VERITAS

Summer 2006

Recent news out of the US suggests that taxpayers there will be on the hook for over $1 trillion to cover future medical benefits for retiring state and local government employees. This is above and beyond the $2.5 trillion the governments have already set aside for pension benefits for those same employees. Activist shareholders are exerting pressure again, this time with GM. A minority shareholder has forced GM into alliance talks with Renault and Nissan, potentially dramatically changing the face of the North American auto industry. Although GM has a presence in Europe through OPEL, and there was the Daimler–Chrysler merger, this alliance would mark the first three way alliance to include an American, European and Japanese manufacturer. We note that Nissan and Renault have had an alliance for over seven years already. In Canada, our strong dollar has allowed the Bank of Canada to dramatically reduce our foreign debt to a level that could make us a net creditor nation within five years. Another positive effect of the strong dollar has been to keep our gasoline prices in check. If not for the Canadian dollar, our prices would be approximately 30% higher than they are. For example, since 2003, gasoline prices are up 17% annually (70% total) in the US, but only 7.7% annually (28% total) in Canada.

CURRENT SITUATION

David Kelly, portfolio manager with Putnam Investments, recently commented that "… stock market investors today are a little like earthquake survivors. Any little tremor makes them run for cover." Although he was referring to US investors responding to Federal Reserve comments, the analogy is equally appropriate for Canadian investors, and for good reason. The TSX hit a record high on April 19, 2006 and then retreated for the next two months until it hit a low of 10,904 on June 13, 2006. At that level, the TSX was off 12.73% from its peak, and 3.27% for the year. Putting the magnitude of the move in another way, the TSX went from plus 10.85% to minus 3.27% for the year, equating to a 23.58% peak to valley swing between January and June. On a more positive note, the TSX did end June up just over 3% for the year.

To put the last three months' market activity in perspective, this is the third consecutive spring pullback since 2004, and only one of 20 in the last 40 years that has been 10% or greater in magnitude. Historically, pullbacks serve to remove market excesses, speculation, complacency and 'irrational exuberance', allowing markets to find new trading ranges from which to move higher. In this case, the pullback can be attributed to the anticipated effects of higher interest rates, the overbought condition of the markets, and a combination of momentum reversal, speculation and euphoria. As expected, resources were the biggest point losers, and because they represent almost 50% of the TSX, continue to drive market sentiment.

It is worth pointing out that over the last several years, the TSX has become very concentrated in two sectors, resources (includes energy and materials) and financials, which combined comprise 76.8% of the index. The implication for investors is that buying the index is no longer as effective a diversification strategy as it once was, necessitating them to look to specific stocks or sector funds to obtain sufficient diversification to reduce market risk.

In domestic economic news, the Bank of Canada stated in May that the current level of interest rates will "keep the Canadian economy on the base-case path." Although we don't quite know what the "base-case path" is, we read the BOC statement to mean that the Canadian economy is operating at capacity, and that interest rates are at or close to neutral, and further rate hikes will be only in response to clear inflationary signals. The neutral interest rate policy also allows the BOC to modestly reduce rates to stimulate economic activity if an

economic slowdown in the US has a significant impact on Canada.

On that note, although the US Fed raised rates again at the end of June, it does appear that a US economic slowdown is unfolding as anticipated. The expectation is that the US economy will experience a slower pace of expansion over the next 12—18 months, but not a contraction leading to a recession. However, the risk to this outlook is the Fed: if they overshoot their inflation control target and raise rates too high, it would not take long for the effects to be felt in an already slowing economy, pushing it over the brink into recession. Decelerating economic growth is a natural inflation fighter, hence the concern that any further tightening by the Fed will be too much.

To complete the economic picture, data suggests that European economic growth continues, but is still mixed. Italian and German economic growth, previously somewhat lacklustre, has rebounded, but the Dutch economy has begun to lag. Overall, the strength in the region has been sufficient to compel the European Central Bank (ECB) to raise interest rates notwithstanding a strong Euro and high fuel prices. Asia too continues to be strong, with Japan taking recent headlines with the announcement that they have become a net seller of US government debt, a topic we raised in the last issue of *Veritas*. Japan is the top Asian holder of US debt, and until now has been a predictable and heavy buyer, but is now selling, which means they are bringing their money home by selling dollars and buying Yen. This may be the first trickle in a coming wave of Asian currency repatriation, which could put massive pressure on the US dollar. We will watch with interest as this unfolds.

OUTLOOK

Tensions in the Middle East, and North America's response, and politics in Latin America will weigh heavily on the markets for the balance of the year and into next, particularly as they affect the price of oil. News items will have a profound impact on commodity price and market volatility. That said, our overall economic and market outlook has not changed substantially. A combination of levelling off of interest rates and a fairly benign North American economic growth outlook confirms our view that the TSX will post positive returns for the year, but double digit gains are unlikely. Given the spring correction, we feel there is a three to four percentage point gain to be had before we finish the year, but led by sectors other than resources. Growth will be limited by central bankers around the world being more concerned about inflation than they were 12 months ago. In response to these concerns, we expect to see interest rates increasing around the world, systematically removing liquidity from, and slowing, world economies, similar to what has recently occurred in North America.

STRATEGY

We were able to spend some of the cash raised at the end of the first quarter, adding to existing positions when markets pulled back this spring. For the balance of this quarter, and conceivably the year, we expect that markets will remain in a trading band with a modest upward bias, creating a few trading opportunities, primarily in the energy sector, for our clients. Accordingly, clients can expect to once again see a slight increase in activity, but no dramatic changes to their accounts. Because we did lose Fairmont Hotels in the quarter, but did not lose CHC Helicopter, only one new name was added to the portfolios in the quarter. With interest rates levelling off, those portfolios with outstanding bond purchases will receive short dated positions in satisfaction, but our preferred asset class remains conservative, well managed and moderately defensive equities.

It has been a dramatically volatile quarter, and there are likely many issues and concerns stemming therefrom not addressed here. Please do not hesitate to call for discussion of any of them.

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