VERITAS

Fall 2010

DID YOU KNOW...

- V Latest Census numbers show that the creation of new US households hit a postwar low last year, which helps to explain why the glut of unsold homes remains stubbornly high.
- V The first "teddy" bear was created in 1902 by Germany's Steiff, the world's oldest manufacturer of soft toys, based on a political cartoon of Theodore ("Teddy") Roosevelt.
- V China overtook Japan in the second quarter to become the world's second largest economy behind the US. Some forecasters see China surpassing the US as early as 2030.
- V According to the American Bankers Association, the delinquency rate on US home equity loans is higher than on all other types of consumer loans, including credit cards.
- V 60% of daily US equity trades are "high frequency" trades.
- V At 2.2 million, Canada led the world in working days lost because of strikes in 2009.
- V Over the last two years, half of US household debt reduction has been by way of default, as opposed to scheduled pay-down.

CURRENT SITUATION

Playing into the theme that we are experiencing range-bound markets, the TSX reversed second quarter year to date losses, and closed the third quarter up 7.50% year to date. This translates to a 10.50% gain for the quarter, the majority of which occurred in September. Gains were broad-based, notwithstanding gold's run up to and through a record USD1,300 per ounce, a run that has had a profoundly positive effect on Canadian gold mining stocks. The US experience has not been as stellar, with the S&P 500 up just under 4% for the year, and still below its April 2010 peak. Adjusting for currency, it is up only 1.5% year to date.

The media has been alive with chatter about a "double dip" recession, and the risk of the US experiencing one. According to Investopedia, a double dip recession is defined as when an economy falls back into recession following one or two quarters of post-recessionary economic recovery (growth). Given that official figures show that the North American recessions ended at least five quarters ago, referring to fears of a double dip at this stage in the recovery is nothing short of sensationalising any evidence of moderating economic activity. Economic activity in the first half of this year spiked as warehouses and stores restocked inventories that were depleted and not replaced while the economies were contracting. Replenished inventories now need to be sold down, which will slow output, but as a normal replacement cycle starts to take hold, which is reasonably expected at this stage in a recovery, economic activity will stabilise. It is a matter of the inventory/consumption pendulum reducing its arc as inventory management becomes more precise in response to normalising spending patterns, which will also serve to stabilise economic activity. That said, there is no question that stable economic activity will be at a level far below that experienced in the early days of the economic recovery, or even prior to the recession.

Addressing the question of whether or not North America will fall into another recession, evidence suggests that absent another series of events similar to the 2008 catalyst, it would take a combination of massive corporate capital spending cuts, inventory draw-down and massive layoffs for a new recession to occur now. This is not to say that this could not happen, but given conditions we see now, it is unlikely. The combination of high corporate cash reserves, translating to stronger balance sheets than prior to the last recession, relatively stable western economies, notwithstanding problem countries in Europe, and stable, but admittedly high, unemployment is not

indicative of another imminent severe economic contraction.

There are other reasons to believe that things are not as bad as is frequently being reported. The US Congressional Budget Office estimates that the Troubled Asset Relief Program (TARP) will cost $66 billion overall, substantially less than the original $350 billion estimate, and significantly less than the $700 billion initially approved. Corporate debt defaults have declined to levels that prevailed prior to 2008. Furthermore, over the last 18 months, virtually all corporate debt scheduled to mature in 2011 has been addressed, as has almost half of that scheduled to mature in 2012. To quote the Wall Street Journal, this marks a "...swift turnaround for the fate of the most troubled US companies." Vacancy rates in malls in the top 80 US markets improved for the first time since 2006. Of note, the commercial real estate market, which includes office as well as retail properties, is closely watched as a barometer of the prospective health of an economy. In response to this improvement, landlords are expressing cautious optimism, but are saying that an even stronger rebound will be dependent on job gains and renewed consumer confidence. An economic recovery is not linear and does not follow a straight trajectory upwards, especially when it is a recovery after what is being called the worst economic slowdown since the Great Depression. To quote Tim Price of PFP Wealth Management, "years of massive misallocation of capital cannot be followed by an effortless recovery."

OUTLOOK

Economies will continue to grow, but in a two step forward, one step back manner, and markets will take their cues from these moves. Interest rates will remain low, but the risk is to the upside. When rates do move in any meaningful fashion, bond prices, which move inversely to interest rates, will be punished. US employment data will be watched closely, and any departure from expectations will be felt in the markets. On this topic, we observe that corporate capital expenditures continue to increase, and historically job creation follows because at some point, companies will need people to run the new machinery. Structural unemployment (the mismatch between available labour skills and those required by employers) will remain problematic for the US. This is especially so now as we learn that the foreclosure process has been subject to alleged widespread fraud, and has been suspended by many institutions as a result. As bad as foreclosure is, assuming the owner is still in residence, any delay in the process makes it more difficult for the owner to take the steps necessary to make a new beginning, particularly if that new beginning involves moving to a new state where jobs are going wanting. Hopefully though, as has been the case with many other issues that have been reported of late, this one too will prove to be less serious than the press would have us believe.

STRATEGY

We have mentioned in the past that market volatility is not necessarily risk, and can create opportunities. With equities trading in lockstep as much as they have been of late, wholesale price movements allows the purchase of unloved assets at attractive prices, or the reduction of "overbought" assets at profitable levels. Interestingly, conditions can reverse themselves overnight, with absolutely no change in any fundamental conditions. In this environment, our goal is to remain essentially fully invested relative to the client's investment objective, and to take tactical advantage of market moves to add to or reduce individual holdings. We remain committed to owning quality companies that operate in stable industries that in turn provide the essentials of what we all need on a daily basis. We are encouraged that others are increasingly taking the same position: market stats show that investor interest in dividends is on the rise, demonstrating once again that quality, although often ignored, never goes out of style.
Please do not hesitate to call for further discussion of any of the topics touched on here.

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