VERITAS

Spring 2009

## DID YOU KNOW...

- Lamborghini made record deliveries and profits in 2008, bucking the trend of overall declining global auto sales.
- Canada's economy is roughly the size of that of California, but happily, is in much better shape.
- 40% of the world's wealth was destroyed in the five quarters ended December 31, 2008.
- Elevator and background music producer Muzak has filed for bankruptcy.
- The market value of Tim Horton's is approximately five times that of General Motors.
- Canada officially became a net creditor nation at the end of 2008 for the first time in modern history.
- US households are paying down debt for the first time in over 50 years.
- Polaroid, the company that brought the world instant photography and anti-glare sunglasses, has been purchased from bankruptcy by a group of investors, including a Canadian private equity firm.
- It costs over $70 to find and produce a new barrel of oil. This is lower than it was last year, but $20 higher than oil prices today.

## CURRENT SITUATION

Although still down marginally for the year, North American markets ended the quarter significantly higher than the lows posted in early March. As at the time of writing, the TSX has extended its gains and is up just under 5% since January, and is 22% higher than the March low. What makes the current rally interesting is the fact that it has been largely uninterrupted, and where the interruptions have occurred, the pullbacks have been to higher lows. Another interesting observation is that the financials have been significant contributors to the rally, suggesting that we may be experiencing a thaw in the credit markets. However, there are still significant risks in the economy, the news of which could easily pull markets back to prior lows. Headlines of credit card delinquencies, job losses, declining productivity, personal and corporate bankruptcies and slowing global economic growth do nothing to improve market and investor sentiment. Yet despite these headlines, it does appear that sentiment is improving. Indicators that were very much in focus when they were declining have shown tremendous improvement, but with little fanfare. For example, the interest rate banks charge one another is back to near normal levels, whereas at the peak of the credit crisis, the rate was some four times higher. Overall, the lower this rate is the better, indicating that banks are seeing less lending risk, at least among themselves. As a side comment, Canadian banks posted first quarter earnings that were lower than last year, but were nevertheless healthy. In fact, Royal Bank posted first quarter earnings in excess of $1 billion. We make specific mention of this because Royal was the first bank to post earnings of $1 billion for the *year*—in 1998.

Equity market volatility, as measured by the "VIX" is also declining, suggesting that risk appetite is returning to the markets. Under what would be considered normal conditions, a reading of 40 on the VIX is considered high, indicating risk aversion among investors. At its peak in November, the VIX hit 90, and is now at 35. While still high in an historical context, the improvement is remarkable, and somewhat encouraging for those of us who felt that the markets had become dramatically oversold over the last several months. Again, while headlines and emotions could well pull markets lower from here, we are largely in agreement with those market strategists who have said that we have put in a market bottom. And if we are to look for another indicator of improving sentiment, it is, for a change, the media. It would appear that there has been a subtle, but continuing, shift away from the doom and gloom to which we have been perpetually subjected since October. If there is one single factor that will have a positive impact on market psychology, it will be an end to the media's practice of sensationalizing the negative. When this happens, it should break the existing negative feedback loop, and we hope rational, fundamental analysis will then return to the markets.

A great deal has been made of how bad the recent economic and market experience is and has been. While we acknowledge that it has had a profoundly negative effect on many, some good is coming out of it as well. For example, take the exposure of fraudsters like Bernie Madoff, R. Allen Stanford and Weizhen Tang, all of whom have been defrauding investors for years and decades. These rogues, and many others like them, would have continued doing so if what we have recently experienced was just the run of the mill market correction and economic contraction. But the speed and severity of the declines did not allow the fraudsters time to react, finally exposing them for what they are. The same factors have also exposed the fact that many purported hedge funds were not hedge funds at all. Instead, they were simply vehicles created to use borrowed funds to play the markets. Many of these "funds" have failed as a result of their bets going bad and in turn resulting in their inability to pay the loans being called. In the same vein, the recent debacle has exposed the weak policies employed by many lending institutions, and has forced them and many of their counterparties out of the market. On balance, but giving due regard to the innocent victims of the mess, we feel that when we emerge from this period, market and economic fundamentals will be stronger, providing a more stable foundation for real future growth. All this said, a big long term negative result of this experience will be an environment of severely heightened regulation and oversight, which will make commerce more difficult, and more expensive.

## OUTLOOK

Until we know with certainty that economic conditions are improving, markets will be jittery. They will continue to react to headlines, looking for reasons to pull back. However, if we continue in the pattern that we have witnessed in the last six weeks, we may well see higher highs and higher lows, even on pull-backs. Should this prove to be the case, markets could establish a base near current levels, much as we suggested in the winter edition of *Veritas*, with a modest positive bias for the balance of the year. For all the negatives still in the system, there is also much support for the economy and markets in the form of low interest rates, declining house prices, abundant stimulus programs, and an emerging sense of optimism that has not been present in the better part of a year. At this point, one of our largest concerns for the future is the emergence of inflation, coming as a result of the stimulus that has been provided by lower rates and the printing of money, and the ability to control it in a fragile recovery.

## STRATEGY

We have not altered the strategy or discipline with which we manage our clients' portfolios. With interest rates as low as they are, and expected to stay low for the foreseeable future, equities remain our favoured asset class. We remain long-only. Our focus continues to be on well and conservatively managed companies that are leaders in their preferably needs-based industries. As this year progresses, and markets demonstrate a convincing bottom, we will likely reinvest some of the overweight cash that has been held in the portfolios since late 2007. While adding to existing positions, we are also examining ways of taking advantage of what we expect to be a long term decline in the US dollar resulting from current and future stimulus programs. We are also considering establishing more direct exposure to oil. We would like to take advantage of what we think will be the inevitable increase in oil prices, resulting from increasing demand arising from economic recovery coupled with supply constraints due to recent cutbacks in exploration, development and production.

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