VERITAS

Summer 2010

DID YOU KNOW...

- Wall Street firms are adding jobs for the first time in two years, a widely accepted sign that the economic turnaround is underway.
- Canada has recouped 430,000 jobs, or 97% of those lost in the recession.
- 20% of US mortgage defaults are strategic, where people who have the capacity to pay their mortgages stop doing so by choice.
- China has overtaken the US as the world's largest energy consumer.
- There are over 563 million mobile phone subscribers in India, nearly half of the country's population, but only 366 million people have access to proper sanitation.
- Nickel has climbed so much in price this year that the US five cent coin now contains six cents worth of the metal.
- Greece has been in default of its debt for 105 of the last 200 years. Canada, on the other hand, has never defaulted on its debt.
- Households with $5 million or more in wealth represent 0.10% of worldwide households, but own 21% of the world's wealth.

CURRENT SITUATION

The rally North American markets enjoyed through the first quarter ran out of steam and started to reverse in May. By the end of June, the TSX was in fact down 2.50% for the year. US markets fared even worse, with the S&P declining over 11% in the quarter, leaving it down almost 7% year to date. Demonstrating the volatility that continues to plague the markets, the TSX declined four full percentage points in the last two weeks of June alone, and has since recovered to being flat for the year as at the time of writing. At its worst, the S&P was off a whopping 15% from its April peak, a decline qualifying as a correction (over 10%). Adding to the frustration of the volatility is the markets' susceptibility to headlines. One day, or in fact one hour, markets might be reacting to news about the economic impact from the disaster in the Gulf of Mexico, and the next, headlines coming out of Europe rehashing the old news surrounding the instability of the Greek banking system or the weak US economy.

There is no question that North American economic growth is slowing modestly, but this was expected to occur going into the second half of the year given the backdrop of rising interest rates in Canada and the gradual windup of stimulus programs in the US. And there is no question that US unemployment numbers remain elevated, and will likely remain so for some time to come, especially if US policy makers continue to extend unemployment benefits, a practice which many see as causing more harm than good. Statistically, less than 40% of unemployed job seekers spend an average of four hours a day looking for work, and less than 7% spend six hours at what is widely accepted as what should be a full time job. This in an environment where business managers are reporting they are having difficulty finding qualified people to fill positions. If this is so, the implication is that some individuals are making more money by staying unemployed, and/or are waiting for a job that paid as much or more than when they were let go. In either case, the standoff will mean that the US will likely take longer to return to full employment than in previous recoveries. But with companies spending on plant and machinery, and productivity levels dropping, we do expect that the imbalance will start to correct in the not too distant future. A final comment on jobs: as of July, for the first time in 15 months, more people quit their jobs in the previous three months than were laid off, a sign of an improving job market where people feel sufficiently comfortable with their future prospects to leave what they have today.

In all the negative headlines, much of the good news in terms of improving corporate earnings, recovering global economies and improving economic stability is being lost. For example, the OECD adjusted its forecasted global growth for 2010 and 2011 upwards to 4.6% and 4.5% respectively from its previous forecast of 3.4% and 3.7%. Of interest, the average annual global growth rate from 1974 to 2008 has been 3.4%, so even the earlier, lower forecast was above trend. Global money market assets, representing the amount of investment dollars investors are holding in cash, has declined to 27% since March 2009. Although this does mean that there is less liquidity in the system to support equity markets, it also means that there is that much more capital already committed to those markets, another indication that there is growing comfort and confidence in the global recovery. It is worth noting that no industry, market or environment can continue to accept new entrants and maintain status quo: something has to give. There is a natural cycle that occurs in a competitive market whereby, independent of overall changes in consumer spending, revenue flows to the various companies naturally decline as the number of companies in that marketplace increase, thereby reducing profitability and slowing their collective growth. Under normal circumstances, the weaker participants will not survive, and when conditions are exceptional as they have been over the last few years, the failures are concentrated, making things appear perhaps worse than they really are. Given this, there may be some validity to the claim that what we are experiencing is the natural consequence of a period of unchecked growth in which the normal laws of supply and demand did not have time to adjust in an orderly fashion, and are doing so now retroactively.

OUTLOOK

Despite the negative headlines, we believe that the road ahead is one of economic growth, but not at the level that we have witnessed over the last several decades. The world is a different place, with new and influential players in the marketplace who are in a position to significantly alter the way business is done, and who will play a large role in defining the new, evolving global economy. Former powerhouse nations will not have the control they have had in the past, and will have to be more conciliatory in their dealings with their international counterparts. We anticipate that we will have to endure higher unemployment, especially in the US, but likely at levels that were considered normal prior to the 1990s. But just in the way that the technology revolution brought unemployment rates down then, innovation, perhaps in industries such as alternative energy, healthcare or even automotive, may do the same for US unemployment now. All said, we are counselling our clients to expect slower, but more historical levels of economic growth, moderating domestic consumption habits, and a much more integrated global economy.

STRATEGY

We reiterate that because our investment horizon is longer than the next couple of quarters, there has not been, and nor will there be any change to the discipline applied to the management of our clients' portfolios. When portfolio construction is undertaken, it is done so on the basis that the holdings, chosen on their fundamental merits, are to contribute long term consistent returns with a minimum of variability and portfolio intervention. However, in a range-bound and volatile market, which is what we view current market conditions to be, trading around core holdings can play an important role in contributing incremental returns to an underlying buy-and–hold strategy. Although we are not advocates of active trading as a rule, we believe current conditions argue for being more active than normal. Any trading will be opportunistic and tactical, never involving total elimination of holdings, especially given that investors are now favouring the types of companies our clients already own, such as those exhibiting stable cash flows and dividend streams. Happily for our clients, fundamentals are becoming fashionable again.

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