VERITAS

Summer 2015

DID YOU KNOW...

- Microsoft turned 40 years old on April 4th.
- The value of world stocks hit a record $74.7 trillion in April, slightly exceeding total global GDP of $74.5 trillion.
- New York City, population 8.4 million, has 1.2 million outstanding arrest warrants open on its books.
- Samsung is the world's largest electronics manufacturer.
- Founded in June 1817, Bank of Montreal is Canada's oldest bank; Bank of Nova Scotia, founded in 1832, is second.
- According to Stats Canada, the inflation adjusted average net worth of Canadian families rose 73% between 1999 and 2012.
- Magna Carta, viewed as a symbol of modern liberty and the document upon which much of North America's justice and freedom is based, was signed on June 15th—800 years ago.
- Since its June 12th peak, the value of the Chinese stock market has shrunk by over $3 trillion, or over six times the amount of Greece's total foreign debt.
- Hawaii consumes more of Hormel's canned meat SPAM than any other state.

CURRENT SITUATION

The last quarter was punctuated by frequent headlines pertaining to Greece, China, Iran and Puerto Rico, and these headlines served to create uncertainty and volatility in global equity markets. North American markets gave up their slim first quarter gains to end the second quarter flat in the case of the US S&P 500, and down an unremarkable 1.6% for our TSX. Although the retreat is unwelcome, the very modest declines in the face of the dire headlines are indicative that markets perhaps are discounting the headlines for what they really are, and that is largely noise, with little or no new information.

As at the time of writing, the Greek parliament has voted to accept a package of conditions that will allow Greece access to three more years of aid. Coincidently, the proposed conditions bear a remarkable resemblance to those rejected by Greek voters in an earlier referendum, where the Greek people resoundingly rejected any further austerity measures that would otherwise be required to secure additional bailout funds. We raise this because with the exception of the referendum, this brinksmanship behaviour and ultimate outcome is what we have experienced twice already, in 2010 and 2012, when Greece required earlier bailouts, and likely is what we will experience in another few years when the current bailout package expires or is exhausted. This is a condition the markets seem to be taking as the new normal, and to which they are assigning, perhaps erroneously, little risk, given their activity cited above.

Much the same can be said about the market response to the issues relating to China, although there is the complication of dealing with a closed economy, making the economic data we receive very difficult to verify. What we do know, as the headlines have been trumpeting, is that the Shanghai stock index (CSI 300) is down 40% from its record high set in mid-June. But this does not tell the whole story because it leaves out the important detail that the CSI 300 had gained over 150% since July 2014. That kind of meteoric rise is bound to reverse, and even with the 40% decline, the index is still up 10% on the year, and substantially more if measured from last July. Our real concern with the Chinese market is the composition of its investors who, to the tune of 80%, are unsophisticated individuals. This concern is compounded by the government's constant intervention in the market, ostensibly to protect those individuals who, by virtue of their lack of sophistication and access to information, are truly no more than speculators. Furthermore, the intervention is being made at the expense of the comparatively sophisticated investors who are subject to a new, six-month prohibition against selling shares. It

should be noted that we commented not too long ago that there was a real concern of mass speculation in the Chinese stock markets fuelled by policies that encouraged individuals to borrow funds to buy into the markets. Evidently, those concerns were not without grounds.

On the global economic data front, it was a quarter of almost universally good news, including from China, which reported 7% quarterly growth, and from Europe despite Greece. Eurozone economic growth came in at 1.45% in the second quarter, higher than estimates, and surpassing Canada's growth rate, which was 1.2%, for the first time since 2009. Much of Canada's lag is still attributable to the slowdown in the energy sector. The slowdown has moderated as oil prices stabilise and the industry, as well as those industries that support the energy sector, respond to the new pricing environment. In the US, labour data has been the focus, and the indications are that conditions in the labour market continue to improve. The issue now is that businesses are having difficulty filling positions, and this is expected to put upward pressure on wages, something the Fed has been awaiting to confirm conditions for a rate hike.

Another US data point that caught our attention was the small business hiring intentions, which are at their most optimistic since 2006. Traditionally, small businesses lead economic recoveries, and their presence in the labour market now, finally, should provide additional support for it, and a lift to economic and consumer sentiment. Because the US remains our largest trading partner, this is also good for Canada. As a side note of things good for Canada, thanks to low interest rates, Ottawa's debt service costs are $4.3 billion less than last year and at 8.8% of total revenues, are at the lowest level since the early 1960s. Given this, it can be argued that all Canadians benefit from low rates, although we know of many savers who would disagree.

OUTLOOK

Our expectations are for interest rates to rise, but we have abandoned trying to anticipate when. Central bank guidance has proven to be undependable at best, and in the case of the now *two* 2015 rate cuts in Canada, misleading. Markets dislike uncertainty, and this uncertainty of timing will continue to impact equity and currency markets in the form of increased volatility. We know that the underlying economic fundamentals are strong for the most part, so as uncomfortable as market gyrations are, and absent a real event that will take markets down for an extended period, the volatility will present investment opportunities. And despite the volatility, equities still are expected to outperform bonds for the balance of the year, especially when rates finally move up, the effect of which will be immediately to depress bond prices, given the inverse relationship between bond prices and interest rates.

STRATEGY

Nothing has happened in the last three months to cause us to alter our strategy, even with the headlines mentioned elsewhere in this letter. Equities remain the preferred asset class in our clients' portfolios, but we are not simply buying the market, or mimicking an index. We intentionally avoid certain sectors because of their inherent cyclical nature, and our disinclination to engage in frequent trading in our clients' portfolios. Our investment horizon is long, and this affords us the opportunity to look beyond the shorter term factors that tend to influence the cyclical stocks, and focus instead on the longer term trends that will shape an industry for years to come. Our portfolio construction goals have not changed either: we seek quality companies run by competent and proven management, companies that are industry leaders, and that are intended to be long-lived holds, periodically trimmed for profit, and sold only if irreparable harm befalls the company. We avoid sector concentration, but also avoid over-diversification so as not to dilute asset specific portfolio return contribution.
Have a very pleasant summer.

R. Guy Amighetti, CFA, TEP
Portfolio Manager

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