VERITAS

Fall 2012

DID YOU KNOW...

- If the season is cancelled, the NHL lockout will negatively impact the Canadian economy by over 0.1%.
- 40% of groceries purchased by US households, or $165 billion worth, wind up in the garbage.
- Toronto has more high-rise developments under construction than Boston, Chicago, Miami and New York combined.
- 28% of Americans are obese, up from 20% 15 years ago. In the same time, the diameter of CT scanners has increased from 60cm to 80cm.
- 2012 Olympic gold medals contain only 1% gold: the last pure gold medals were awarded in 1912.
- The collective average net worth of the 400 wealthiest Americans is equivalent to 1/8 of the entire US economy.
- General Electric (GE) is the only remaining original constituent in the Dow Jones Industrial Index.
- The number of 26 year olds in the US living with their parents has climbed 46% since 2007.
- US bank-issued credit card delinquencies are at 30 year lows, and lower than the 15 year average.

CURRENT SITUATION

Reversing the negative sentiment of the second quarter, North American equity markets posted strong third quarter returns. The TSX gained 7%, pulling it back into positive territory for the year with a 5.4% gain year to date. Although not quite as strong for the quarter, the big winners so far this year have been the US markets. The broad S&P 500 has advanced 16.4% since January, and has been rallying on "less bad", and in some cases outright good US economic news, specifically relating to employment and housing.

The US Federal Reserve (the Fed) has committed to keeping interest rates low for as long as it takes to get US employment back to "normal" levels. Historically, normal or full employment in the US has been defined by an unemployment rate of approximately 5.5%. This may be difficult to achieve present day because of the structural problems that exist in the jobs market where employers are having difficulty matching the skills they require to the available pool of workers. Although this issue has been discussed in past editions of *Veritas*, it bears repeating that one of the largest contributors to this problem is the lack of mobility of workers, largely as a result of them being tied to homes they cannot sell because they owe more on them than they are worth. Happily, recent data continues to suggest that this condition is reversing, even in some of the hardest hit housing markets in America.

The Fed is effecting its low rate policy through an asset purchase program called Quantitative Easing (QE). Oversimplified, QE is where the Fed buys back its own bonds, which in turn supports bond prices, thereby pressuring yields (bond yields move inversely to prices), while injecting cash into the financial system with the purchases. We have already seen two rounds of QE that were somewhat ineffective because there was a limit on how much would be spent on asset purchases. As a result, the market immediately anticipated the limited effect of the purchases, and looked for the next policy response, effectively neutralizing it as well. QE III, often referred to as QE Infinite, has no such limits which provides some policy certainty inasmuch as until unemployment moves meaningfully lower, the Fed will be printing money. With policy certainty, businesses become more comfortable planning for the future, leading to a greater inclination to spend and hire. If we combine an improving business outlook with an already improving jobs market (the most recent unemployment figure was 7.8%, down .3%), and a demonstrably improving housing market, QE III might be the catalyst the US

economy needs to turn the corner. As an aside, US housing starts are 40% below demographic needs, suggesting that the improvement in that market will continue, another plus for jobs.

Unfortunately, the positive effects of the QE programs and low interest policies come at a cost, and that cost is being borne by savers in the form of zero, or even negative returns on their interest bearing investments. Yet despite rock bottom interest rates, retail investor capital continues to flow into bond funds. In fact, even though US equity markets have doubled since their 2009 lows, over $1 trillion has moved out of US stock funds into bond funds in the same period, marking the first time since 1981 that investors have pulled money from equity funds for more than one consecutive year. This behaviour is very dangerous because when rates go up, bond and bond fund prices will slump. Making matters worse, unlike a proper bond, bond funds do not have a guaranteed return of capital in the form of a maturity date. When rates are low, and fund prices decline, they likely will never recover, effectively permanently destroying investor capital. This is one of the perils of buying bond funds when rates are low.

The Bank of Canada (BOC), unlike the Fed, is not as committed to a perpetual low rate policy. Despite a modest slowdown in economic activity here at home, the BOC is maintaining a more hawkish, or monetary tightening stance, emphasising the underlying strength in our economy. While we expect that rates will rise here before the US, the BOC will be careful with rate hikes because any increase in rates will add to the strength of our dollar. A stronger dollar is a negative for Canadian exporters as it makes their goods more expensive relative to a competitor who enjoys a weaker currency. Given that we have such an export driven economy, the value of the Loonie is of significant concern to our politicians and policy makers.

OUTLOOK

We are at an interesting crossroads where we have US economic growth, but a remarkably stimulative monetary policy. Canada is talking about raising interest rates, but our economy has slowed modestly in response to reduced growth expectations in China. If the statistics are to be believed, China is slowing because of reduced exports to the rest of the world, including Europe, where it appears the worst of their issues may be behind them. All in, the economic environment seems to be benign for the first time in a while. Whether this is the calm before the storm remains to be seen. If the right road is taken, we may be seeing the beginning of a period of comparative stability. The risks to stability are there, but they always are: they just need not always be the only focus of attention.

STRATEGY

The value in adhering to a discipline is that by definition, there tends to be very little variation in strategy. On the other hand, it means at times there is very little new to write about from quarter to quarter. Although our clients' portfolios are buffeted by daily market gyrations, we avoid reacting. We do not deviate from our focus on holding companies with strong recurring businesses, run by solid and respected management teams, operating in industries that are relatively insulated from economic cycles. We reiterate that while this discipline is not always successful, and may cause our performance to lag when markets are on a commodity-led tear, it is intended to reduce the variability of portfolio returns over time. Perhaps more importantly, it allows us to step back and assess, and position portfolios for, longer term trends as opposed to reacting to the news of the moment. Our goal, always, is to place the preservation of our clients' capital at the forefront of any investment decision we make, even if that decision is to make no change at all.
Please do not hesitate to call to discuss.

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