VERITAS

Fall 2006

Following up on comments made in the last edition of *Veritas*, merger discussions between GM and Nissan/Renault have been discontinued. However, the speculation now is that a "made in North America" deal may be in the offing, involving some form of combination between Ford, GM and Daimler Chrysler. The rationale is that the Big 3 can no longer exist independently in the face of competition from the Asian car manufacturers. North American manufacturers have been suffering in areas of design, reliability, plant efficiency and an unrealistic reliance on increasing consumer demand for trucks and SUVs. If there is any doubt of this, we have only to look at Ford's recent announcement of its US$1.5 billion loss already this year, and that it is cutting a further 168,000 vehicles out of its fourth quarter production schedule, which will just add to the already substantial loss. GM has already undertaken similar steps, including the laying off of tens of thousands of North American workers in an effort to control costs. Looking at an example of the competition, we had mentioned in the past that Toyota was set to overtake the Big 3 in domestic market share, but more to the point, Toyota remains profitable, even in its North American production facilities, unlike its domestic counterparts.

CURRENT SITUATION

Equity markets in the US have performed well so far this year, posting new record highs, and handily outperforming the TSX. The TSX has recovered somewhat from its decline at the end of the second quarter, but still sits well below its April peak. This kind of disconnect between the two markets is not unusual given the difference in their composition. The US markets are heavily weighted towards industrial, capital intensive companies, whereas the TSX is very resource oriented. Accordingly, if conditions are less positive for our market, such as when commodity prices are flat or declining, as they are now, it is positive for the US markets which tend to suffer when commodity prices are high and rising. The latter is a condition that existed over the last several years when the Canadian equity markets were much stronger than their US counterparts, even accounting for the decline in the US dollar. US markets suffered as higher commodity prices translated to a higher cost of production, thereby reducing corporate profitability and putting pressure on US stock prices. This condition also created, and was made worse by, an inflationary environment that led to higher interest rates, another negative for stocks.

As weak as the TSX has been, its performance is in keeping with our expectation of modest single digit returns for this year and next. Recent TSX trading activity points to a shift away from the commodity stocks that have led the market over the past few years, and into more stable defensive issues. This shift supports recent comments from analysts and portfolio managers that suggest that the easy money in commodities has been made. Quoting portfolio manager John Zechner, of J. Zechner Associates Inc., "…the areas of highest speculation should suffer the most…[which] has been the commodities and this is where the most volatility has been as well."

The exception to the commodity story may be oil and gas. While oil prices are down 25% from a $78 peak, this is largely attributable to a decline in global geopolitical risk, which has been accounting for approximately $15 of the price of a barrel of oil. With risk abating, oil has started to trade on supply and demand fundamentals. Demand continues to rise at a faster pace than reserves can be replaced, creating a potential long term supply shortage. As a result, we continue to believe that current oil prices are realistic, but we view current natural gas prices as being unsustainably low for the same reasons. Unseasonably warm winters or cool summers distort near-term gas prices, as has been the case recently, but do not affect long-term demand, which continues to escalate. As is the case with oil, new

supplies are becoming harder to find and more expensive to produce, suggesting continued strength in pricing in both sources of energy.

The condition of the North American housing market is another topic that has received a great deal of press recently. The strong housing market has kept consumer confidence high, especially in the US. However, there have been a couple of issues that have made the US housing market susceptible to correction: non-conventional mortgages and mortgage equity withdrawals (MEW). Both increase the debt burden of the borrower, either by minimal or no down payments, or the ability to withdraw any increase in the value of the home. Consequently, when prices stop rising and start to decline, the homeowner's debt can quickly exceed the value of the home, resulting in defaults. The first sign that prices will stop rising is an increase in unsold inventory, which we are starting to see in the US and Canada. As of July, US listings are outpacing sales to the point where home prices there are barely above levels a year ago, and the previously hottest markets are showing the worst declines. The concern is that as the inventory of listings rises and prices drop, excessively indebted homeowners will be forced to sell, adding more low-priced inventory to the market, forcing prices down even further and faster. While this may happen in Canada where house sales are down 6.6% year over year, we will not feel the same impact because of our more conservative lending rules and inability to easily engage in MEW. However, because the value of one's home translates to a having a sense of wealth, a severe decline in the real estate market in either country will have a negative effect on consumer confidence, as the homeowner consumer responds to the sense of loss of wealth.

OUTLOOK

With commodity prices levelling off and in some cases declining, we continue to expect to see only modest performance from the TSX, in part as investors take profits in the sector. Because commodity stocks represent almost 50% of the TSX, any meaningful moves in or out of the sector will impact the index. As investors move out of commodities, they will be buying and adding strength to market sectors that have been overshadowed by the commodities bull market. Therefore, we remain comfortable with our expectations for modestly positive equity returns into 2007, but with the returns being generated by more defensive sectors. Interest rates in Canada and the US are not expected to move meaningfully higher, and may even start to fall if a US economic slowdown is at risk of becoming a recession. Geopolitical events and supply disruptions will continue to affect oil, but not likely with the same magnitude as over the last few years. That said, any bad news for oil could add $10—$15 to the price of a barrel in one trading session. Volatility is not a thing of the past.

STRATEGY

Because our investment policy requires us to look beyond short term events and take a long term view in the construction of our clients' portfolios, our strategy tends to remain constant quarter to quarter. When strategy shifts do occur, they tend to evolve slowly as was the case when we started to position portfolios more defensively in 2005 because of our concerns of an increasingly short-sighted market. With the deceleration of global economic growth, and the mounting likelihood of negative earnings surprises after years of only positive reports, investors will be increasingly searching for safe havens. Verity client portfolios should benefit from this: because of their conservative and defensive composition, they already own what previously aggressive investors are seeking. We expect to maintain this defensive policy until we can reasonably forecast a turn in the current cycle that would recommend a more aggressive investment policy.

Please do not hesitate to call for further discussion of any topic in this note, or with any questions or concerns it might have raised.

R. Guy Amighetti, CFA, TEP
Portfolio Manager

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