



Should you be worried about the residential real estate market?

Residential real estate markets have captured a larger and larger share of economic activity in recent years. Lately, stories about a frothy housing market and problems with sub-prime mortgages in the U.S. have been capturing a larger share of the headlines, not to mention discussion at cocktail parties and around the office water cooler. How worried should you be?

The answer may depend on which side of the 49th parallel you live on. In Canada, we're far from the panic stage. Although some cities such as Calgary have seen steep price gains in the past year and are in the process of settling, corrections are much more pronounced south of the border in some formerly red-hot U.S. cities. For most Americans, the days of taking real estate price appreciation for granted are over. However, the credit contraction currently underway in the U.S. sub-prime mortgage market is potentially a bigger issue that may cast a wide enough net to snare economic growth in both countries in 2007. Given this risk, it is worth exploring this issue in more detail.

Americans seeing the boom's flipside

For months we've seen news stories about how U.S. homebuilders have been having trouble selling all the new homes they have been building. Soaring prices have already reduced the pool of potential buyers. As prices started levelling out and then falling in many U.S. cities, homebuyers became jittery. It didn't take long before some buyers were ripping up contracts and backing out of homes they had already purchased (even though these homes were still being built). Some luxury homebuilders were reporting cancellation rates of approximately 40% in early 2007. As demand faded, house prices softened. February 2007 saw the 12th consecutive month in which median existing house prices were below year-earlier levels. Over one-half of all U.S. cities are seeing average house prices below year-earlier levels, making this the most widespread period of weakness in several decades.

U.S. sub-prime lending market imploding

If that's all there was to the story, we would probably still say that the U.S. economy could get through 2007 in decent shape. But against this already shaky backdrop, the U.S. sub-prime mortgage market woes seemed to spring up almost overnight (although the issue had in fact been simmering for some time). While the sub-prime lending sector is relatively small (approximately 10% of the stock of total mortgages outstanding), hiccups in this area have the potential to spread to credit markets in general, and are therefore quite important.

Some background to the sub-prime lending sector may be helpful. Over the past couple of years, extremely easy credit conditions encouraged many mortgage lenders to relax lending standards. A very active mortgage securitization market allowed banks to package groups of mortgages into mortgage-backed securities (MBSs) and sell them to investors, who find them attractive

because they offer relatively high yields in a low-interest-rate environment. Unprecedented demand for such higher-yielding products allowed investment banks to source mortgages with a broader credit spectrum – from very secure to very risky – to fill the demand.

At the same time, mortgage lenders were innovating with products such as interest-only mortgages, low-initial-rate "teaser" mortgages that saw payments ramp up rapidly in later years, high loan-to-value mortgages, and mortgage loans that required little proof of income. These products made it easier for people with shaky credit or cash flow problems to afford (or at least buy) a home. At the highest end of the risk spectrum, many lenders specialized in the sub-prime market and offered borrowers these so-called innovative mortgage products.

Chickens coming home to roost

Fast-forward to early 2007: low and behold, it didn't take long for some of the riskiest borrowers to renege on their mortgage payments; in fact, some buyers saw no-money-down homeownership as a low-cost alternative to renting, at least until the sheriff showed up! With most of the stock of outstanding mortgages very new (generally three years old or less) and 40% of mortgages written in 2006 being below the prime lending standards, concerns are mounting that rot has set in to the \$10 trillion U.S. mortgage finance industry.

The latest data shows sub-prime default rates have crept up from 10% in 2005 to 13% today (but are still below their recent peak of 15% in 2002). Very quickly, markets have changed their assessment of the risks in sub-prime lending. Some mortgage originators now have to come up with money to cover defaults in the mortgage

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Worried about the residential real estate market? (cont)

portfolios they have already sold. Financing has suddenly become more expensive for sub-prime mortgage lenders, if they can get it at all. Finally, U.S. authorities are pressuring lenders to tighten standards, reducing the number of potential borrowers that qualify for sub-prime mortgages. Sub-prime lenders face a sharp deterioration in their business model: drastically reduced access to cheap money, a smaller market of potential borrowers, an increased chance that existing mortgages will go into default, and reduced investor demand for these mortgages once they have been packaged into MBS form.

These problems have caused stock market volatility to rise, but so far have mainly affected Wall Street financiers, and have had little impact on the average household. However, the big risk is that the sub-prime problem is just the tip of the iceberg. As perceived risk rises, credit may be tightened further. Mortgages, car loans and general borrowing would become more expensive for everybody, causing already weak demand for homes, vehicles, building products, and consumer durables to get worse. This would spell trouble for the broader economy. House prices would fall further and layoffs in housing-related industries would follow. More people would then default on loans, credit losses would mount, and credit would be tightened further. Liquidity – the fuel of the current expansion – could dry up.



