VERITAS

Spring 2011

DID YOU KNOW...

- Including Medicare, Medicaid and Social Security, the US Treasury's real obligations are upwards of $75 trillion, 500% of US GDP.
- A BC Business Council study found that, excluding inflation, consumer prices have risen on average only 0.6% since BC implemented the HST.
- The US consumed 378 billion gallons of gasoline in 2009. Every extra penny per gallon costs the economy $1.38 billion.
- The energy required to produce one unit of economic output (GDP) is actually dropping in most countries as the world becomes increasingly industrialised.
- The drug industry will lose control over 10 mega-medicines this year as their patents expire. Historically, the day a drug comes off patent, the cheaper generic alternative will take up to 75% of its market share.
- Coke is the world's largest purchaser of aluminum and the second largest purchaser of glass.
- The Canadian dollar has doubled in value against the Mexican peso in the past decade, making our vacations there much more affordable.

CURRENT SITUATION

After a volatile three months, North American markets ended the quarter broadly higher. The TSX was up 5.6%, benefitting from strong materials and energy prices, while US markets were up 5.9%, responding to indications that the US economic recovery is becoming what policy makers are referring to as "self-sustaining". This status is important because it will provide the US Fed the flexibility to begin removing economic stimulus from the system with less risk of stalling the recovery. It is important to be able to do this before the economy becomes so dependent on the stimulus measures that it cannot function without them. If the economy gets to the point where it cannot stand on its own, it risks collapse when the government ultimately runs out of the means to support it.

Headlines earlier in the quarter were dominated by events in the Middle East, but were ultimately eclipsed by the string of catastrophes in Japan. The devastation there is horrific and the human suffering immeasurable, and Japan will be faced with monumental challenges as the country rebuilds itself. In the immediate term, economic output will suffer as a result of power shortages, a displaced workforce and damaged or destroyed factories. And as Japan grapples with the herculean task of bringing its industrial complex back online, their struggle will be felt by the rest of the world. Although Japan's impact on the global supply chain has been overshadowed recently by China's ascent as a manufacturing superpower, it is worth noting that Japan is still the third largest economy in the world, and represents just over 8% of global economic output. The world relies on Japan for many of the technologies and components that go into finished goods, even though many of those goods may be manufactured elsewhere. To see an example of this, one just has to look to Ontario where Toyota and Honda have idled production for lack of parts. Longer term, the increased economic activity that will come from the rebuilding of the nation may well serve to reinvigorate Japan's economy, which despite the government's perpetual efforts to stimulate it through currency and interest rate manipulation, has been moribund for the past decade.

There is another issue arising from the Japanese earthquake that will bear watching. The quake caused the earth to shift off its previous axis, as did the recent earthquake in New Zealand. If the earth has shifted off its axis twice in less than a year, its orbit will likely have been affected, which in turn will impact tides and weather. It will be

interesting to observe if we experience any new and unusual geophysical phenomena over the next several years.

Conflict in the Middle East has not gone away, and the result has been a spike in energy prices and volatility in the markets. Current energy prices are likely temporary, but will increase the concerns of inflation, an issue that is finally making headlines. We have been concerned for some time that inflation risks were being ignored in favour of continued economic stimulus, but now there is no ignoring it. The main contributors are food, raw materials and energy, this even prior to the recent spike. Companies are now passing higher costs through to consumers, eroding their purchasing power in an environment where wages are not increasing. Partly offsetting the likely decline in consumer spending is an improving US employment picture. The US unemployment rate has fallen a full percentage point in the last four months, with the majority of the jobs being added in the private sector. And with corporate hiring intentions rising, the US government may have an opportunity to shrink itself as it looks for ways to reduce its massive deficit. Of note, improving jobs data is considered a confirming indicator that an economy is on firmer footing.

Conditions in Canada remain favourable. Our strong dollar has insulated us against much of the recent commodity and food inflation, demand for resources remains strong, our employment market is robust, and our finances remain healthy. By and large, the only concerns we have for Canada are over how long before interest rates rise (sooner, we hope), and how political uncertainties that always surround an election will impact our markets and currency.

OUTLOOK

Economic indicators, leading as well as lagging, suggest that despite the political issues in the Middle East and the regional-specific financial problems in Europe, the global economic recovery remains intact. What we are seeing however, is a natural cyclical shift from the fast growth associated with early recovery to the more moderate levels of growth of an economic expansion. Although economic growth in developed economies will slow, the IMF is still calling for self-sustaining global growth of 4.5% in 2011 and 2012. This condition suggests that governments around the world will be reducing their direct intervention in their economies, which in turn could lend further support to labour markets as the private sector steps in to take over from state run projects. Decelerating economic growth will have a moderating effect on asset returns. Consequently, we expect lower, more historical equity returns this year, and a decline in bond prices as interest rates move up in response to a combination of the removal of economic stimulus, and increasing inflation pressures.

STRATEGY

Our role as investors, not traders, means our investment strategy varies little from quarter to quarter. Over the coming year, we see an opportunity to begin to fill in our fixed income portfolios as interest rates creep up. However, because rates are likely to continue to move up over the next few years, the maturities in these portfolios will be kept short to take advantage of hopefully higher rates with each successive maturity. This said, our preferred asset class remains a diversified mix of high quality equities. We stress diversification in the context of the TSX, which has a 50% concentration in commodities, and when they are doing well, so too does the TSX. However, commodities are very sensitive to economic and business sentiment, and when this turns sour, commodity stocks can decline very quickly, resulting in a quick decline in the TSX. Because they are less concentrated, and are invested in companies that are less sensitive to business cycles, our clients' portfolios tend not to mimic the TSX. This is appropriate in that the market does not reflect our clients' goals, preferences or risk tolerance: their portfolios do.

R. Guy Amighetti, CFA, TEP
Portfolio Manager

Tel: 604-632-4081
Email: rga@vici.ca
www.vici.ca