VERITAS

Fall 2011

DID YOU KNOW...

- One third of Royal Dutch Shell's (Shell Oil) global reserves are in Canada.
- According to publication *ThinkQuarterly*, there are 48 million people in the world that have mobile phones, but do not have electricity.
- Also from *ThinkQuarterly*, a person with a current generation smartphone has instant access to more information than the US president did 15 years ago.
- According to the consulting firm Mercer, Toronto is now Canada's most expensive major city.
- US Labor Dept. data shows that in the three years ended June 30, almost $19 billion in state unemployment benefits were paid out in error—more than 10% of the total benefits paid nationwide in the same period.
- In a sign that the 30 year consumer debt cycle in the US may be ending, Wal-Mart and K-Mart are offering layaway plans.
- The S&P 500 closed at the exact same level on October 3, 2011 as it did on October 3, 2008.
- A record 7.5 million litres of beer was consumed at this year's Oktoberfest in Germany.

CURRENT SITUATION

What started early in the quarter as a pullback in equity markets quickly turned into a correction which in turn briefly became a bear market. A bear market is defined as a market decline of over 20% from an intra-cycle peak which, in this case, was in April. In short, global equity markets got mauled over the last three months, posting their worst quarterly performance since the third quarter of 2008, during the height of the credit crisis. The resource-heavy TSX did not escape the selloff, dropping 12% on the back of a 19% decline in the energy sector as oil prices declined to below $80/barrel. Following commodity prices down, the Canadian dollar shed over six percent of its value against the US dollar in September alone, marking its second worst monthly performance in over 60 years. Tempering these comments, commodities, the dollar and markets have rallied in October, and the TSX has still posted a 10 year compound average annual return to date of 8%.

The principal reason for the sharp decline in commodities is the fear of slowing global demand for raw materials and energy as sentiment deteriorates. And it is in this comment that we are finding the cause of much of the recent volatility in the markets as well: sentiment has been trumping data for the last several months. There is no question that conditions can change, and as fear breeds more fear, the data can quickly turn negative in response to sentiment. But for now, the data is turning up reasonably well, especially in North America, and certainly is not indicating anything as calamitous as what we experienced a few years ago. Even the US jobs market is showing some life, and may be poised to improve further if we continue to receive news such as the recent announcement by Otis, the elevator maker, that it is joining the likes of IKEA, Ford and GE in repatriating manufacturing jobs that it had previously moved offshore to save money.

The media has shifted its focus from the US to Europe and the perceived parallels to conditions existent in 2007/2008 that caused the global financial system to seize. But this is not 2008 all over again. Observations supporting this include: the continued flow of global credit, even in Europe; equity market volatility, despite how it feels, is near half of what it was then; incoming economic data continues to signify expansion. Assuming Greece gets the funds it needs to restructure, which appears to be the case, and the other weaker countries in Europe can get their houses in order with some help, the economic data should prevail. However, the biggest challenge the EU faces in implementing any restorative economic policy is the need for unanimity amongst its members. This in a structure where all members, currently 17, have equal vote, regardless of size of economy or country, and perhaps more importantly, regardless of political structure. A consequence is what happened a few weeks ago: Slovakia, a full EU member with a comparatively tiny economy, governed by a coalition, as a lone dissenter was able to block a policy decision aimed at aiding Greece. Incidentally, the Slovak "no" vote was more about a domestic pork-barrel compromise than about blocking aid to Greece per se. It has been said that without political unity, one cannot have economic unity, leading again to our observation that if the EU is to survive, it may have to take on a political structure similar in appearance and function to that of Canada.

Canada's economy is doing reasonably well, and will continue to do so as long as the world still wants what we have: commodities. The risk Canada faces is that of having become too reliant on commodities in the event of a real and significant decline in global demand for raw materials. Happily, this condition does not appear to be imminent, but this does not mean that it could not come to pass. Improved domestic economic diversification, similar to how portfolio diversification works, could assist in protecting our economy against shocks in the sectors to which it is heavily exposed when they inevitably occur.

OUTLOOK

Equity fundamentals continue to be overshadowed by politics, and as long as the political dithering continues, the uncertainty of policy outcomes will cause further market volatility. However, as the issues plaguing Europe are slowly resolved, investors will get back to work evaluating individual companies instead of trading the markets. When this does happen, the existing strong correlation between markets and stocks will begin to decouple. As a colleague recently observed, correlation is at its highest when markets are declining. As decoupling intensifies, volatility will be reduced further, and as the two decline, there is less incentive for the high frequency and algorithmic traders to participate in the markets. Their exit will further reduce volatility, a condition not dissimilar to what we experienced in 2008/09. There was a day in March 2009 when nothing else changed but sentiment itself, and it was simply this that was the catalyst for the markets to turn up dramatically. Despite the recent concentrated market downturn, we are not in nearly as severe an environment as then. Because of this, we would not be surprised to see a sharp market rally when sentiment does shift. The one change to our outlook as a result of all that is going on is on interest rates. Based on recent policy announcements, and even though all measures of inflation are rising, we expect rates to remain at current levels for at least the next year.

STRATEGY

With correlation between individual stocks and the overall market at record highs, and approaching 1:1, strategic investment decisions on a stock by stock basis appear increasingly irrelevant. That said, the advanced correlation is not a reason to abandon a discipline of buying conservative, quality, dividend paying companies that operate in relatively constant industries. When the current correlation disconnects, the companies with the strong fundamentals will advance ahead of their weaker peers. Furthermore, less cyclical companies should deliver more consistent returns than would be expected from the more commodity exposed issuers. In making the decision to purchase the stock of a particular company for our clients' portfolios, the goal is to capture earnings consistency and visibility, which, in a normal market, should translate to comparative stability in share price performance. While we may not be in a normal market presently, our investment discipline has not changed, nor will it. These are unpleasant times for investors. Please do not hesitate to call to discuss.

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