VERITAS

Summer 2013

DID YOU KNOW...

- Average house prices in Canada are 62% higher than in the US, whereas up until 2006 there was little, if any, pricing gap.
- The US Navy announced it will stop using all capital letters in its orders, a practice that has been in place since the 19th Century because original teletype machines lacked lower case characters.
- The Harlem Globetrotters are for sale (again). The team, founded in 1926, is being marketed by its private equity owners who bought it from former player Mannie Jackson in 2005.
- Twinkies are back, and with an extended 45 day shelf life. "Old" Twinkies had an "official" shelf life of 29 days, suggesting that Twinkies are not the perfect doomsday food solution after all.
- Gold prices fell 23% in the second quarter of 2013, the largest quarterly price decline since 1974, the year in which modern gold trading began.
- The Greek economy has been downgraded to "emerging" status, marking the first time *ever* a "developed" economy has been downgraded.

CURRENT SITUATION

North American equity markets continue to diverge, as they have been doing for the last couple of years. US equity markets have been strong since the beginning of the year, with the S&P 500 gaining 13.8% year to date. The blip in US returns in June was in response to recent comments from the US Federal Reserve (the "Fed") suggesting that because of the pace of growth of the US economy, the Fed plans to start reducing the extraordinary measures in place intended to stimulate that economy. This is being referred to as "tapering", and essentially it means that the Fed will be tapering its asset purchase program, thereby reducing liquidity. Markets, both bond and equity, incorrectly interpreted this to mean that interest rate hikes were imminent, and reacted accordingly. Bond prices corrected, and equity markets sold off as interest sensitive stocks were dumped.

The same influences are affecting us, but because the TSX has already been under pressure from continuing weakness in commodity prices, and the heavy weighting of interest sensitive stocks like banks and other financial services companies, the impact of rising yields here has been amplified. As a consequence, the TSX is lagging its US counterparts by over thirteen percentage points and is more or less flat as at June 30th. A market commentator recently made what we thought was a very interesting observation when she said that, of late, markets seem to have taken to reaching what she called their "terminal point" in response to news much more quickly than they have done in the past, which is what we see having occurred in June. Interest rates are not rising per se, and given this, the equity market response has been overdone. Bond prices on the other hand have been at risk for some time, and the recent correction is welcomed and, after a very long dry spell, is finally creating some opportunity to extract returns from fixed income portfolios.

Assuming interest rates do not spike, the likelihood of which is low given that policy makers worldwide are still preaching low rate policies, removal of the exceptional stimulus measures is a positive development. At a minimum it signals to markets that the ultra-easy monetary conditions will not continue in perpetuity, and that there will be a return to policy normalcy. This hopefully will translate to companies prudently adjusting their business and capital plans to anticipate the change in policy. As an aside, the past period of exceptionally low interest rates has afforded prudent corporations the opportunity to fortify their balance sheets, but has also allowed more aggressive management teams to engage in borrowing practices that

would have been prohibitive in a normal rate environment. As their low-rate debt rolls over in a future, more expensive environment, replacement funding will be more difficult to obtain for these companies, and they will not survive. This supports our discipline of owning quality companies for the long term wherever possible, even if it means sacrificing short term gains.

With capital markets, and equity markets especially, exhibiting their knee-jerk reaction to the shift in the Fed's stance, it is worth looking at why we think the reaction was overdone. The Fed is responding to, and anticipating further, good economic news: US payroll numbers are supportive of economic expansion; the June tantrum aside, equity market activity is indicative of a move away from a blind reliance on stimulus to a focus on fundamentals; important economic indicators such as the jobs numbers and auto sales, while not at pre-recession highs, are at pre-recession levels; the sustained upturn in new home sales should provide a tailwind for consumer spending as buyers outfit their new homes; and US households have recovered the $16 trillion of wealth lost in the recession. This final point resonates with us inasmuch as we have always advocated staying the course in the face of adversity, and the recovery of the $16 trillion demonstrates why: those who sold, or did not stay the course did not recover, and what they lost was lost permanently. The recovery also demonstrates the importance of maintaining a long-term outlook despite the challenges to doing so given all the short term data to which we are exposed.

OUTLOOK

Our outlook for good quality equities remains favourable. The evolving rate environment will continue to add volatility to markets, but as money flows out of bonds as prices decline, it needs somewhere to go, benefitting stocks to some degree. Fundamentals, particularly in the US, continue to improve, and even if economic growth there and in Canada is not as robust as hoped, the amount of revenue earned by North American companies from faster growing international markets, now near 30% of total earnings in the S&P 500, will go a long way to offset domestic sluggishness. US private (non-government) spending remains healthy, but not excessive, offsetting some of the effects of US sequestration, and with US consumer debt burdens the lowest on record, enhanced by the shrinking proportion of credit card debt, consumers are in much better financial health than prior to the recession, and far more resilient to economic turmoil. Here at home, because of our exposure to natural resources, our broad market earnings are being assigned a lower multiple than more "industrial" markets. This condition is unlikely to change, but the offset is that because the market does not represent all stocks, opportunities will continue to present themselves on a company by company basis.

STRATEGY

Despite the recent back up in bond yields, there is no change to our strategy: equities remain our asset class of choice, and within this class we will continue to focus on well run companies in industries less influenced by business cycles and in which the companies tend to be leaders. A key component to our strategy always has been to seek companies that can maintain earnings in bad times, and grow them in good, and to continue to pay and raise their dividends, a significant contribution to a stock's return over time. The ability to grow dividends without sacrificing the future of the company (by taking on debt to pay the dividends, for example) will become more important to stakeholders as rising rates put pressure on current yields. And for those of our client accounts that have had outstanding fixed income requirements, at long last we have been able to satisfy some of them thanks to the move in rates. Although the returns are low, at least they are now positive, and can be achieved without sacrificing capital by buying premium bonds (priced over par).
As always, we welcome your calls for discussion or questions.

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