VERITAS

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In the news last quarter, former Indonesian Prime Minister Suharto died at the age of 86. Suharto went from notoriety to obscurity after being driven from office in 1998 following the Bre-X scandal. Microsoft launched a $4.5 billion bid for Yahoo. If the bid is successful, to fund it, Microsoft will have to issue debt for the first time in its history. Hasbro, the big US games maker, is paying $80 million to the Canadian creators of Trivial Pursuit for the intellectual rights to the game. We speculate this will form a question in the newest edition when it is released. On a related topic, in a report prepared for the federal government, Secor Consulting concluded that Canada has the dubious distinction of being the easiest country in the world for foreigners to take over domestic companies. Population flows between provinces are experiencing a sea change. Alberta has witnessed a net out-migration for the first time in over ten years and those leaving seem to be moving to Saskatchewan, which is experiencing significant economic growth. Newfoundland is also experiencing net population inflows, the first since 1990, and New Brunswick's population growth is the strongest since 1984. And after climbing an eye-popping 500% in two years, the Chinese stock market has plunged 45% so far this year.

CURRENT SITUATION

North American markets endured a great deal of volatility in the first quarter, much of it driven by news relating to the ongoing credit crisis. However, as dramatic as some of the market swings were, the level of volatility is still significantly below levels experienced during the Asian currency crisis and the more recent "Tech Wreck". The present lower level of volatility could be interpreted to either suggest that conditions are currently not as bad as they were in previous periods of severe volatility or that the worst is yet to come. For a multitude of reasons, including better disclosure rules, we subscribe to the former. We believe that although we are not finished with what has been causing the markets pain, more of the bad news is known than not, allowing the markets to begin looking forward to recovery with improving investor sentiment. Some of the higher levels of volatility have been experienced in the resource sector on fears of a slowing global economy, and in the financials as their stocks respond to news of continued credit tightening and ongoing write-offs of non-performing loans. However, despite recent market conditions, many companies, including financials, have been very successful in raising equity, even after taking substantial write-offs. For example, CIBC recently wrote off several billion dollars in impaired assets, but was able to raise almost $3 billion in new equity. In the US, financial firm Lehman Brothers went to market last month to raise $3 billion, but the demand for the stock was so strong that the deal was increased to $4 billion. This deal was particularly interesting because in the face of diluting existing shareholders by 15% with the new equity, the stock rose by 18% on the day the deal was announced. We are also seeing operating earnings in this sector holding up reasonably well. For example, UBS AG, a global financial firm, took a $19 billion write down last quarter, resulting in a loss of $12 billion. This means that ignoring the one time event of the write down, their quarterly profit would have been $7 billion. Something to consider regarding the write-downs is that over time, as credit markets improve, institutions like CIBC, Lehman and UBS will recover some of the value of the assets they write off.

Global credit markets remain tight as lenders continue to reassess and re-price risk. Because this tightness restricts the flow of funds among lenders and borrowers, it is perpetuating what has been frequently referred to as a liquidity crisis. The good news is that there are indications that this is easing, but more importantly, there is not an overall liquidity crisis. We have mentioned in the past that there were trillions of dollars awash in the market, looking for a place to invest. This remains so today, suggesting that the difficulties we are experiencing in the markets will be refined to the point where they will impact only the entities directly involved in the weaker parts of the credit market. Along these lines, a study reported in the February 2008 edition of the CFA Digest suggests that just over 2% of outstanding loans in the US are delinquent (sub prime loans represent between 10 - 13% of outstanding loans), a level insufficient to cause the collapse of the economy. The authors stress that local economies will suffer, but the impact will vary from region to region.

The International Monetary Fund (IMF) recently released its revised 2008 economic forecasts, in which global economic growth has been scaled down from 4.8% to 4.1%, with China and India as the only two regions not expected to experience a slowdown. Conditions in the US are having an impact on investor sentiment around the world, which is understandable when the IMF goes on to say that the US is experiencing the "worst financial crisis… since the Great Depression". To combat negative sentiment and stimulate economic growth, central banks around the world have been cutting interest rates by varying degrees. The US has been particularly aggressive and forecasts that the rate cuts and other components in the recently implemented stimulus package will provide for economic recovery in late 2008, and continued growth in 2009. There are some early indications that this will be so, but there are also increased signs of inflation in the US economy. If growth does not pick up, and inflation continues to rise, the US Fed is going to run out of options, and may be forced to tip the US into a real recession to ultimately re-ignite the economy. This is a worst case scenario, and the Fed is actively working to avoid it.

OUTLOOK

Given the very rough start to this year, it would be easy to say that we are in for more of the same for the remainder. However, while there remain many storm clouds on the investment horizon, we are cautiously and modestly more optimistic of investor prospects than we were in our last edition of *Veritas*. Part of what has changed is that we have experienced a three month period in which it seems that the majority of companies that had bad news to report did so, but also reported on anything that might be perceived as bad. This was a "kitchen sink quarter", where companies throw everything from the real problems to the 'it might become a problem some time in the future' into their financial reports and, where necessary, write the affected assets off. Another ray of hope is found in the ability of these affected companies to raise money in the markets at the same time as they are writing off assets, suggesting that the markets believe the worst is behind us. And because markets are forward looking, there may be reason to be optimistic that they are anticipating a recovery.

STRATEGY

Client portfolios continue to carry higher than normal levels of cash, although some of it was used earlier in the quarter to add to financial services stocks that had experienced some significant declines. Overall, we remain comfortable with the larger cash balances through the upcoming earnings reporting season. Assuming companies are not hiding any unpleasant surprises and have done what they had committed to doing to reassure investors, we anticipate reinvesting the cash later this quarter. Client portfolios remain short one holding, as a result of the 2007 sale of BCE, and we are expecting to lose another company to take-over this quarter. Both voids will likely be filled at the same time as we utilize surplus cash. In replacing these companies, we will continue to focus on conservatively and well run companies that provide for the necessities of life, as opposed to the luxuries. Our preferred asset class remains equities, and because we continue to believe that capital appreciation will be more difficult to achieve now than in recent years, dividends will play an increasing role in portfolio construction and returns.

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