VERITAS

Spring 2005

Earlier in the quarter, the federal Liberals delivered their first budget as a minority government. Of note to investors was the proposed removal of foreign property limits for retirement accounts. While limits were expected to be raised, the absolute removal came as a surprise, and has the potential of changing the face of the retail investment product market by making the use of so-called RRSP clone funds unnecessary and rendering them obsolete. If the budget is passed, investors will be able to purchase shares in foreign companies directly to any level they wish, avoiding the need to use this often expensive hybrid product. In other news in Canada, a release from Statistics Canada shows that Canadians are spending less on alcohol. Sales at beer, wine and liquor stores have declined by 8% since last year, largely due to the NHL and Quebec liquor store strikes. Further abroad, newly elected Palestinian leader Mahmoud Abbas has successfully negotiated a temporary ceasefire in the region, sparking hopes that a permanent resolution may not be far off. As one observer in the region noted: "more progress has been made in re-solving issues in three months than in the previous ten years."

CURRENT SITUATION

Canadian markets finished a volatile quarter up just over 4%. The strength in the TSX was largely as a result of an 18% gain in energy stocks, which have benefited from a year to date 27% rise in oil prices. The energy sector's gain was offset somewhat by a 10% decline in the Information Technology sector, and a 17% decline in the Paper and Forestry sector. Neither sector is represented in our clients' portfolios. US markets did not fare as well as Canada, with the broad S&P 500 declining 1.50% in Canadian dollar terms (2.10% in US currency). US markets continue to be overshadowed by ever-increasing US budget and trade deficits, a weak currency and the spectre of declining US corporate profitability in the wake of higher interest rates.

Canadian manufacturing activity increased 5.90% year over year, despite the Canadian dollar remaining solidly over USD 0.80. On the face of it, the increase suggests that manufacturers are adjusting to the stronger dollar, and can remain competitive even as our dollar finds a higher trading level. Supporting this comment is the recent statement made by International Monetary Fund (IMF) that Canada has room to raise interest rates, even with the impact of our higher dollar on our economy. The IMF forecasts that our economy will grow at just over 3% this year, with a slight emphasis on domestic demand over exports, reflecting the impact our strong dollar is having on our export sector. However, given that energy (oil, gas and electricity) represent 17% of our exports and are growing, the emphasis to which the IMF refers may balance out in the near future when we consider that energy exports are set to eclipse our largest export, autos. Furthermore, manufacturing capacity utilization is at 85% which is considered full utilization, implying that there is very little slack in the economy. With capital spending poised to increase to enhance capacity, and the forecasted strength in our economy, it is not surprising that David Dodge, governor of the Bank of Canada, once again warned of higher interest rates to come. In recent Senate testimony, Dodge commented that "eventually, rates are going to have to be higher than they are today."

Referencing a pickup in inflationary pressures and indications that pricing power (the ability of vendors to increase prices and have the increases stick) is more evident than it has been over the last several years, the US Federal Reserve (Fed) recently raised interest rates for the seventh time in a row. Unsurprisingly, the inflationary pressures cited are stemming primarily from high commodity prices, although capacity utilization rates in the US are at multi-year highs as well. This is slightly misleading though, because capacity has shrunk over the years due to a sharp increase in US reliance on imports to satisfy consumer demand for cheaper and cheaper goods. Of interest here is that China, while accounting for 6% of US imports in 1995, now stands at 10%, and virtually all imports are of finished goods. For comparative purposes, Canada represents 19% of US imports, which are mostly raw materials and energy. The increasing reliance on Chinese imports is a significant contributor to the US trade deficit because of the lack of offsetting US exports to China.

Global economic activity, although moderating in some regions, remains healthy, and is expected to grow at just under 3% for 2005, a reasonable level given the challenges faced by many countries because of rising oil prices. Rising oil prices tend to lead a decline in the demand for oil, and an attendant decline in economic activity, by one year, and it was just over a year ago that oil started its run. Therefore, the slowdown in some areas would appear to be part of a normal cycle.

On the topic of oil demand, it is interesting to note that as prices rise, demand will decline, and a new price/demand equilibrium will be established. However, the process is lengthy, and because global oil demand is much higher than is has been in the past, and new oil reserves are harder and costlier to find and exploit, the new equilibrium will be at a substantially higher price level than we are used to. In the absence of a global shift away from a reliance on fossil fuels, higher oil prices will be a permanent part of our lives. Furthermore, because of the chronic shortage of refining capacity, and the length of time it takes to construct a refinery, diesel and gasoline prices will be even higher, especially in peak driving seasons.

OUTLOOK

Higher interest rates and oil prices will be moderating influences for the balance of the year. Higher energy and capital costs will erode margins and reduce corporate earnings, except in the energy sector. As oil reserves become harder replace, even the oil companies will see their earnings come under pressure, but not for a year or two yet. In the last edition of *Veritas* we called for single digit equity returns in 2005. With Canadian markets having already returned over 4%, we expect the balance of the year will be comparatively weak and volatile as markets digest jobs, inflation and interest rate data, and their implications on corporate profitability. In our view, the remainder of the year will continue to be a stock picker's market with an emphasis on defensive sectors. Investor caution is warranted, especially in terms of expected returns for the balance of the year.

STRATEGY

Despite our cautionary stance on equities, they remain our asset class of choice. However, given the strength of first quarter returns, and in an effort to preserve them, clients can expect to see cash levels rise in their portfolios as we reduce the level of some of the stronger names in the accounts. As a result, overall equity holdings may be marginally reduced over the next few months, but no names are expected to be removed. Depending on market activity, we expect to be back to full weights by the Fall. With interest rates expected to rise in Canada, the yield curve is slowly shifting in favour of those accounts needing fixed income. In a first step, we were able to fill the 5 year maturity gap with an attractive newly issued preferred share. Adding this preferred to the appropriate accounts has reduced the cash drag on the performance of those accounts, and is consistent with our ongoing efforts to enhance portfolio returns and reduce volatility.

We would be pleased to discuss any of the points raised here in more detail. Please do not hesitate to call.

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