VERITAS

Spring 2006

Likely the biggest headline grabber in Canada this past quarter was the initial public offering (IPO) of Tim Horton's by its parent company Wendy's International. The IPO price of CA$27 per share values Tim's at US$4 billion, a significant gain over the US$600 million Wendy's paid for it in 1996. This proved to be one of the most widely anticipated and popular deals in Canadian market history. It was remarkably oversubscribed, meaning that there were many people standing in line to buy each share issued. The demand resulted in many disappointed investors, large and small, who could not participate in the IPO. More Tim's shares are coming, but not via an IPO. Another piece of financial news that caught our eye was the announcement that some financial institutions are now offering 35 year mortgages, and expect 50 year terms to follow soon. The longer term reduces monthly payments, but dramatically increases the overall cost of borrowing. For example, a $300,000, 25 year mortgage at 6% has a total cost of borrowing of $575,826. The cost of a 35 year loan with the same terms jumps to $712,213. By offering these terms, financial institutions are trying to attract future buyers today at the expense of the future, similar to what the automakers did when they extended car loans from five to seven years.

CURRENT SITUATION

The TSX Total Return Index posted another series of strong gains and new highs culminating in a rise of 8.0% for the quarter. Although the performance was stronger than many had anticipated, the gain was much broader than other recent advances. Half of the TSX sectors outperformed the index in the quarter, whereas previous gains of late have been almost entirely attributable to the natural resource sector, energy specifically. As an example of the broadening of sector leadership, we note that the health care sector, which has chronically underperformed in recent rallies, posted a respectable 7.9% gain for the quarter, essentially in line with the index. Although it is too early to say with certainty, this leadership change may be reflecting a catch up by sectors that have fallen out of favour while the focus has been on energy over the last couple of years. Canadian corporate profitability ex-energy has improved significantly since its trough in 2002, but has not been entirely reflected in share price appreciation. For this reason, we would not be surprised to see non-energy share price appreciation to continue until an equilibrium is reached where valuation of these companies is at more historical levels, given current economic conditions.

Unemployment in Canada is at its lowest level since 1974 at 6.3%. Not surprisingly, the figure is much lower in Alberta due to the voracious appetite the oil sands projects have for labour. Even in Ontario, where the manufacturing sector has been shedding jobs, the labour market is tight. Recent statistics suggest that there has been a significant number of replacement jobs created in residential and industrial construction, including infrastructure, thereby dramatically reducing the net loss of jobs. Moreover, the majority of these jobs are considered more skilled than the ones they replaced. If the trend continues, the shift away from manufacturing could serve to boost Canada's economic productivity levels which have historically lagged other developed nations, but were until recently masked by our weak dollar.

We have previously commented that it appears that the Canadian economy is operating at or near capacity as evidenced by a utilisation rate measure of just below 90%. Recent data confirms that this is the case. Results from the most recent Business Outlook Survey from the Bank of Canada (BOC) indicate that 50% of the firms surveyed anticipate difficulties in meeting any unanticipated increase in demand for their goods or services. More importantly, 15% of the respondents stated that they are already having difficulty meeting increased demand. The results of this survey imply that the Canadian economy can continue to expand outside of the energy sector. There is enough potential growth to allow the BOC to continue to raise interest rates at least a few more times this year in its ongoing effort to stay ahead of inflation, currently at 2.5%. Of note, BC has the lowest inflation rate in Canada at below 2%. Whether this distinction holds in light of skyrocketing housing costs, especially in the Lower Mainland, remains to be seen.

In the face of its escalating twin deficits (trade and fiscal), the US economy remains resilient, but still primarily on the backs of consumers. Consumer demand remains robust, but that demand is increasingly being met by lower and lower priced imported goods. This reliance on imports is exacerbating the deficits, which in turn increases the government's need to borrow. Increased borrowing requirements are causing issues for US Congress. The US government has a legal maximum debt limit of $8.18 trillion which has been surpassed a couple of times this quarter. As a result, the US Treasury has suspended special treasury auctions, and may have to suspend regular auctions, so that the legal debt limit is not permanently breached, unless Congress agrees to increase the limit. As risky as raising the limit is, it begs the question of who will be the purchasers of that new debt. A Chicago Federal Reserve member recently remarked openly that he is worried that Asian central banks will discover there are better domestic uses for their accumulated cash, and that the banks will bring the cash back and invest it in their own countries. We raised this possibility in the last edition of *Veritas*, but this is the first time we have seen these concerns raised publicly by a member of the Fed. If this does occur in any meaningful fashion, raising the US debt ceiling may be ineffective, and perhaps even unnecessary, because demand for existing debt may dry up, causing other problems such as how to continue funding the deficits.

OUTLOOK

After we called for moderating equity returns for 2006 in the last edition of *Veritas*, the TSX promptly had one of its strongest first quarters on record, effectively meeting our return expectations for the entire year. However, our cautions remain in place. We still see the decelerating effects of higher interest rates, a strong dollar and high raw material and energy costs translating into lacklustre equity returns for the balance of the year. There will be pockets of out performance, but the index heavyweights will not be the leaders they have been. Volatility is rising off its historic low, a point where investor complacency is at its highest, and markets at their most vulnerable. We are regularly seeing 100 point-plus days in the market. This implies that any negative surprises will result in dramatic swings in the market, and it may easily decline before finishing the year at roughly the level it is at today.

STRATEGY

With equity returns having already almost met our expectations for the year, we are wary of catalysts that may take the markets lower. While markets remain strong, we will take advantage of them and take profits in companies that have exhibited the strongest returns. This frees up cash that will permit us to add to any currently owned companies that might face weakness if markets pull back this summer. On a company specific basis, our portfolios will be losing CHC Helicopter Corporation and Fairmont Hotels because management of both companies intends to take the companies private by selling them to outside bidders. While profits will be realized on both transactions, the challenge will be to replace them. Any companies considered as their replacement will have the same conservative characteristics that are the hallmark of the balance of the holdings in our clients' portfolios. Candidates have been identified, and clients can expect to see the changes in their June statements.

As ever, we welcome your feedback to this letter. Please feel free to call for discussion.

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