VERITAS

DID YOU KNOW...

- Viewing online programming on Netflix accounts for almost 30% of peak evening internet traffic into Canadian homes.
- Economic shocks from the Japanese earthquakes and tsunami have pushed that economy into its third recession since 2000.
- TD Bank now has more branches in the US than it does in Canada.
- US policy makers are considering increasing the retirement age of today's young adults to 70 in an effort to alleviate the burden that is being placed on social services by increased longevity.
- Switzerland has the highest concentration of people who have over $1 million in investment assets, but the US has the most in absolute terms.
- The excessive use of a growth promoter combined with heavy rains is blamed for the explosion of over 46 hectares of planted watermelons in China.
- Used car values in the US are at record highs due to a shortage of supply resulting from the sharp drop in new car production during the recession.

CURRENT SITUATION

Very similar to last year, the first quarter rally in North American equity markets ran out of steam and started to reverse in May. Although the TSX was down 1.10% year to date by the end of June, this decline was not quite as severe as in the same period in 2010. However, significantly different from last year is that at one point in June, the TSX was down over 10% from its March 2011 peak. By definition, this decline qualifies as a correction: had the decline been less than 10%, it would have been only a "pullback". The materials sector, and in particular base metals, has been the worst performing sector this year, but was also the one that had demonstrated the strongest interim performance as the market was rising. We have commented in the past that the materials sector represents over 21% of the TSX. As a result, the year to date decline of over 11% in this sector will have a noticeable negative impact on the overall market. The cause of the decline was a combination of a natural correction after the sector's recent short, strong run, and fears that the global economy, and China in particular, is slowing, thereby leading to reduced demand for raw materials. Of note, the recent negative market reaction has been largely "made in Canada" inasmuch as the declines we have experienced have not been mirrored in the US. Markets there hung on to their earlier gains, posting a 6% return to the end of June, essentially flat to last quarter. This again highlights the risks associated with a stock market so heavily concentrated in one sector.

There has been a great deal of discussion of late around the sustainability of the global economic recovery. In the sense that North America exited the recession two years ago, it is probably more appropriate to view our recovery as being behind us, implying that we are now in a new economic and market cycle. If this is reasonable, then perhaps it is reasonable to view the present point in this cycle in the context of other, more historical cycles. From this perspective, fundamentals suggest conditions might not be as dire as some would have us believe. A combination of factors, including modestly accelerating global economic activity, even after discounting the impact of China's rapid but arguably unsustainable growth, and a slow but gradual improvement in the US jobs market, is economically supportive. It is clear that there are problems that need to be addressed, and while some of those problems, such as the size of the US deficit, and sovereign debt default risk in Europe, are monumental, problems of like magnitude are evident in all economic cycles. So, instead of referring to the sustainability of the economic recovery, perhaps we should be analysing the health of the current cycle, and what might cause it to falter. Given the economic data we have to date, it appears that there is much to support it. It also appears that this cycle is bearing the historical hallmarks of a more stable, slow growth cycle, and thus far exhibiting none of the excesses of the more recent ones. This could mean that full employment in the US could once again be represented by a 7% unemployment rate, at least until workers can retrain for the skills employers seek. It could mean that homeownership, which hit record highs before the last recession, may continue to decline as more people rent, particularly those who need to relocate for work. This phenomenon could absorb some of the excess housing supply in the US, which will add further confidence and support to this cycle. It could mean that the low-skilled manufacturing jobs that are being repatriated from overseas will not command the same high wages as they did when they were sent overseas, precisely in response to those high wages. It could mean that demand and consumption moderate, finding a basis in need as opposed to media hyped trend buying. All this could translate to less waste, lower costs and more opportunities for all in a longer, more stable economic cycle.

OUTLOOK

For the balance of this year, markets are going to be influenced in part by outcome of the brinkmanship politics in the US as related to the government's ability to increase the amount of debt it is permitted to issue. The Republicans and Democrats will ultimately come together on at least a short term compromise on the disputed debt and deficit reduction plans, and any decision on how to reduce the US deficit will include a combination of spending cuts and tax increases. While the uncertainty of the outcome will add to short term market angst, action must be taken. The consequences of not acting will be worse than anything the decision will bring. On a more positive note, employment, a closely watched indicator of an economy's health, is doing well in Canada, and is improving in the US. Although we have seen a couple of months recently where US numbers were not as strong as expected, it is widely believed that the weakness is temporary, and stems from supply chain disruptions related to the Japanese earthquakes. Notwithstanding this, private sector hiring intentions remain high, both in Canada and the US, and much of the hiring is expected to be by small to medium sized enterprises, which are generally seen as the backbone of both our economies. With higher employment comes higher consumer confidence and spending. This in turn should translate to higher corporate revenues, but the corollary is that earnings are expected to moderate as the recent big productivity gains get absorbed and company payrolls expand. And with higher consumption will come additional inflationary pressures, resulting in higher interest rates, likely this year in Canada, and in 2012 for the US.

STRATEGY

It is worth repeating that neither economic recoveries nor economic cycles are ever smooth. Given this, we should not be influenced by the short term movements in markets, and instead ought to focus our attention on expectations for several years ahead, and develop our strategy accordingly. It is this thinking that gives rise to the portfolios we have constructed for our clients today. While we may not fully participate in the spikes in the market, whether up or down, our clients take comfort in knowing that the companies in which they are invested will be around to generate profits for them when many other "outperformers" have ceased to exist. Our responsibility to our clients is one of prudent investing and preservation of wealth. In making this comment, we reaffirm our strategy of focusing on strong, well run companies, primarily Canadian but with geographically diverse operations, generally operating in less economically sensitive industries. We prefer established to exciting, subscribe to the notion that no news is good news, and believe that change is not necessarily good.

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