VERITAS

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DID YOU KNOW...

- A recent study showed that drivers of Hummers, the now discontinued over-sized GM SUV originally developed for the US military, picked up 5 times the number of traffic tickets than the average motorist.
- There were four IPOs (initial public offerings) in Canada in the first quarter of 2010: the same number of IPOs as <u>all</u> of 2009. This statistic is another indication that capital and credit markets are healing.
- Germany's economy is recovering so rapidly that the country is facing a shortage of freight cars and some 50-100 locomotives.
- The Canadian dollar has been one of the strongest currencies in the world this year, trailing only the Mexican peso.
- In 2009, the number of announced Canadian acquisitions of foreign companies exceeded foreign takeovers of Canadian companies for the first time in five years.
- US households lost over $17 trillion during the recession. The good news is they have since recovered one third of the loss through rising asset values and personal debt reduction.

CURRENT SITUATION

Despite a weak start to the year, the TSX Total Return Index ended the quarter up 3.1%. The US S&P 500 outpaced the TSX, gaining 5.4% in US dollars, but adjusting for currency, was up only 1.6%. In fact, on a currency adjusted basis, the TSX has posted near twice the return of the S&P 500 over the last twelve months. The implication is that if a Canadian investor had held significant assets in US dollars, and had not hedged their exposure to or insured themselves against currency fluctuations, nearly half of their returns would have been lost to US dollar depreciation. However, hedges are expensive, have a limited life and are difficult to obtain for the average investor. Given this and the recent experience with the US dollar, individual Canadian investors would do well to examine how much exposure they have to non-Canadian dollar assets, and why those assets are being held. If the goal is geographic diversification, to limit currency risk, consider investing in Canadian companies with foreign operations as opposed to investing in the jurisdictions directly.

Notwithstanding the ongoing concerns about the solvency of "PIIGS" (Portugal, Italy, Ireland, Greece and Spain), there is mounting evidence that global economies continue to expand. In the last edition of *Veritas*, we spent some time on the topic of employment, and how it factors into economic declines and expansions. Since then, US jobs numbers have improved markedly. While unemployment numbers remain high, and the number of underemployed is worse, actual jobs *created* in March numbered 162,000, the fastest growth rate in three years. The accelerated growth serves in part to support our thesis that in the early days of the economic contraction, employers cut their workforces more than warranted, and now must hire more and faster just to bring staffing to levels consistent with the current stage of an economic recovery. Regardless of what has driven the employment gains, March marked the fourth out of the last five months that the US economy added jobs. It will take time for the new jobs to bring unemployment levels down, given that in excess of 8.4 million jobs have been lost in the US since December 2007. Assuming the conditions are in place to support continued jobs growth, the new jobs should translate into increasing domestic demand and increased economic activity. This is why jobs growth is a critical issue for an economic recovery to be self-sustaining

As US economic activity accelerates, there appears to be a shift in its drivers. The emerging "new" US economy is showing signs of being more about exports, investment and savings, as opposed to housing, debt and consumption, arguing for greater sustainability of the emerging economic expansion. The change of focus is encouraging inasmuch as excess consumerism has long been recognised as a poor way to forge a strong economy. This is especially so when the majority of goods being consumed are imported, a pattern that is generally detrimental to domestic production. Also affecting consumption will be the weaker US dollar, which increases the cost of imports, making them less attractive. Consumption habits less focussed on having more, bigger and new should be less energy intensive, further benefitting the US by reducing their dependency on foreign energy sources.

The story in Canada has been the strength in our dollar, a result of a combination of strong economic fundamentals, low sovereign risk, a soft USD and record foreign purchases of Canadian assets and securities, all of which creates demand for our dollar. In 2008, the last time our dollar hit parity, the fear was that our economy would contract because of expected dramatic export declines. This time, this concern seems to be largely absent, perhaps partly because we have been told to expect a strong CAD since it last sold off. Companies have been adjusting, for example, by using our dollars to import productivity enhancing machinery and technology. This could help to narrow Canada's output gap which, despite a recent surge, remains right at the 25 year average. The strong dollar also aids the Bank of Canada by restraining growth and acting as a built-in inflation buffer, permitting the BOC some latitude in how aggressively it will raise interest rates.

OUTLOOK

The consensus forecast now seems to be that global economies will continue to improve, sustaining the earnings growth and resulting increased equity valuations we have witnessed in the last few quarters. There is a relationship between equity returns and macroeconomic factors, including population growth and inflation, a change in which can influence returns independent of company specific fundamentals. Current inflation expectations, although rising, are low, combining with other factors to create an environment in which we should expect more modest equity returns than in the recent past. If, in an era when inflation was at 4—5%, return expectations were 10%, then it follows that now with inflation at 2%, long-term returns should be lower, holding all else equal. We believe this will be the case for some time to come as markets continue to normalise and adjust to their new economic realities. We are looking for extended low inflation, low but higher than current bond yields and long-run average equity returns. This will be supported by modest economic growth that will be less dependent on the consumer, and will see more contribution from the domestic manufacturing, service and construction sectors.

STRATEGY

There has been much press recently devoted to the investment industry's shift in focus to higher dividend paying, good quality, less economically sensitive companies as the investments of choice. According to a recent article in the Globe and Mail, fundamentals are now playing a much more important role in security selection. In hearing this, we are pleased that there are others who appreciate the merits of a discipline that we have consistently applied to our clients' portfolios since day one. Despite it garnering widespread attention, this discipline shall remain in place. Our responsibility is to preserve and conservatively grow our clients' wealth over time. Sound fundamentals of the assets we use to discharge that responsibility are essential. This is not new or novel to our clients. Our portfolio structure remains equity biased, but after years of waiting, rising interest rates may finally allow us to get some modest bond exposure into those of our clients' portfolios that call for it. We will focus on high grade credit, corporate as well as government.

Please do not hesitate to call for discussion or more detail.

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