VERITAS

Fall 2005

The Bank of Canada, in a long anticipated move, raised interest rates by 0.25%, the first hike since October 2004. News of continued rate hikes in the US was eclipsed by the devastation caused by the hurricanes that hit the southern US in August. The toll they are taking on the people in the region is tremendous, and will be felt for a long time to come. So too will the economic consequences as authorities attempt to restore services and rebuild cities. Fuel prices were driven up around the world because of the damage that was done by the storms to an already severely constrained refinery infrastructure. And with hurricane season not finished until the end of November, more problems will likely occur. Overseas, the Chinese government re-valued their currency, the Yuan, for the first time in history. Previously, the Yuan was pegged to the US dollar, which arguably kept the currency artificially low, thereby making Chinese exports unrealistically cheap. It will now be pegged to a basket of currencies, including the Canadian dollar and the Euro. This will permit the Yuan to float more freely, better representing its real value in international currency markets. And regarding our summer comments on auto maker incentives, they topped $5 billion in the US in July alone.

CURRENT SITUATION

The TSX continued its energy led rise in the last quarter, climbing 10 percentage points to close over 11,000. However, what lives by the sword dies by it: at the time of writing, the TSX has given back half of the last quarter's gains in six trading sessions, led by the energy sector.

After peaking at over US$70 a barrel, with the last price spike being caused by supply and refinery disruptions in the wake of Hurricane Katrina, the price of oil has been trending downwards to current levels of closer to US$62 a barrel. Downward price pressure has been largely in response to concerns of slowdown in global economic activity which, ironically, is seen to be caused by high energy prices. In the US, there is the additional concern that the hurricanes will rob that economy of some growth this year, but the numbers so far are not supporting this. There is no indication that energy demand is waning anywhere in the world, and with 28% of US refining capacity currently out of service, and the winter heating season approaching, we expect that the current weakness in the energy sector will be temporary.

Ongoing peak energy prices are finally starting to take their toll on consumers, especially in the US, and will be felt even more severely as winter wears on. With heating oil supplies tight because of lack of refining capacity, the same issue that is affecting gasoline prices, and natural gas prices at the highest level they have ever been, the American Petroleum Institute estimates that the average US household will see their heating bills rise over 50% from last year. Although not as badly, Canadians will be affected too, and consumers here can expect their shock to come in early 2006 when Canadian gas distributors apply to the regulators for their annual price revision, which will certainly reflect the higher market prices for natural gas today versus last year. As is the case with gasoline, higher heating costs, which are unavoidable, will ultimately take away from consumer discretionary spending. We are already seeing the effects on the 'value' retailers such as Wal-Mart, where sales have declined some 40% since July. For comparative purposes, the majority of the major US retailing chains have seen their sales decline anywhere from 5% to 20% in the same period, with the luxury retailers remaining virtually unaffected. Adding to consumers' woes are the manufacturers who, up to this point, have been absorbing much of their higher energy related production costs, and are now passing those costs through to purchasers.

A slowdown in US mortgage refinancing suggests that there is no more money to come out of houses for discretionary spending, further affecting the consumer, and the numbers at stake are tremendous. In 2004, Americans borrowed US$600 billion against their homes to spend. This number is equal to 7% of total disposable income. Policymakers have been referring to the housing bubble, but their concern is not with the prices of homes as much as with the use of the money that was borrowed against the value of the home, and the level of that borrowing. US personal balance sheets are in the worst shape they have ever been, and with a negative savings rate, if the value of the leveraged properties decline, the risk of widespread default is very real, potentially leading to the first consumer led recession in 14 years. Because tax and mortgage rules in Canada make it less cost effective for us to repeatedly refinance our homes, the risks of widespread defaults is not as great here, but we are not immune given some of the very creative financing options that are being advertised that will allow borrowing against 110% of the value of a home.

Even with the decline in consumer spending, the US Federal Reserve notes that the US economy continues to grow, with productivity gains providing support. While Canada is not showing the same productivity gains, we are running at close to full capacity, making further rate hikes a likelihood. It is interesting to note that our economic strength has allowed us to cut our foreign debt to just 11.4% of GDP, as compared to 10 years ago when it was over 40% of GDP, prompting the Wall Street Journal at the time to suggest that we were a Third World candidate. If trends continue, we could become a creditor nation in five years for the first time since the early days of the Hudson's Bay Company. Under the circumstances, it is a good thing that we did not accept the argument to 'dollarise', or adopt the US dollar as our currency, to protect us from certain poverty when our dollar was weaker.

OUTLOOK

Caution, discipline and focus remain the watchwords for our outlook. We are getting a sense of investor euphoria and complacency in increasingly volatile markets. This is a time when things can turn negative very quickly, as we witnessed in 2002. Momentum investing is gaining popularity at the retail level as people become concerned that they have missed the boat, just at the time when peaking markets suggest it should be avoided. Our forecast for higher interest rates is being fulfilled here and in the US, and with sustained high energy prices, the corporate profitability we saw in 2005 will be difficult to repeat in 2006. We remain surprised at the strength in the markets this year, and expect that without energy's lead, 2006 returns will be lower, but still positive. Sustainable, quality earnings will be the key.

STRATEGY

With our increasingly cautious outlook, our policy of staying with stable relatively defensive holdings has become even more critical. While client portfolios continue to perform well, especially in light of the fact that we are substantially less exposed to energy stocks than is the TSX, we are focussed on preserving those gains. Accordingly, we are continuing to raise cash by taking profits as appropriate, and waiting for a meaningful pull-back in the market before we commit those funds back into the market. We are also evaluating the current holdings in the portfolios in the context of what we expect to happen next year, and will be removing any that we think will not stand up to what we see as a challenging business environment. As a result, clients can expect to see continued higher than normal cash balances, and fewer than normal equity holdings as we end the year.

There were many topics touched on in this issue, and we would be pleased to discuss any of them, or others, in more detail. Please do not hesitate to call.

R. Guy Amighetti, CFA, TEP
Portfolio Manager

Tel: 604-632-4081
Email: rga@vici.ca