VERITAS

Summer 2005

The most recent quarter was highlighted in Canada by political wrangling at the federal level, the likes of which have not been seen in decades. The Liberal budget, which became the issue of a no confidence vote introduced by the Conservatives, narrowly passed by one vote. Had it not passed, not only would its contents not have come into force, but the minority Liberal government would have failed, and Canadians would have faced a summer election. As it was, the machinations that resulted in the budget passing were fascinating, including an MP crossing the Floor, and deals being made between opposing parties to secure supporting votes. Also in the news was the announcement that Ford was paying $1000 to employees who enticed friends and family members to buy Ford products. Subsequently, GM, Ford and Chrysler announced that 'for a limited time', they would be offering employee pricing to the public. These, plus existing incentives, make us wonder how the North American car makers can turn a profit. And in Europe, the proposed European Constitution was voted down by a few of the member nations, including France, one of the largest supporters of the EU, making some observers question the longer term viability of the EU.

CURRENT SITUATION

The TSX closed above the 10,000 level for the first time since October 2000. However, in 2000, the TSX dropped by over 800 points the next day, and continued to decline for the next two years to the 5,000 level. This so far has not happened this year. A major difference between 2000 and today is that the current market advance has been much broader, and in an environment of much stronger earnings. In 2000, the markets were led almost exclusively by technology stocks where earnings were marginal, if they were present at all.

Posting an 8.10% return to June 30th, the TSX continues to outperform its US counterparts, as it has done for the past four years. The outperformance is not surprising given the condition of our economy versus that of the US. Canada has much less debt at all levels of government and at the consumer level. The US carries huge budget and trade deficits (the government spends more than it earns and imports more than it exports), whereas Canada is in a surplus position. And Canada is an exporter of what the US desperately needs to keep running: energy. These strong economic fundamentals also allow us to keep our interest rates lower. What is surprising, and of interest, is the overall magnitude of the rise so far this year, given the strong returns we have witnessed over the last couple of years. Generally, after several consecutive years of market strength, we expect that returns will moderate as factors that contribute to returns moderate as well, such as demand declining, or interest rates rising. We have seen neither of these yet in Canada. In looking at the sectors that have led the advance this year, effectively all of the 8% return can be attributed to financials and energy and energy related stocks. These two sectors now account for over 50% of the TSX. Notionally then, if interest rates remain at close to current levels, and oil does not decline significantly, current TSX levels may well be sustained for the year.

The same cannot be said for the US. The same factors that are helping us are hurting them. Interest rates continue to rise, in part to support the US dollar, and in part to prevent inflation from becoming a problem. However, the Fed must be careful in raising rates, which has the effect of slowing the economy, when oil is at current levels. Because the US has to import so much of its oil, paying a higher price for it acts as a drag on the economy, but also builds in an inflationary element by increasing production costs where energy is required. This applies to everything from steel production to getting food to supermarkets. Thus, if the Fed raises

rates too far while oil prices remain high, there is a real risk of slowing the economy too much, and tipping the US back into a recession.

While North American economic activity continues to expand, albeit a little more sluggishly in Canada than the US, European growth has stalled. In fact, Italy is experiencing a mild recession, and if they report one more quarter of economic slowdown, so will the Netherlands. Unsurprisingly, the main culprit in Europe's slowdown is oil. Europe has always been vulnerable to oil prices because of its dependency on imports, which account for virtually all consumption. A small mitigating factor for Europe has been the strength of the Euro. Without the strength in the Euro, European energy costs may well be 20% higher. Economic weakness has been exacerbated by the failure of the Constitution, which has created an environment of business uncertainty in Europe. Offsetting Europe is China, where economic expansion continues at over 9%. And if it ever appears that demand in that region is waning, remember that China is a country of 1.3 billion people, growing at 25,000 people a day.

Because oil continues to dominate international headlines, a couple of further observations on the topic are appropriate following our last edition of *Veritas*. Recently, the International Energy Agency (IEA) commented that the oil industry must spend $105 billion a year, or $3 trillion, by 2030 to meet the surge in demand for oil in that period, assuming reserves can be found. The IEA went on to say that conventional production has all but peaked, and new unconventional reserves will be much more expensive to discover, develop and produce. These comments lend credence to our recent suggestions that high oil prices, whether due to lack of supply or lack of refining capacity, are with us to stay. The positive side of this is that there may be now more incentive and economic viability to pursue and develop alternative energy sources and technology.

OUTLOOK

Our outlook has changed little from last quarter, and if anything, has become even more cautious in light of already strong market returns this year. The risk to interest rates continues to be modestly up. We continue to see rates in Canada up to half a percentage point higher by year end. Interest rates at the levels anticipated in 2006 will give both Canada and the US latitude to cut rates if economies slow meaningfully. A key theme in portfolios remains defensiveness, with a bias to stocks over bonds, and Canada over the US. Volatility, marked by dramatic intra-day share and commodity price swings, will continue for the balance of the year. This will distract many investors from their long-term investment objectives, but create trading opportunities for those who remain disciplined.

STRATEGY

Client equity returns have been favourable this year and have kept up well with overall market returns. As mentioned in our last edition, we have been selling into strength in some holdings, and will continue to do so as market conditions permit. Cash levels have been rising to levels higher than what we would consider normal, and may rise further in the absence of a near term meaningful market pullback. And because it looks like the market wants to move higher yet, our objective to be back to full equity weights by the Fall will likely be delayed as we see more opportunities to trade for profits. We look to September as an opportunity to add another missing piece to our fixed income portfolios if the Bank of Canada raises rates as expected. Despite these articulated objectives, we remain vigilant for other opportunities to preserve capital and add to our ignored or out of favour holdings if prices are compelling.

We wish all our readers a very pleasant summer, and invite all to please contact us for further discussion or information.

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