VERITAS

Summer 2008

DID YOU KNOW...

- Ireland recently rejected the Lisbon Treaty which, if ratified by all 27 EU member nations, would have consolidated power in one leader, streamlining a ballooning bureaucracy;
- In May, a herd of itchy cows in Wales caused a 16 hour blackout when power lines dislodged from the transmission tower they were using as a back scratch;
- Americans are renting at the highest rate since the Bush Administration started its campaign to expand home ownership, a campaign that has been blamed for much of the current housing and credit crisis;
- Canadian crude oil exports have exceeded auto exports for the first time, and we are exporting more fertilizer now than trucks, lumber or newsprint. It is no coincidence that Alberta has the highest standard of living of all the provinces;
- In an interesting turn of events, many US companies, including Hallmark Cards, are centralizing operations of their Canadian subsidiaries to the US because of the low US dollar;
- Because of high asphalt prices, another consequence of high oil prices, the US is reducing road paving and repairs. It is going to be a bumpy road ahead.

CURRENT SITUATION

Canadian equity markets ended another very volatile quarter up 6.00% year to date. However, if an investor did not have significant exposure to oil and gas or materials stocks, individual performance would likely be much lower. With these two sectors comprising over 50% of the TSX, and financials, which have not performed well over the past six months, another 25%, any significant move in any of them is going to be immediately reflected in the index. For example, the TSX set an all time high on June 18th, climbing 24% from its January low, which in turn was an 18% percent drop from market highs of 2007. But the movement was almost entirely attributable to oil and gas stocks, and to a lesser degree, materials. It is in large part because of this very narrow leadership that the market has been as volatile as it has.

Further contributing to market volatility has been the tendency of the media to focus on bad news. Retail investors make most of their immediate investment and trading decisions based upon what they read in newspapers, see on television or hear on the radio. Given the sensational negative headlines we are seeing day after day, it is little wonder that those investors are selling everything, from their long held mutual funds to their recently purchased oil stocks, all of which places negative pressure on the market. However, from troubled markets come opportunities, and to quote the late Sir John Templeton, one of the most famous fund managers of our time, "The best time to buy is when there is blood in the streets". While we might not be there yet, the time is coming. There have been several recent reports outside of the mainstream media that support this. In one, it was reported that as at June 18th, a record $12.5 billion was issued under the Canadian Mortgage Bond program, indicating that Canadian wholesale credit markets remain robust. Even in the US, consumer credit is up 5.7% annualized, slightly higher than last year. This is good news, but again, the media will pick up only the related negative news that foreclosures are up year over year. This lack of balanced reporting is only serving to harm the markets.

In an effort to balance the reporting, and focus on some good news in a sea of bad, it has been reported that as at June 30th, banks globally have written off $416 billion relating to credit market weakness, but they have also raised $325 billion in new capital. Notwithstanding IMF estimates that credit losses globally will top $945 billion, institutional investors still have an appetite for bank stocks. This is refreshing in an environment where investors seem to be far less concerned

with fundamentals than they are with momentum.

On the topic of momentum, there has been a great deal of it propelling the price of oil. High oil prices have many effects aside from making it much more expensive to fill our gas tanks. One of the most significant and potentially positive effects is to encourage a change in consumption habits. As habits and attitudes change, it increases the focus on alternative energy sources which in turn leads to advances in the research and development of new technology. The longer oil remains this expensive, the further the research will be taken, perhaps leading to significant breakthroughs before oil prices pull back. A pull back in oil prices is inevitable because of what is referred to as demand destruction. This occurs at an arbitrary point in any price cycle where the price of oil becomes so high, industries will mothball plants or switch to other energy sources. A good example of this activity occurred several years ago when natural gas prices hit record highs. BC greenhouse operators, who consume huge quantities of natural gas to generate heat, made a wholesale shift to burning wood chips to save money. If we apply the same pattern of switching behaviour to current oil markets, but globally, demand will come off significantly, and the price of oil will decline, offset only partially by the recent increase in demand by developing economies. As an added benefit, the decline in oil prices will serve to moderate global inflation, an issue that is becoming increasingly of concern to central bankers worldwide.

OUTLOOK

The near term outlook for global economies and their equity markets remains challenging. As mentioned, inflation is becoming a concern, but economies are under pressure, limiting central banks' abilities to combat the inflation threat with higher interest rates. Conversely, to stimulate economies will only heighten inflation risks. The struggle to balance the two issues will continue to plague markets, and we expect the struggle will be punctuated by frequent interest rate tweaks, depending on which risk is considered more apparent. Unfortunately, this activity will add confusion to the markets as interim interest rate movements of this nature do not signal a trend. It will also act to create a vicious cycle within the already ailing credit market. Economic uncertainty causes banks to restrict lending to even their best corporate customers, which limits those customers' ability to expand, further contributing to any existing economic sluggishness. At some point, this will pass. August marks the one year anniversary of the credit market crunch. If history provides a guide, we can expect to experience the repercussions for another six months, during which we will start to see pockets of stability and improvement in the performance of some of the worst performing sectors, especially the banks. We will view this as a signal of a prospective market turnaround.

STRATEGY

With bonds expecting to return only 2%, cash 4% and equities 6-10% for 2008, our favoured asset class continues to be equities, although our return expectations are at the lower end of the anticipated range because of volatility. Bond returns will be particularly weak because of the need for central bankers to raise interest rates to combat inflation, causing bond prices to decline, reducing returns. In difficult markets, it is critical to maintain established investment discipline. Our focus will continue to be on well run and conservatively managed companies in stable industries that exhibit earnings resilience in volatile times. To quote an analyst at RBC Dominion Securities, "A high level of fundamental stability… (will) serve as a magnet for capital in the midst of a difficult earnings environment." It is companies with that high level of fundamental stability that comprise Verity client portfolios and that we expect will benefit from the ultimate rotation of capital out of the momentum sectors.

This has been a very challenging year for investors. Please call for discussion of any of the issues that have made it so.

R. Guy Amighetti, CFA, TEP
Portfolio Manager

Tel: 604-632-4081
Email: rga@vici.ca