves holding these bonds of dubious quality. Investors have recorded sharp losses, the cost and availability of credit has been affected for many would-be borrowers and this has wreaked havoc in the financial markets.

Our Proactive Stance

The problems of the U.S. housing market and sub-prime debt have come as no surprise. In the January 2006 edition of our sister publication, Investment Outlook, we highlighted impending problems in U.S. housing as a serious issue. Similarly, the Fall 2006 edition noted that our client portfolios had "... very little exposure to the U.S. housing sector, consumer durables manufacturers or the regional banks and sub-prime lenders that could be vulnerable to the real estate slowdown." **The net result**

is that your portfolio has had very limited direct exposure to those sectors that have faced serious damage from the events described above. In addition, the high quality stocks that make up your portfolio have proven resilient in the face of past adverse market conditions and we expect no different in this case.

The high-quality bonds that are held in most client balanced portfolios have actually benefited from the turmoil discussed above. The resultant flight to quality has pushed bond yields down and bond prices up, increasing the value of your bonds and thus helping to cushion the impact of falling equity markets.

Notwithstanding the above, there has been collateral damage as concerns about tightening credit weigh on the

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stock markets. Canadian bank shares are an excellent example. While Canadian sub-prime mortgage debt is negligible and exposure to U.S. sub-prime debt is modest, shares have dropped about ten percent. This will likely prove temporary as analysts ascertain that losses incurred by the banks should be modest relative to overall earnings.

The Outlook

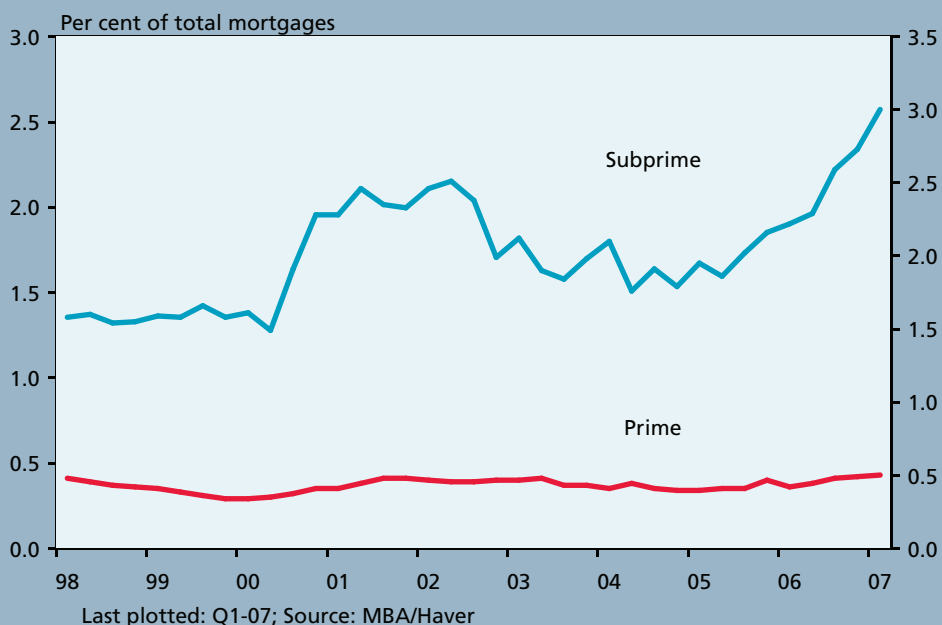
The recent stock market sell-off represents the first significant pullback since Spring 2006. As was the case then, investors' concerns are valid but the fundamentals remain solid. Valuations are reasonable, earnings growth is slowing but positive and the bond market is supportive. **In short, we do not believe recent market weakness heralds a new bear market but that**

we are in a transitory, corrective phase. While the equity markets will likely see above-average volatility in the near term, we expect the solid fundamentals will re-assert themselves later this year and your portfolios will make renewed progress.

Pre-emptive Measures Taken To Protect Your Capital

- Very little exposure to U.S. housing sector
- No U.S. regional bank holdings
- Minimal U.S. sub-prime exposure
- Overweighted in defensive, large-cap issues among U.S. equity holdings
- Underweight U.S. small caps
- Investment grade bonds held, benefiting from flight to quality and cushioning impact of sliding stocks

Chart 3 - 60 Day Delinquency Rates



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