VERITAS

Fall 2008

DID YOU KNOW...

- **V** The US SEC acknowledged that flaws in regulatory oversight significantly contributed to the global credit market freeze-up. Deregulation will quickly become re-regulation.
- **V** Morgan Stanley and Goldman Sachs, the last two major independent US brokers, converted themselves to banks last month. This marks an historic and perhaps encouraging shift in the shape of Wall Street.
- **V** The $2 trillion hedge fund business has experienced a 20% increase in year over year liquidations, and outright failures are up over 30%, partly as a result of negative performance, which has been posted for only the second time in almost 20 years.
- **V** Before factoring in the costs of rectifying the current crisis, the new US president will inherit a $482 billion deficit, as opposed to the **surplus** the current administration inherited when it first came into power.
- **V** US Federal Reserve chairman Ben Bernanke has been nicknamed "Helicopter Ben" for his quip that if necessary, the government should scatter money from the skies.

CURRENT SITUATION

Since our last edition of Veritas, global equity markets have declined quickly and significantly as fears that the credit crisis is going to plunge the world into recession. In Canada, declines have been in order of magnitude of several percentage points a day, and at time of writing have taken the market to levels that were last seen in May 2004. Commodity related stocks have led the declines, but no sector has been immune. Because market volatility is making commentary irrelevant almost as soon as it is written, we would like to instead focus on some of the other factors that are being affected by the current, and we hope short-lived, turmoil.

Oil, since hitting a peak almost $150/barrel in the summer, has corrected back down to below $80/barrel. In general terms, this is the level at which it was trading this time last year. The decline in price is actually a positive at many levels, although producers might argue the point. More on this in a moment. Lower oil prices means lower energy prices, which in turn translates to lower production and operating costs for businesses and lower energy costs for consumers. The lower costs take some of the inflationary pressures out of the system, and provides an immediate direct financial relief to consumers via lower prices for gasoline and heating oil, and via moderating costs for consumer goods, including food. At a much higher level, the reduction in inflationary pressures reduces the need to increase interest rates and may allow central banks more latitude to in fact cut rates further if weakening economic conditions warrant. Finally, something to be aware of is the fact that oil is trading below average reserve replacement costs, which are estimated by the industry to be around $100/barrel. This, along with fact that global demand has not declined materially, and supplies have not increased, would suggest that current oil prices are not sustainable, much as they were not at their peak.

The **Canadian dollar** (CAD) is viewed on the world stage as a "petro-currency", and as a result has suffered significant declines to the mid-USD 0.80 level along with the drop in the price of oil. As bad as this is for those wishing to travel, our weaker dollar benefits our export-focussed economy, and helps mitigate the damage done to oil producers by lower oil prices. The biggest benefit of the weak CAD will be felt in the export manufacturing sector, good news for Ontario. However, given the consensus view that the appropriate trade weighted value of our dollar is closer to USD 0.90, we would expect to see some near term recovery in the CAD, although not back to its

USD 1.10 highs. Regarding the previous record highs of our dollar and oil prices, we believed then that the levels reached were largely driven by speculation, and believe now that the current oversold levels are also as a result of speculation, but this time on the short side.

Interest rates around the world are trending downwards as central banks attempt to invigorate credit markets by making funds available to lending institutions at attractive rates. It should be noted that there is no shortage of money in the system. The single largest issue that is paralysing the credit markets is not a lack of capital, rather it is the unwillingness of banks to not only lend the capital to their clients, but to one another. If not tempered, this new found aversion to risk could render the recently approved Troubled Asset Relief Plan (TARP) ineffective. In short, it will not matter how much capital is injected into the banks if they will not put it to work. We look for the symbolic first dollar to move between banks as an indication that the sentiment has turned, and confidence is returning to the credit markets.

There has been widespread criticism of the TARP as it is seen as not doing enough for "Main Street", while giving a pass to Wall Street "fat cats" and not holding them responsible for their roles in the creating the mess we are in. While there may be some truth to this, the fact remains that if Wall Street, Bay Street, and all the other "streets" are not functioning, Main Street will have much bigger issues to worry about than whether it got a fair deal under the TARP. In this vein, we surmise that as current issues are resolved, and they will be, we will see some accountability at the executive level. That said, no single group can be blamed for what we are experiencing, but nor is anybody blameless: a vicious cycle was created years ago, and it finally closed in on itself in August 2007 when the credit markets froze. Today's environment has been compared to Japan's past banking crisis. While the causes are similar, countries today have been much quicker to cut interest rates and print money to offset deflationary pressures that are likely to result from a decline in demand and consumption.

OUTLOOK

Because of market volatility, and the dramatic disconnect between fundamentals and valuations, forecasting is becoming increasingly difficult, and fundamental analysis is being rendered largely irrelevant. However, current conditions will improve, and given the speed and intensity with which markets unwound, the speed of the turnaround might surprise many. As mentioned, there is much that has happened that is supportive of a sustainable recovery from what are arguably oversold levels. All this said, given the severity of the downturn, we do not expect that a recovery will be adequate to provide for positive returns by year end, but we do look to pare back losses.

STRATEGY

In the current market environment, strategy is more a matter of discipline. Verity manages long-only portfolios, does not employ leverage and maintains a minimum three to five year investment horizon. With volatility exceeding the worst levels witnessed in 1987 (Black Monday) and 2001, we are staying on the sidelines until we see more stability in the market. We were active in the markets earlier in September, strategically adding to existing positions at a time when markets were somewhat more rational. Our concern now is that with fundamentals having taken a back seat to emotions, any trading now would be borderline speculative, notwithstanding some very compelling valuations. Quoting the CFO of Agrium Inc.: "...no individual company can stand up to a tidal wave of panic selling." The TSX has not experienced negative returns in any given ten year period since 1935, and has only done so 4% of the time in any five year period. We are thus comfortable waiting out the volatility. Owning good companies without using leverage means we can wait, and our clients are not forced to crystallize losses by selling.

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