VERITAS

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There has been more potentially industry altering news from the auto sector. Leaving aside Ford's 2006 financial results wherein it lost $12.7 billion, the largest loss in 103 years, it was Daimler-Chrysler confirming rumoured plans to undo the 1998 merger, and sell its Chrysler division. The anticipated sale price is near $5 billion, substantially lower than the $37 billion Daimler-Benz originally paid for the operations. In other financial news, it was reported that in 2006, hedge fund assets in the US topped $1 trillion, which, recalling from the last edition of *Veritas*, is equivalent to the value of the Chinese foreign exchange reserve. The level of investment in hedge funds is indicative of the widespread acceptance at the retail level of this historically esoteric 'alternative investment' asset class, and also of the willingness of investors to assume increasingly alarming levels of risk to satisfy their appetite for return. In Canada, March was Federal Budget month. The budget, widely anticipated to be aggressive and investor friendly, was received as safe and according to some, rather disappointing. One item of note for RRSP holders is the increased age at which these accounts must be converted to RRIFs, from 69 to 71. The change provides for two additional years of RRSP contributions and related tax deferral.

## CURRENT SITUATION

Markets in North America got off to a rocky start this year. The TSX shed 3.50% in the first seven trading sessions of 2007, but then reversed course to set a series of new record highs in very choppy trading. At the end of February, the day after its highest close to date, the TSX suffered its second of three significant pullbacks in the quarter, dropping some 364 points, or 2.72%. This drop was in response to a dramatic one day decline in the Chinese stock market. The TSX recovered half of its decline within a couple of trading sessions, only to suffer its third pullback. This one day drop of 256 points, or 2%, was precipitated by news out of the US that several sub-prime mortgage lenders there were seeking bankruptcy protection. Again, the TSX quickly reversed itself, and finished the volatile quarter up 2.60%.

US markets did not fare as well. While they were impacted by the same negative events as was the TSX, they did not rally back with the same strength, finishing the quarter up only 0.6%. The weaker performance can be attributed in part to a weaker US economy, and the fact that the last market decline had its roots in the US, and its cause may have a significant negative impact on the US economy.

Because they affected markets and received as much press as they did, it is worth looking at the two events that caused markets to correct last quarter. The weakness in the US sub-prime mortgage market is a serious problem. Sub-prime mortgages are granted to people who generally cannot qualify for a standard mortgage, making the loans inherently riskier, and therefore carry higher than market interest rates. It is a market dominated by independent non-bank lenders engaged in creative lending practices with people whose credit rating is often low. The upshot is that if the housing market sours, whether from declining real estate prices or rising interest rates, it will be these borrowers who will be the first to default. This causes a liquidity crunch for the lenders who themselves have borrowed to fund the lending. A domino effect ensues: borrowers default, the sub-prime lender defaults in turn and the main lenders start foreclosing against what little equity is in the borrowers' homes. What the markets fear is the potential creation of a new segment of the population that not only will not be consuming, but will be requiring financial assistance, leading to a marked decline in consumer spending, and accelerating an economic slowdown. The risk is real, but the Federal Reserve will likely act to forestall the worst effects by lowering interest rates to ease the burden of borrowers. As a trading partner, Canada will feel some of these effects, but not to the same degree as the US. The positive side to this issue is that it might discourage homeowners from taking on more consumer debt at the expense of their shelter in the form of mortgage equity withdrawals.

The Chinese market decline, on the other hand, was non-fundamental in nature, and did not reflect a feared weakening in their economy, which remains strong. Global stock markets recovered quickly after it was determined that Chinese demand was not waning and a recession was not imminent. The decline was a localized event sparked by policy makers stating their concern that there is too much speculation in the Chinese market, and to control it they are considering restricting account openings and investment borrowing. To put these comments in context, the Chinese market was up 80% in 2006, and 98% of the trading was retail, coming from an existing 80.5 million brokerage accounts, with an additional 90,000 being opened every day. Quoting the Chairman of the National People's Congress, the Chinese equity market was exhibiting "bubble-like characteristics", and a correction was due. The Chairman commented further to the effect that over 70% of the universe of companies listed on the Chinese exchange are *below* investment grade by western standards, and that every investor, or perhaps more accurately speculator, thinks they can win, but "...most will end up losing." Even with these strong words, people were still lining up for hours to open accounts on the days after the decline.

## OUTLOOK

Market volatility notwithstanding, little has changed over the last three months to alter our outlook. Economic activity around the world remains stable, with emerging markets exhibiting the most growth. While there are areas of slower growth in Europe, these are well compensated for by the faster growing regions, allowing for what is expected to be near 5% overall economic growth in that area this year. Even the US continues to post relatively stable numbers, but not so strong as to be a risk for rising interest rates. In fact, as mentioned earlier, provided the it does not cause a spike in inflation, it would not surprise us to see rates decline in a bid to support consumer demand. Canada's economic outlook remains good, although the weakness in the manufacturing sector is dragging down overall numbers. North American equities are expected to continue to outperform bonds, and remain within historic return ranges. Volatility will continue throughout the year as markets react to news before the implications of the announcements are fully known. However, if we experience more pullbacks like we did this last quarter, volatility might actually decline towards the end of the year as investors reassess their risk tolerance. Absent clear inflationary pressures or risks of recession, we expect interest rates to remain relatively unchanged for the remainder of the year.

## STRATEGY

Looking at the three market pullbacks we experienced this last quarter, it is interesting to note that it was the smaller and lower quality companies that were hardest hit. This observation reaffirms our thesis that investing in quality companies will define the successful and stable portfolio in the coming quarters. Volatility will affect even the best constructed portfolios, but to a much lesser degree than one that is based on chasing momentum, trends and short term returns. We have experienced market pullbacks as expected, but for the wrong reasons which suggest that investors are becoming jittery and will be looking to move their assets to areas where we are already invested, providing further support for our clients' portfolios. In this sense, we welcome volatility as an opportunity to bolster our positions in these safe havens. Because of our view on interest rates, we continue to view equities as the preferred asset class, and will add fixed income only to portfolios with specific income requirements.

Please feel free to call with questions or for further discussion.

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