A liquidity crisis is not upon us yet and may never materialize. Certainly, it will take more than a few weeks to determine to what extent the sub-prime mortgage sector's ills have infected general credit conditions. Regardless, the sub-prime mortgage mess has reminded investors of two things. One, that they are not bullet-proof. Abnormally low volatility and tight credit spreads signalled that the market's view of the risk of a negative event was minimal, but we've seen that it's not. Two, the problems for the U.S. housing sector are not nearly over, and more downside is likely, which could mean softer GDP growth for the U.S. in 2007.

The impact on Canada

Canada's main exposure to U.S. housing weakness is through its role as an exporter of lumber and other building products. Exporters have already taken a hit as demand has faltered, but more weakness will come as U.S. homes currently under construction are completed and housing starts fall further. Canada is also exposed to U.S. credit market conditions, as rising risk aversion causes lenders throughout the financial markets to demand a greater cushion of safety (i.e., higher interest rates), and this makes borrowing more expensive for Canadian corporations.

Beyond these factors, Canada's exposure to the sub-prime mortgage issue is minimal. This country has avoided the worst excesses of the U.S. housing market and is consequently in much better shape. Canadian mortgage lenders have not adopted the aggressive lending practices of their counterparts south of the border, in part because there's less competition among lenders, and in part because Canada's housing and financial markets are smaller and less able to support niche lenders or a sufficiently liquid MBS market (though this is changing). As a result, fewer Canadians risk losing their homes when interest rates rise. Canada is also in good shape because mortgage rates continue to be lower than in the U.S. and job growth has been very healthy.

The soaring housing prices in Canada may be levelling off (and, in the most extreme markets, declining slightly) – which is both healthy and expected. Nevertheless, the state of the Canadian economy, real estate market, and household balance sheets suggest that the extensive deflation of the housing market in parts of the U.S. is unlikely to creep North across the border.

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CUMIS Market-Based Funds

Gross Annualized Rates of Return as at June 30, 2007

Fund	3 Month (%)	1 Year (%)	3 Year (%)	5 Year (%)	10 Year (%)
Money Market					
Canadian Money Market Fund (PH&N)	1.1	4.4	2.8	3.1	3.9
Fixed Income					
Retirement Security Fund (CUMIS)	1.2	4.9	5.1	5.3	6.2
Universe Bond Index Fund (BGI)	-1.7	4.8	5.3	6.0	6.4
Income Fund (Ethical)	-1.7	4.9	5.4	6.2	—
Fixed Income Fund (McLean Budden)	-2.1	5.2	5.2	5.9	6.6
Short-Term Bond & Mtgage Fund (PH&N)	-0.6	4.3	3.8	4.6	5.5
Bond Fund (PH&N)	-1.6	5.0	5.6	6.5	6.8
Balanced					
Balanced Fund (Ethical)	1.6	16.2	11.8	9.5	—
Balanced Core Fund (McLean Budden)	1.1	15.1	10.2	9.4	—
Balanced Fund (PH&N)	2.0	16.3	12.4	10.6	9.2
Active Balanced Fund Benchmark	1.3	15.4	10.4	9.8	7.4
Canadian Equity					
S&P/TSX Composite Index Fund (BGI)	6.3	22.9	20.2	16.6	10.0
Canadian Equity Fund (Bissett)	3.5	22.2	17.6	13.8	—
Growth Fund (Ethical)	4.5	26.3	18.0	13.3	—
Special Equity Fund (Ethical)	7.8	14.3	21.2	—	—
Canadian Small Cap Fund (Franklin Templeton)	5.0	24.6	—	—	—
Large Cap Canadian Equity Fund (Mawer)	8.1	27.7	21.6	17.0	13.4
Small Cap Canadian Equity Fund (Mawer)	9.8	26.8	23.9	22.4	17.6
Canadian Equity Core Fund (McLean Budden)	8.2	28.9	19.5	16.3	13.5
Canadian Equity Value Fund (McLean Budden)	6.5	24.6	17.4	14.6	14.8
Canadian Equity Fund (PH&N)	6.5	25.7	16.6	14.6	9.9
Dividend					
Dividend Income Fund (PH&N)	3.1	23.2	15.6	15.3	15.7
U.S. Equity					
U.S. Equity Index Fund (BGI)	-2.1	15.1	3.1	2.8	4.2
U.S. Equity Fund (Mawer)	-2.5	11.6	1.5	2.3	4.2
American Equity Fund (McLean Budden)	-0.7	16.8	4.6	5.8	7.6
U.S. Equity Fund (PH&N)	-0.5	12.1	0.6	0.9	1.0
Foreign Equity					
EAFE Equity Index Fund (BGI)	-1.8	21.6	13.1	9.5	4.9
International Fund (Bissett)	-2.1	23.9	14.3	10.2	—
International Equity Fund (Ethical)	-1.9	18.1	—	—	—
Non North American Equity Fund (Mawer)	2.3	26.7	19.1	13.2	9.7
Global Equity Fund (McLean Budden)	-1.6	16.4	6.8	6.2	6.7
Overseas Equity Fund (PH&N)	-1.9	23.9	12.3	8.3	—
Growth Fund (Franklin Templeton)	-1.7	19.0	10.4	8.3	—
Actively Managed Asset Allocation Funds					
LifePoints Balanced Income (Frank Russell)	-0.7	9.9	8.3	7.8	7.9
LifePoints Balanced Growth (Frank Russell)	0.0	13.6	11.1	9.5	8.2
LifePoints Long-Term Growth (Frank Russell)	0.5	16.9	14.2	11.4	9.0
LifePoints All-Equity (Frank Russell)	1.0	19.9	13.4	—	—
Index Managed Asset Allocation Funds					
Conservative Balanced Index Fund (BGI)	-0.7	10.5	7.3	7.0	6.1
Moderate Balanced Index Fund (BGI)	0.6	14.2	10.5	9.4	7.5
Aggressive Balanced Index Fund (BGI)	2.2	17.8	13.6	11.5	8.0
Target-Date Funds					
LifePlan™ Retiree Fund (McLean Budden)	-0.5	10.6	7.6	7.5	7.7
LifePlan™ Retirement 2010 (McLean Budden)	-0.1	11.9	8.3	8.0	8.1
LifePlan™ Retirement 2015 (McLean Budden)	0.3	13.3	9.0	8.5	8.4
LifePlan™ Retirement 2020 (McLean Budden)	0.6	14.2	9.4	8.8	8.7
LifePlan™ Retirement 2025 (McLean Budden)	0.9	15.3	9.9	9.1	8.9
LifePlan™ Retirement 2030 (McLean Budden)	1.2	16.8	10.5	9.6	9.2
LifePlan™ Retirement 2035 (McLean Budden)	1.5	17.7	11.0	9.9	9.4
LifePlan™ Retirement 2040 (McLean Budden)	1.8	18.7	11.4	10.2	9.6

