VERITAS

Spring 2018

DID YOU KNOW...

- V **WE HAVE MOVED** (but only down one floor)! We are now at: **820**—925 West Georgia Street. All other contact information remains the same.
- V China holds the world's largest foreign currency reserves at approximately $3.1 trillion.
- V Cockroaches eat just about anything, can live a week without a head (!), and can run the equivalent of over 300 kmh.
- V For the first time ever, Canada has displaced Venezuela, historically the dominant provider, as the largest supplier of crude to Texas Gulf Coast refineries.
- V US job openings now equal the rate of joblessness, meaning that if there was a perfect match of skills to requirements (a practical impossibility), unemployment would cease to exist.
- V The cost of borrowing in Greece is only one percentage point higher than in the US, as compared to 2012 when the difference was a whopping 40 percentage points.
- V Because of poor corporate performance last year, GE withheld bonuses for most of its senior executives for the first time in its 126 year history.

CURRENT SITUATION

After so many quarters of positive performance it was bound to happen: the broad S&P 500 index suffered its first quarterly loss in two years in the first quarter. Granted, the decline was modest at one percent, but it does remind us that despite our recent experience, markets cannot go up uninterrupted indefinitely. Canada's main stock index fared worse, declining 4.5% in the quarter, with most of the decline being felt again in the energy sector because of the significant, but narrowing, difference in the price of our crude oil versus the global benchmarks. Since the quarter end, the differential has been reduced by approximately 30% as a result of decreasing transportation bottlenecks as more of our crude is being delivered to market by rail. There are physical limits to this method of transportation however, and when they are reached, and until there is additional pipeline capacity made available, we expect the price differential will widen again.

A notable feature of market activity in the last quarter was the rapid escalation of volatility, which largely has been absent since prior to the 2016 US presidential election. Although this might sound counterintuitive, and admittedly it can be difficult for investors, we welcome the return of some volatility to the markets, in part because it removes some of the complacency that has been building up in markets as they continued their essentially uninterrupted climb. To put the shift in market dynamics in perspective, as at March 31, the volatility index (VIX) closed above 15 (which signifies elevated volatility) on 38 occasions, versus a total of seven times in *all* of 2017. Similarly, the S&P 500 had only eight days of returns in excess of one percent, positive or negative, in 2017, whereas already it has experienced 23 such days in the first three months of 2018. We should comment that despite the recently elevated level, volatility has not approached that which we experienced during the financial crisis: it just feels that way because it has been absent for so long. A number of factors have combined to cause the increase: interest rate hikes; trade spats, both domestic and international; and heightened protectionist rhetoric in the US. We have commented in years past that markets do not like uncertainty, and the aforementioned factors are certainly creating their share. Markets are reacting to it as would be expected and, capturing the essence of what we are experiencing, one of our colleagues made the comment that the last quarter saw "markets trading on fear versus fundamentals".

Concurrent with the increase in volatility, it appears that investors and markets are moderating their expectations for the overall success of the US government accomplishing all that was promised during the 2016 election campaign. As evidence of this, we note that since reaching its most recent record high this past January, the S&P 500 has lost 37% of its post-election gains. We view the retreat as healthy for both the markets and the economy, as it should reduce the risk of a more severe pullback or correction later, not dissimilar to the effects of a pressure relief valve.

What is at risk of being lost amid the headlines, hubris and political posturing is that global macroeconomic conditions continue to improve. A US Conference Board report shows that consumer confidence is at the highest level since 2000. Given the earlier comment on the state of the US labour market, this condition is expected to continue for some time, lending further support to the US economy, which is primarily consumer driven. The Eurozone is reporting economic growth in all regions, including some of the heretofore "lost cause economies". A notable example of this is Greece, which after essentially a decade of bailouts, has announced that it is expected to exit the final phase of them this summer. Economic strength outside of Canada should be good for us, given our export oriented economy, and overall, it is. Unfortunately, there are mitigating circumstances involving the trade dispute between BC, Alberta and now Saskatchewan that are offsetting that strength. The dispute is costing our economy in terms of reputation and real output, and is also making Canada a less attractive place to invest because of uncertainty arising from the challenges to constitutionally established jurisdictional authority.

OUTLOOK

We recall, somewhat nostalgically, the days of 3% T-bills, 5% bonds and 7—8% stock returns, and are hopeful that we are heading in that direction, or, in other words, moving back to an historical normalisation of asset returns, starting with interest rates. Macro conditions suggest this is happening: inflation is definitely heating up in North America, and interest rates are rising in response. We note, however, that they are thus far just entering neutral territory, where the level of interest rates neither stimulates nor constrains growth. The implication is that rates have some room to run before they become truly restrictive. With rates rising, bond prices will fall, making equities the preferred asset class for allocating capital. Although equity returns appear to be moderating, we expect them to remain positive in the context of the global economic expansion. We acknowledge that there are risks to our outlook, but they relate primarily to the US administration's demonstrated "shoot from the hip" approach to trade and diplomatic relations. In the face of this, our responsibility is to make our decisions based on the "real" facts and data that we have at hand, and for the present, they remain positive.

STRATEGY

The return of measurable volatility to stock markets reaffirms our commitment to the discipline of investing our clients' capital in quality companies operating in industries that are relatively insulated from significant swings in demand for the goods or services they produce. Consider that no matter what else happens, we still have to eat and live, and focussing on the companies that provide daily necessities plays a significant role in our discipline. Assuming a business is sustainable over the long term, we can take advantage of the volatility to add to companies that are "not in the sun". Furthermore, volatility provides us the opportunity to fill in gaps in client portfolios where we have cash on hand, whether as a result of contributions or asset sales. Historically, volatility has been a portfolio manager's friend in terms of portfolio rebalancing, and we will treat it as such now. Long time clients and readers of this letter will appreciate this position, given past experiences. We think we are entering a new phase in the markets, and one in which disciplined management will be increasingly important. Please feel free to call to discuss.

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