VERITAS

Fall 2014

DID YOU KNOW...

- Funds on deposit at US banks are at record levels of over $10 trillion.
- According to the London Zoological Society, over half of the world's wildlife species have been lost over the last 40 years, largely due to human activity.
- The Canadian home renovation market is as big as the new home construction market.
- The US financial derivatives market, the collapse of which played a large role in the 2008-09 credit crisis, is valued at over $700 trillion, as compared to entire US economy at $17.3 trillion.
- Almost half of the collective revenue of the S&P500 is generated overseas.
- Equity market volatility, as measured by the Volatility Index (VIX), is up over 100% from its five year low—set in June 2014.
- There are 2,325 billionaires in the world, 155 more than last year, with combined net worth of US $7.3 trillion.
- Halloween has become one of the most popular "holidays" in the US, with related spending totalling $7.4 billion, but still well behind Christmas spending of $704 billion.

CURRENT SITUATION

Reminding us that equity markets do not always go up, and are volatile places to invest, the TSX declined for the first time this year, falling by 1% in the last quarter. September has long been considered the worst performing month of the year, and this year was no exception, but it has bled into October as well. It is as if traders came back from summer holidays, hit the sell button, and kept on hitting it, taking our market down 4% in September alone, and as at the time of writing, 10% from the peak set in September, defining the current decline as a correction. In the US, the broad S&P500 posted a modest 1.1% gain for the quarter, but with its post-September declines, continues to lag the TSX, although the gap has narrowed. Equity market declines have been swift and brutal, but despite them, both Canadian and US markets are still modestly positive for the year.

In an attempt to reconcile the disparity in quarterly returns between the two markets, we look to their composition. The TSX remains very concentrated in three sectors: energy (25.5%), materials (11.1%) and financials (34.7%), and when these sectors come under pressure, so too will the TSX. These factors do not impact the S&P as dramatically because industry representation in the S&P is much more broadly diversified across the US economy. Materials and energy stocks are reacting not only to fears of slower than forecasted economic growth in Europe and China, translating to the potential for lower commodity demand, but also to tensions in the Middle East and Eastern Europe, and the expanding Ebola epidemic. The latter is arguably the more serious issue because in addition to the human impact, the fear of the spread of the disease can significantly disrupt the global economy by, amongst other things, cancelled factory orders, escalating regional quarantines, closed trade routes and restricted air space, these last two impacting travel and the flow of goods. On a more positive note, the recent pressure on financials, both here and in the US, is actually as a result of the ongoing improvement in US economic fundamentals, which is leading to heightened speculation of imminently rising interest rates. The spectre of higher rates will always put pressure on equities, but tends to hit the interest sensitive sectors, including financials and utilities, harder.

With volatility suddenly returning to equity markets, albeit still at low levels compared to what we endured in 2008—09, it is worthwhile revisiting the topic of correlation between individual stocks and the market. A recent piece by BMO Capital Markets confirms that intra-stock correlations have dropped to below average levels after being well above normal for an unusually long period. This is

important to us as asset managers because an environment of low correlation favours stock picking, as opposed to index, or passive, investing. The author of the BMO article goes on to observe that correlation trends are not uniform, and not all sectors or stocks will behave in the same manner. They will respond differently to various macroeconomic factors, further emphasising selectivity in investing. Despite the discomfort that comes with volatility, our view is that it, coupled with decreasing correlations, creates opportunities at the individual security level that do not exist when all assets are moving in unison. It is also an environment in which underlying fundamentals should take on greater importance in the security selection process.

On a much more macro level, in the last quarter we received more data confirming that despite pockets of weakness, such as record low manufacturing activity in Ontario, North American economic fundamentals are strengthening. The US labour market is getting tighter as measured by the declining unemployment rate, now below the 20 year average of 6%, and the "positions hard to fill" index. In conjunction with these two data points, there is upward pressure on wages, a phenomenon that has been absent from the labour market for the past seven years. The combination of labour market data with existing home sales data is considered a reliable indicator of future economic activity, and with existing home sales at 10 month highs, the indicator is positive. This is important to Canada because our economy remains heavily influenced by the health of our export markets, and as the US is still our largest trading partner, their positive economic data is expected to benefit us. We will feel the effects of Europe's sporadic growth and China's economic restraint, but likely not enough to cause a measurable domestic economic slowdown. Furthermore, the more the Canadian economy diversifies away from resources, the less the impact will be felt.

OUTLOOK

Current market activity is affirming our outlook. The US Fed has confirmed that higher interest rates are on the way, and equity markets are expected to react negatively to this, but quickly respond to good economic and company specific news, so we expect higher levels of volatility to persist. The Canadian dollar will remain under pressure, a benefit to our export based industries, for as long as commodity prices remain pressured. Europe's economic expansion is expected to continue to be fitful as it tackles integration challenges that arise as the Eurozone grows to include more of the peripheral nations. North American equity returns, although moderating from the levels experienced over the last several years, and likely more or less flat to year end, are expected to be positive longer term, and certainly higher than returns on bonds. When interest rates rise, bond prices ultimately must come down, despite their current reluctance to do so.

STRATEGY

Heightened market volatility and decreased correlations create opportunities to add incremental value to our clients' portfolios without altering their composition. By maintaining a close watch on the portfolios, we look to be opportunistic with the price movement of individual holdings, where the moves, whether up or down, appear to us to be inconsistent with the underlying fundamentals of the company in question. The challenge in doing this is to avoid being distracted by the current "noise" that affects the broad markets in the short term. Because we are committed to focussing on their long term investment goals and objectives, we strive to ensure that our clients' portfolios always are comprised of quality companies operating in stable, needs-based industries, both of which must stand the test of time and cycles. This requires us to look beyond what is making headlines today, and pay attention to the influences that are more likely to affect our clients' holdings in years, as opposed to hours and days, and make our investment decisions accordingly.
Please do not hesitate to call for further discussion.

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