VERITAS

Spring 2015

DID YOU KNOW...

- Major League Baseball has 41 players with contracts worth over $100 million each, 24 more than the three other major North American sports leagues combined.
- Speed cameras in New York City issued over $23 million in fines in 2014.
- Ten percent of all the photos ever taken anywhere were taken in the past 12 months.
- For the first time on record, Americans are spending more in restaurants and bars than on meals at home.
- Switzerland has become the first country in the world to issue ten year bonds with a negative interest rate.
- Vancouver is now the "supercar" capital of North America, with more Lamborghini, Ferrari, Porsches and the like per capita than LA, the former capital.
- Over $1 trillion has left mainland China illegally since 2002.
- If Major League Baseball was a listed company, it would be worth $36 billion.
- Global debt has risen by $57 trillion since the financial crisis, and now represents 286% of global economic output.

CURRENT SITUATION

After absorbing some of the impact of the decline in energy prices, North American markets were able to eke out another positive quarter ending March 31. The S&P 500 posted a modest gain of 1% for the quarter, but a Canadian investor, converting that return to Canadian dollars, would have enjoyed a 10.1% return, owing entirely to the weakness in our dollar. The disparity in returns highlights the sometimes profound impact currency can have on inter-country investment returns. Here at home, our S&P TSX was up 2.6%, with strength in Consumer Discretionary, Health Care and Information Technology stocks offsetting continued but moderating weakness in resource names.

Trading activity and production numbers suggest that energy prices have begun to stabilise. And with just a 1% decline in the quarter, perhaps the worst of the decline in the share prices of this sector has already been experienced. The price of oil has recovered from its recent lows to a current $58 per barrel, close to what Canadian government economists see for their budget estimates as a break even number of $60. Consensus estimates in the oil and gas industry are that it costs between $70 and $80 to replace an existing barrel of oil, down from nearly $90 only a few short years ago. We raise this because it implies that prices should continue to move upwards to establish some form of equilibrium between cost of production and market price per barrel. If prices do not move up, supply will be taken out of the system as higher cost producers fail, which in itself will put upward pressure on energy prices. We have made this point before, but do so again in the context of stressing the need to own companies with proven production, and that can keep their production costs down, allowing them to weather the low price environment.

It is interesting to note that there is an historical price relationship between oil and gold, and over the past 30 years it has taken an average of 16 barrels of oil to buy one ounce of gold. At March 31, the relationship implies that oil should be trading at just under $80 per barrel, close to the aforementioned replacement cost, or gold, which is currently at $1,200 an ounce, should be at $750 an ounce. When we consider that unlike gold which, for the most part, remains in existence forever, oil reserves are finite, and once they are burned they are gone, the relationship is compelling—for the price of oil.

As has been widely reported, the decline in energy prices has had an impact on government revenues, particularly in Alberta. But despite this, and almost counter-intuitively, as at March 31, the unemploy-

ment rate in Alberta was at 5.5%, a full percentage point better than it was in October, and still below the national average of 6.8%. Part of the explanation for the surprisingly modest unemployment rate is that a portion of the Alberta workforce that was laid off as the oil industry contracted over the past nine months has left the province, mostly to go to BC, but those who stayed appear to have found jobs in industries that were begging for workers while the oil patch was booming. While it is likely that we have not seen the end of the pain in Alberta, there is clearly some new flexibility in that economy and labour force that, despite a significant reliance on the energy sector, has permitted both to respond to changing economic realities, as opposed to collapsing completely.

The Canadian dollar, already under pressure from low commodity prices, gapped down another two cents against the US dollar during the quarter, testing 2008—2009 lows. The catalyst for the decline was the Bank of Canada's (BOC) surprise interest rate cut, notionally intended to provide some insurance against an economic slowdown emanating from collapse in oil prices. Interestingly, despite the weakness in our dollar against the USD, the Canadian dollar is one of the strongest global currencies, aside from the USD. So, instead of travelling to the US, think of visiting Mexico, where the peso is down 3% against the Canadian dollar, or Europe for the summer: the Euro is not much more expensive to us than the USD. But visit Europe soon: the weakness in the Euro may not continue if the Eurozone economies continue to coalesce and expand as they appear to be doing. And if the financial challenges facing Greece can be met and addressed, the reduction in that uncertainty will bring investment back to the region, providing further support for the Euro.

OUTLOOK

Our outlook remains constructive on select North American equities, particularly those less tied to the business cycle. We remain cautious of non-energy resource names, but do believe quality energy names will continue their recovery. We have an increasingly negative sentiment towards bond prices, especially in light of the recent BOC rate cut. While it did come as a surprise, the cut has done little to alter our view that interest rates are poised to rise, resulting in a decline in bond prices. Interest sensitive assets are expected to experience mounting price pressure as we approach the US Fed's first rate rise, anticipated to be in June. In addition to responding to weak commodity prices, our dollar will remain under pressure against the USD if the Fed raises rates, and we do not. Investors will sell our dollar to buy USD to take advantage of the comparatively higher rates in the US. But because the US is still our largest trading partner, as long as the US economy is expanding, our weak dollar provides an additional boost to the revenues of companies that export to the US.

STRATEGY

Our responsibilities as stewards of our clients' financial assets are, broadly, to minimise portfolio risk, earn long term sustainable returns, and minimise transaction costs and portfolio turnover. To meet these broad responsibilities, we make no attempt to find and jump on the next hot stock. Instead, we focus on industries that we anticipate will be less volatile than the overall market. Within those industries, we seek companies that have a proven history with respect to industry leadership, fiscal prudence, maintaining competitive advantage, and management's execution of a clearly articulated corporate strategy. All companies that comprise our clients' portfolios will not exhibit these traits at all times, and temporary departures are to be expected. If, however, the shift is permanent, we are no longer minimising risk, and change is mandated. But above all else, we believe that clear communication with them is what matters most to our clients. Without it, and the understanding of what we do and why, all our other activities are largely meaningless.
Please do not hesitate to call for further discussion.

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