VERITAS

Spring 2012

DID YOU KNOW...

- Eastman Kodak filed for bankruptcy in January, after 130 years of operation.
- According to the Cisco Visual Networking Index, the number of connected mobile devices will exceed the earth's population by the end of this year.
- 43% of Americans have less than $10,000 saved for retirement.
- Canada is the world's largest export producer of lentil beans.
- Energy (oil and gas) represent 25% of Canadian exports, double what it was 10 years ago.
- Russian and South Korean scientists are attempting to clone a wooly mammoth from a 10,000 year old specimen found frozen in the Siberian Tundra.
- Student loan debt in the US stands at $870 billion, as compared to credit card debt at $693 billion and auto loans at $730 billion.
- "Return Fraud", which includes "returning" shoplifted items back to the store from which they were stolen, cost US retailers $14.6 billion in 2011.
- In 2010, Denmark had the highest private debt burden in the world at 310% of disposable income.

CURRENT SITUATION

Although all North American equity markets ended the first quarter in positive territory, the divergence in performance that we witnessed in 2011 continued. The Canadian market was a standout for its lagging performance, gaining 3.7% in the first three months of the year. US markets on the other hand had a banner quarter with the broader S&P 500 gaining over 12%, its best quarter since 1998. But even this number was overshadowed by the ever volatile NASDAQ which spiked over 18%. Just for interest, the Japanese Nikkei had its second best quarterly showing in the last 15 years, gaining 19.3%, coming off a series of very weak quarters post the 2011 tsunami.

The millstone for the Canadian equity market remains the energy and resource sectors, representing 46% of the index, which continue to struggle in the face of reports of continued economic uncertainty emanating from Europe and China. Energy, 26% of the index, has been particularly hard hit by stubbornly near record low natural gas prices. Prices have been falling largely because of a supply glut brought on by production increases arising from advancing technology and extraction processes that have made available previously inaccessible reserves. The condition has been exacerbated by an overall mild North American winter. If we have a hot summer, pricing will improve as increased power demand for cooling translates to a higher demand for gas to generate the required electricity.

Natural gas is an interesting commodity because of its very regional nature. There is no global pricing arena for it as there is for oil (West Texas Intermediate, or WTI as it is known, or the more international Brent crude) or gold, and it is difficult to store because of its volume in a gaseous state. This also makes it difficult to transport, meaning that for the most part, natural gas is priced in the market where it is produced, and its price is affected significantly by regional supply and demand. A partial solution to the transportation problem is a process that involves liquefying the gas, similar to how a barbeque or camper propane tank is filled. Being able to transport gas in this manner would permit domestic producers to get their gas to offshore markets where prices are significantly higher because of scarcity. This in turn would take supply out of the local market, providing some pricing support. Absent the ability to transport the gas, domestic producers will generally "shut in" production, taking supply out of the market, until pricing improves. As an aside, in a challenging pricing environment, assuming one still likes long term gas fundamentals as we do, investors are well advised to focus on large, low cost producers who control their own land, and who have the capacity to hedge the prices they receive for future production, all of which allows them to weather temporary pricing weakness.

Data coming out of the US indicates that the economy there is continuing to expand. Recent figures peg growth at approximately 2.25% which, based on conventional thinking, is adequate to keep the jobs market at least static. A fairly stable unemployment rate of 8.2% (8.5% in December) seems to support this but it does not tell the whole story. The US economy has added over 700,000 jobs year to date, and while the unemployment rate has fallen only marginally in the same period, the participation rate of the labour force has increased. This increases the productive capacity of the economy, but mutes the decline in the jobless rate. The trend in jobs creation supports consumer confidence, reflected in several consecutive months of rising retail sales data, which in turn supports hiring intentions. Firming consumer confidence also supports the housing market which, even in the worst hit regions, is showing signs of life in new construction, sales of existing homes, and increasingly stable pricing.

A brief look at Europe, where things have been quieter recently, reveals some encouraging developments. Perhaps the most important is the recent successful bond auctions held by Italy and Spain, the completion of which suggests there is not a complete aversion to sovereign debt issued in the Eurozone. Although equity markets continue to react dramatically to negative headlines, this kind of positive news is playing a role in reducing market volatility around the world.

OUTLOOK

The Bank of Canada has been commenting recently that despite policy statements made within the last several months, it might be time to take some of the “extraordinary” monetary stimulus out of the system. Translated to English, this means the long anticipated interest rate hikes may be on their way, precipitated by a closing productivity gap and stubborn inflation. And inflation is no longer benefitting from cheap imports because production costs, especially wages, are rising offshore as well, leading to an increase in “re-shoring” of domestic companies’ assets and production. We consider all this to be good news, and potentially moving North American economies to firmer footing. Rising interest rates may put some pressure on equities as income focussed investors move from yield stocks to bonds. However, we expect this price pressure to be offset by the demand from capital appreciation investors who will be selling bonds in favour of equities as bond prices drop in response to the higher rates. This could be the catalyst that brings equity valuations in Canada to the level that fundamentals indicate they ought to be.

STRATEGY

As our readers have come to expect, our strategy has changed very little since the last edition of *Veritas*. The fundamental tenets of what drive our investment philosophy and discipline remain firmly in place, which has served our clients particularly well this past quarter by avoiding the difficult performance of the materials sector. We continue to focus on quality companies that operate in needs-based industries, doing our best to avoid cycles, trends and traps. Equities remain our preferred asset class, even in the face of expected higher interest rates. What rising rates may give us the opportunity to do, finally, is deploy cash that has been long earmarked for the fixed income market. If the opportunity does present itself, for those portfolios that remain below their policy bond allocations, we will look to purchase short dated bonds, with maturities of no longer than four or five years, likely from corporate issuers with investment grade debt, operating in the same industries as the companies in whose shares we invest.

Please do not hesitate to call for discussion of any of the topics mentioned herein.

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