VERITAS

Fall 2013

DID YOU KNOW...

- **V** US non-financial companies collectively are sitting on $1.48 trillion in cash, 10% of which is in Apple's bank account alone.
- **V** Restrictions on taxis in Vancouver have inflated the cost of a hack licence to $800,000, getting very close to the $1,000,000 cost of a New York taxi medallion.
- **V** Detroit city has filed for bankruptcy, making it the largest municipal bankruptcy in history.
- **V** Accounting for nearly 25% of all North American internet traffic, Google has a larger internet presence than Facebook, Twitter and Netflix combined. As recently as 2010, Google represented only 6% of internet traffic.
- **V** Cal Worthington, the colourful used car salesman who "entertained" us over the years with his TV ads that featured his "dog" Spot (who was rarely a dog) died in September.
- **V** The recent US government shutdown was the first in 18 years and the 17th in US history. Of interest, George W. Bush was the first president since Nixon to not preside over a shutdown, whereas Reagan saw eight over his two terms.

CURRENT SITUATION

North American equity markets continued their advance in a relatively quiet third quarter, quiet at least up to the last part of September. Despite some weakness earlier in the quarter stemming from uncertainty over the direction of the US Federal Reserve's (Fed) interest rate policy, the broad US S&P500 tacked on a 5.2% gain in the quarter, for an impressive aggregate 19.8% gain for the year. Canada's TSX actually outperformed its US counterpart for the quarter, but with an cumulative gain of only 5.3%, continues to lag the US by over 14%year to date.

As we headed into the last quarter, there had been a great deal of chatter in the media on the subject of whether or not the Fed was finally going to begin to remove some economic stimulus from the system, and if so, how much would be removed. Some reduction was widely anticipated, and as expected, bond and equity markets started to act accordingly by selling off. On decision day, and in a move that surprised many, us included, the Fed announced that there would be no change in policy, no "tapering", and the current extremely accommodative monetary policy would remain in place. Immediately upon release of this announcement, US markets staged an impressive late day rally, and continued to climb to new record highs in September.

But markets, being as volatile as they are, quickly retreated from those highs in response to the budget-related political posturing in Washington that resulted in the partial shutdown of the US government, and renewed the brinksmanship over raising the debt ceiling. As a reminder, when the US government runs out of money, if the debt ceiling is not raised, the government runs the risk of a potential partial technical default on some of its financial obligations, which include not just interest payments on bonds, but federal payrolls and social assistance payments as well. Long time readers of *Veritas* will recognize this as being the same issue, absent the government shutdown, that caused a great deal of market distress in the summer of 2011. While it is clear from the recent pullback that markets are still reacting to the headlines of this issue, their reaction is more muted than in 2011. An explanation for this might be market complacency in the sense that they are shrugging off the issue, assuming that a deal will be reached by the 11th hour, similar to 2011. Alternatively, market participants might be looking beyond the politics and focusing on the so far good health of the economy itself, and recognising that the government shutdown likely will cut only 0.6% from fourth quarter US economic growth. *[As at the time of final edit, the 11th hour*

accord was in fact reached. While this is good news for the American people, we remain concerned that those responsible for taking matters to the brink have yet to recognise that there are significant consequences to their behaviour which are borne primarily by those they represent. And because the accord alleviates matters only until early 2014, the consequences remain a very real risk unless a more permanent agreement can be reached in the interim.]

In the last edition of *Veritas* we examined the health of the US economy, and in particular the heavyweight employment and housing markets. Recent data has confirmed their continued robustness: past due mortgage payments are at their lowest point in over four years, and small business hiring is increasing. This is significant not only because of the implied positive sentiment, but also because it has helped to offset government layoffs and change the economic leadership from government to the more stable and expanding private sector. Generally, because businesses tend to make hiring and investment decisions based on their long term economic outlook, business-led economic growth is considered healthier and more sustainable than government based activity which is more "of the moment". We are seeing positive developments in Europe as well where, despite pockets of weakness in some of the southern countries, overall business and consumer confidence continues to improve. Perhaps this relates to the fact that the European recession officially ended in the second quarter, providing for more optimism about the future. As we learned back in 2008/09, sentiment can have a very powerful influence on an economy, and this new sense of optimism could be the thing that tips the Eurozone economy back to long term growth and prosperity. Anecdotally, UK auto sales rose to a five year high in September, and are close to pre-recession averages. This may not be a valid indication of the health of the rest of Europe, but combining it with the sentiment data and other country by country developments does suggest that Europe is doing better than it has done in a very long time.

OUTLOOK

Despite the Fed's surprise decision to leave all stimulus measures in place, thereby keeping interest rates artificially low, we still see the risk to rates as being upwards, which will produce price declines in bonds and other interest sensitive assets. While the Fed's decision will temporarily reduce it, we expect the flow of investor capital will continue to be from bonds to equities. Some will remain in cash to take advantage of the marginally higher interest rates, despite that when rates do move, they still will be low by historical measures. We view the combination of low rates, continuing improvement in global business and economic fundamentals and sentiment, very liquid, cash-rich balance sheets, and significantly improved personal finances, to be supportive of equities. Canada's non-resource sectors, which have lagged their US peers disproportionally, particularly should benefit.

STRATEGY

Our strategy continues to be to focus on the things that matter to and truly affect an economy, industry or company in which our clients are invested, or in which we are contemplating an investment for our clients. Our strategy does not include reacting to headlines that cause the markets to swoon or rocket ahead: this is the stuff of the media outlets and their talking heads. Paraphrasing a respected colleague, the companies in which our clients are invested were around long before we were, and likely will be around long after we are gone. The implication is that quality endures, and investing in quality, fundamentally sound companies with good prospects will go a long way to mitigate the short term effects of headline-driven market volatility. As we have stressed before, we are not traders, and consequently we can look well beyond the near term events that can often immediately and negatively affect stock prices. Assuming corporate fundamentals remain intact, we call these setbacks buying opportunities for the long term, not reasons to run for the hills.
We always welcome your calls for discussion and feedback.

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