VERITAS

Spring 2016

DID YOU KNOW...

- According to Forbes, the US tax code is a daunting four million words long, and has been subject to 5,000 revisions since 2001.
- For the first time since the early 2000s, Ontario experienced its first back to back quarterly positive migration in the fourth quarter.
- There are 7.9 million pet cats and 5.9 million pet dogs in Canada, three per cent on which owners have taken out pet health insurance.
- Despite using woefully out of date 2009 data, the OECD concluded that trade in counterfeits, from goods to software to therapeutic drugs, is the world's second most profitable criminal enterprise after narcotics trafficking.
- More than 40% of US student borrowers are either severely delinquent in their payments, or are not making them at all.
- With the decline in energy prices, autos and parts are vying with energy to be Canada's most valuable export, as they were up until the last decade.
- As at June 2015, 47.4% of all US households had wireless telephones as their only in-home phone, up 8% year over year.

CURRENT SITUATION

Contrary to the conditions evident earlier in the quarter that saw North American equity markets significantly extend their 2015 declines, the losses were reversed, and first quarter returns were positive. Canada outperformed the US, with the TSX gaining 4.50% in the quarter. What is interesting about the TSX performance, aside from the fact that the totality of its gain was recorded in March, is that the TSX was down approximately 8% at its worst point in the quarter, alongside a 28% decline in oil prices during the first two weeks in January, and a Canadian dollar that fell well below USD 0.70, but despite this, it still posted the gain that it did. In the US, the S&P 500 posted a much more modest 1.30% quarterly gain, but that number masks the fact that the index was down near 10% at its lowest point in the quarter, making 2016 the second worst calendar start for the S&P 500 since 1927. Given what we have been witnessing in the markets over the last several years, it appears that these types of swings are becoming more common, and ought to be factored into the assessment of investors' risk tolerance.

Examining the swings in the market, we are reminded that the stock market and the economy are not one and the same. Furthermore, neither the market nor our currency are leading economic indicators, so just because they are being sold off does not necessarily indicate that our economy is heading for disaster. What we experienced in the first quarter was a necessary periodic resetting of prices for financial assets and commodities, an experience that is not new to investors. The uncomfortable part of the reset, aside from what seems to be the increasingly common severity in the movements of prices, is its indiscriminate nature, with all assets, overpriced or not, suffering the same fate. But this too is not completely unfamiliar, and as we have witnessed in similar episodes previously, assets that should not have been dramatically re-priced tend to recover relatively quickly, such as we have experienced so far in March and early April.

Focussing on the Canadian economy, the 84% of it that is not resource related continues to grow slowly. Canadian unemployment is at 7.1%, only one percentage point higher than it was just prior to the last recession. Despite this, we have the dubious distinction of being the only developed economy in the world to experience an increase in unemployment in the last year. This can be attributed to the contraction in the oil and gas industry, but with the apparent stabilisation in energy prices, and as the industry continues to adjust to the current price structure, it is not unreasonable to expect the unemployment rate to decrease as employment in this sector begins to re-

cover. Part of the determinant of the strength in the recovery will be the level of energy demand, which shows no indication of waning. Additionally, as production drops, now at 2014 levels, and demand rises, the industry will return to a supply/demand equilibrium, widely expected to occur late this year or early next. We have mentioned previously that when the energy industry approaches equilibrium, the stronger surviving companies can start planning and investing for the future, further contributing to the economic output of producing regions.

Energy demand is driven primarily by economic growth, and much has been made of late about the "sluggish" growth in the G7 countries: Canada, France, Germany, Italy, Japan, UK, and the US. What is rarely mentioned is that what is considered a sluggish 1.8% growth rate today is actually the average over the last 20 years, with much stronger growth recorded in only a few of the more recent years. The historical growth rate is a reasonable expectation for developed economies with mature industries and a relatively static population, which provides few catalysts for exceptional growth. Even if all economies, including the faster growing, but maturing developing ones are included, the 2015 global economic growth rate was "only" 3.2%, also criticised as being sluggish and cause for concern. But again, what is omitted from the commentary is that this is right in line with historical values. The lesson for us in this is that when reading or listening to particularly negative reports, perspective and context are critical.

OUTLOOK

During the first quarter, as commodity prices and our dollar were experiencing significant declines, and economic data from China was considered "weak", there was speculation that the global economy was heading into recession. Talk of this remains even today, but based on our comments elsewhere in this letter, and what the bond market's yield curve is telling us, we do not agree. We do maintain that the investment environment will remain challenging as investors adjust their return expectations to reflect the "new normal" of more modest, but historical global economic growth. This adjustment will be particularly challenging for investors in commodity focussed assets as developing economies mature, and their demand for resources slows. But as long as there is growth, sound companies will profit, and share prices should continue to rise. Because of this, we remain positive in our outlook for equities, and less so for bonds. Although central bankers around the world remain committed to low, or even negative, interest rate policies, the risk is that rates will rise, pressuring bond prices. Rising rates, when they come, will pressure equity prices in the short term as well, but rising rates generally are in response to improving economic conditions, a long term positive for equities.

STRATEGY

Given our stated goals of achieving long term consistent returns with as little volatility as possible for our clients, the corollary is that our investment strategy remains very constant over time. Consequently, for long term readers of this newsletter, this section has become repetitive inasmuch as often it is a restatement of our investment strategy, which is to focus on quality companies that are leaders in their industries, where those industries are involved in the production of needs based goods or services. The expectation is that these industries will exhibit less volatility, especially in times of turmoil, because consumers will not, or cannot, stop buying the staple-like goods or services produced by the companies in these industries. Our responsibility to our clients is one of prudent stewardship of their capital, the principal driver of our very conservative and constant investment discipline. Consequently, we are concerned with the long term sustainability of a company's business, as opposed to being on the leading edge of the next new investment or market trend.
Please do not hesitate to call for further discussion.

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