VERITAS

Summer 2009

DID YOU KNOW...

- Kodak will discontinue production of Kodachrome film, as digital photography takes increasing market share away from film.
- F.A.O. Schwartz, the iconic US toy retailer founded in 1862, has been sold to Toys 'R' US. The Schwartz flagship Fifth Avenue store played a prominent role in the 1988 movie "Big", starring Tom Hanks.
- China will ban smoking in 2011—but only in hospitals and medical facilities.
- In a sign of the times, Molson has ended the long tradition of supplying free beer to its retirees.
- GM has been in the Dow Jones Industrial Average since 1925; once sold half the cars sold in the US; once employed as many people as the combined populations of Nevada and Delaware.
- As of May 15, the US economic and financial condition was upgraded from a "tailspin" to simply a "downtrend", and as of June 18 to only a "slump".
- Over the last 12 months, the term "perfect storm" was used more than 28,000 times in mainstream print media as a metaphor for the world economy.

CURRENT SITUATION

North American markets extended their late March rally into the second quarter. As of June 30, the TSX was up 17.6% year to date. The rally has been broadly led, but the emphasis has been on the commodity and resource sectors, which still represent almost half of the TSX. Of interest in recent market movements is that North American and world equity markets appear to have once again begun to reflect their own regional fundamentals, as opposed to exhibiting the synchronous movements they did in the six to nine months leading up to the March lows. For example, in October there was a 97% correlation in the movements of the S&P 500 and the TSX, whereas in April, the correlation dropped to 87%. The correlation is even lower today. To put numbers to this, while the TSX is up over 17% from its March lows, the S&P is up a more modest 3.2%. We also note that if the recent positive market performance marks the end of the 2008-09 bear market, then while it was the deepest bear market since WWII, it was only the fifth longest at 16 months, some nine months shorter than the bear of 2000-2002.

Leading economic indicators are suggesting that the worst of the North American recession just possibly may be behind us. This is particularly true for Canada. We have seen strength in equities and commodity prices, an increase in durable goods orders, which measures consumer spending on long term purchases, and existing home sales have rebounded. And in the US, planned layoffs continue to decline to levels not seen since before the credit crunch. Investor and consumer sentiment continues to improve at a modest pace. This was summed up in a recent comment made by a well known market strategist who said "widespread pessimism is now just broad scepticism".

We are entering second quarter earnings season, and although earnings are expected to come in substantially lower than last year, there have been very few warnings leading up to the current season as compared to the last several quarters. We comment again that markets tend to be forward looking, and we believe that the declines that we experienced up to March this year were in anticipation of the earnings erosion that we have already experienced, and expect to see this quarter. However, markets have since rallied, and are looking out towards the end of the year, when we are expecting to see signs of economic, and corresponding earnings recovery. If history is a guide, the markets have likely already priced in the expected weak second quarter earnings reports, and any meaningful pullbacks will

be on a stock by stock basis in response to previously unannounced negative surprises.

Although we may have entered into an environment of “not so bad news”, there remain issues that may yet erode sentiment. One that is getting much attention right now is unemployment levels, both here and in the US. While high, it should be noted that historically, unemployment has been a lagging indicator, meaning that by the time we see a marked improvement in employment numbers, the economic recovery will have already have been well under way. We note too that unemployment levels are increasing at a decreasing rate, which coupled with the reduction in planned layoffs is an economic positive.

Another topic getting negative press is the US savings rate. It is currently at approximately 6%, as compared to a negative rate (spending more than earning) just a year ago. The irony is that the big concern last year was excessive consumer spending, leaving them with no savings cushion, whereas now the concern is that there is too much savings and insufficient consumption to sustain economic activity. There is merit to this concern, but the likelihood is that as consumers rebuild their personal balance sheets, and reduce some of the debt that was incurred to fund their earlier spending spree, they will feel more comfortable spending again, but at a more sustainable level. With reduced home equity, and less ability to tap it than in the past, consumers will be more aware of what they can realistically afford, and new spending habits will reflect this. Spending habits will also likely reflect a return to an historical savings rate which is coincidently very close to the current level.

OUTLOOK

The consensus view is that North America will experience some economic recovery in the second half of this year, but the recovery will be sluggish. The effects of the massive amounts of fiscal stimulus that have been spent will start to be felt as funded projects get under way. This, combined with a trough in unemployment numbers, and a modest decline in the savings rate, should help accelerate economic activity in 2010, barring any further major financial disruptions. Canada is expected to lead global developed economies out of the recession, largely because of our resource exposure and overall better financial condition. Should all this come to pass, there will be more talk from central banks about an “exit strategy”, whereby they remove some of the recent massive stimulus from the system. As we mentioned in the last edition of *Veritas*, their ability to do this effectively remains our largest concern for the foreseeable future. It will be a challenge for the central banks to control inflation and remove stimulus without potentially pushing economies back to the brink of recession.

STRATEGY

Because our investment horizon is longer than the next couple of quarters, there has been no change in the strategy we employ to manage our clients’ portfolios. When the portfolios were originally constructed, they were done so on the basis that the holdings, chosen on their fundamental merits, were to contribute long term consistent returns with a minimum of variability and intervention. While the last year has turned all investment styles on their ears, largely due to emotional response, we believe that there will be a return to a focus on fundamentals in relatively short order. Investors will once again be concerned with the tangible results of a company and its business, resulting in a shift in focus in the types of companies in which they wish to be invested, similar to our experience in 2001—2003. We are confident that our clients’ portfolios will benefit from this shift. On overall asset mix, we continue to favour equities in the face of historically low interest rates for the next 12—18 months, augmented by the fact that still fully 50%, or US$10 trillion, of the value of the S&P 500 is being held in cash, earning no return.

R. Guy Amighetti, CFA, TEP
Portfolio Manager

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