Note: All performance data is shown on a gross or "pre-fee" basis except for Retirement Security Fund

1 - Retirement Security Fund charges 1.2% in Investment Management Fees. The returns shown above for RSF are net of fees.

2 - Please see the Fund Fact Sheets posted on the CUMIS website (www.cumis.com) for benchmark returns on all fund(s).

3 - Pooled funds are not guaranteed, their values change frequently and past performance may not be repeated

4 - The Ethical Funds charge an expense management fee against the fund up to a maximum of 20 basis points

5 - Mawer Investment Management charges expenses against the funds and are not included in the above fees

News from the Government

Ontario Locked-in Accounts (Ontario Budget March 22, 2007)

The government is proposing to introduce a new life income fund (LIF) that would increase income for seniors in retirement and permit up to 25 per cent of the funds to be unlocked. The new LIF, and other modifications to the rules governing locked-in accounts, would give seniors who hold locked-in retirement savings transferred from employment pension plans increased flexibility in managing their retirement income.

The new LIF would replace all existing LIFs and locked-in retirement income funds (LRIFs). This would give seniors more flexibility by eliminating mandatory annuity purchase requirements and introducing:

- the right to an optional one-time unlocking of up to 25 per cent of locked-in funds no earlier than the early-retirement date under the pension plan from which the money was transferred (in most cases, this is age 55)
- an amended annual payment schedule that would increase retirement income and permit withdrawal of the entire remaining account balance when the LIF holder reaches age 90
- the opportunity to withdraw additional income based on investment returns in the previous year.

Additional changes would allow direct transfers of unlocked small amounts to non-locked-in accounts and unlocking for non-residents of Canada. The changes would also introduce consistent rules for the waiver of spousal entitlements to locked-in funds. Consultations will be initiated on the process for implementing the new LIF and other changes to the rules for locked-in accounts. It is expected that implementation of these proposals would begin as early as January 2008.

British Columbia Mandatory Retirement

On May 31st, Bill 31, the Human Rights Code (Mandatory Retirement Elimination) Amendment Act, 2007 passed through the Legislature from 2nd Reading through all stages, and also received Royal Assent. People will no longer be forced to retire at age 65. According to the Government backgrounder:

- Existing pension rights are protected. Bona fide retirement, superannuation or pension plans will continue to be able to make distinctions on the basis of age as they do now.
- Access or entitlement to employer-sponsored pensions is unaffected. Provincial changes will not affect entitlement under the Canada Pension Plan.
- The legislation will continue to permit age-based distinctions under bona fide group or employee insurance plans, including those that are self funded by employers or provided by a third party. As is the case in other jurisdictions, age-based distinctions can be made only under insurance based benefit plans. Employers continue to have discretion regarding the provision of benefits.

Old Age Security

Old Age Security (OAS) benefit rates are increased for the July to September 2007 quarter.

Basic OAS benefits, paid to people age 65 and over, are \$497.83 per month. The Guaranteed Income Supplement is \$570.27. The Spouse's Allowance and the Widowed Spouse's Allowance are increased to \$912.79 and \$1,011.80 respectively for the July to September 2007 quarter.