VERITAS

Fall 2009

DID YOU KNOW...

- 7-Eleven has named Winnipeg the Slurpee Capital of the World for the 10th year in a row.
- In August, a US judge issued a permanent injunction preventing Microsoft from selling "Word" in the US, citing the violation of a patent held by a Canadian company.
- The State of California has turned to the online auction site eBay to sell off surplus state-owned items, from autos to desks, in an attempt to raise cash to reduce its $30 billion deficit.
- West Virginia drivers lead the US in collisions with deer for the third year running.
- Of the $800 billion in announced stimulus spending in the US, only roughly 10% has been spent to date.
- Alberta has seen the largest year over year increase in EI recipients in Canada, with recipients increasing nearly 270%.
- In order to profit from an investment discipline, you must be prepared at times to hold the course and look foolish while the market moves against you.

CURRENT SITUATION

North American equity markets extended their gains from their March 2009 troughs. As at September 30, year to date, the TSX is up 30% including dividends, and is up 51% since its March low. To put the dramatic swings in equity markets over the last 18 months in perspective, the TSX is still down some 17% from the end of 2007, and 27% from its peak in 2008. However, if we accept that the absolute low and high points were overdone, and given that the world is just coming out of a severe recession, equity markets, at least in Canada, are at reasonable levels. There is further support for them in the context of low interest rates, comparatively high dividend yields, improving earnings and earnings outlook and dramatically improved investor sentiment.

Global economic fundamentals are continuing to improve, confirming the indicators that were suggesting improvement several months ago. These Leading Economic Indicators (LEI) continue to show strength which, if confirmed, suggest that we will witness a significant rebound in global economic activity in the next six to nine months. This should not come as a surprise given the level of stimulus that governments around the world have injected into their respective economies. The issue will be how long the increased activity will be maintained as stimulus is removed from the system. Key to the sustainability of the turnaround will be private sector economic activity, which in turn is dependent on consumer demand which itself is affected by corporate health as it impacts employment.

Corporate earnings have been improving quarter over quarter, but are still lower than they were a year ago. The quality of earnings is also lower than a year ago inasmuch as the earnings improvement has been coming from cost cutting rather than increasing revenues. Much of the cuts were to labour, contributing to the huge job loss numbers we have witnessed in the last year. In response to the economic difficulties, companies have generally become more efficient, and when revenues do improve, the efficiencies will translate into accelerating earnings growth of improved quality. As demand continues to increase and inventories are depleted, companies will start hiring, reversing the job loss trend. This relationship helps to explain why reported unemployment figures are considered a lagging indicator: in the majority of circumstances, an economic turnaround is well underway before the job loss numbers improve. It is worth noting that corporate capital expenditures were significantly reduced last year as well. As this condition reverses, which it must do as older equipment requires replacing and obsolete facilities can no longer keep up with demand, the reversal will have a secondary ripple effect on employment when providers of the improvements find it necessary to hire in response to the increased demand on their resources.

This discussion would not be complete without a look at the credit markets, the seizure of which was one of the single largest contributors to the world's recent economic difficulties. Consumer credit in the US continues to contract, but this tells two possible stories. The first is that institutions are not lending, either because of the riskiness of the customer, or because of a lack of available funds in the system, a condition that is becoming less of an issue. The second and more prevalent story is that consumers are just not borrowing, choosing instead to save more, reduce debt and improve their personal balance sheets. Interestingly, Canadian consumer credit has not suffered as much as in the US, reflecting in part our more conservative lending practices and modestly lower propensity to live on credit. Conversely, commercial credit has rebounded significantly since mid-year, suggesting these markets too are on the mend, in turn implying a further pickup in business activity. For example, with commercial credit more readily available, companies will be more willing to spend the money on those previously mentioned postponed capital expenditures.

Overall, in recent quarters we have seen remarkable improvement in fundamentals at the corporate level, in the equity and credit markets, and in global trade. Economic indicators turned positive in the last quarter, were confirmed, and continue to improve. Investor and consumer sentiment has been improving and has been "positive" for the last several months, a condition that is expected to improve as jobless numbers continue to improve. In short, it appears that after enduring a very difficult 18 months, we are experiencing a process of normalization which will likely continue for a few quarters yet.

OUTLOOK

There are signs that a tentative economic recovery has taken hold in the majority of the countries that were in the grips of recession. With the recovery and the ensuing increase in industrial production, Canada and other resource rich economies will be the principal beneficiaries. Fears of global hyperinflation appear to be abating, in part due to existing spare economic capacity relative to the anticipated weakness of the recovery, and also due to the fact that much of the global stimulus packages went to shoring up balance sheets, and not shovel-ready projects. The implication is that as we get more clarity on the nature of the recovery, it appears that a relatively benign inflation environment will be with us for a while, giving central banks some much needed time to extract stimulus from the system in an orderly manner.

STRATEGY

We have not altered strategy in the management of our clients' portfolios. We continue to view equities as the favoured asset class, with the standing focus on conservatively and well-managed companies operating in primarily needs-based industries. The durability and sustainability of the businesses in which the selected companies operate is critical, as it is these factors that provide some comfort in the knowledge that these types of companies will emerge from a downturn relatively unscathed, and perhaps even stronger than before the difficulties. The Bank of Canada continues to affirm its low interest rate policy until mid-2010. While this may help the economy, and is also meant to keep a lid on the Canadian dollar, it is creating challenges for income oriented investors. After inflation, low as it is, and taxes, the effective rate of return on bonds is barely one percent, further supporting our risk adjusted preference for conservative equities.

Lastly, we are pleased to advise that our website is now active.

Please visit us at **www.vici.ca**.

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