VERITAS

Winter 2005

Geopolitical events captured the world's headlines in the last quarter of 2004. George W. Bush secured a second term as President of the United States, narrowly beating his opponent, John Kerry. Mr. Bush is to be sworn in on January 20. Palestinian leader Yasser Arafat died in Paris. While a hero to many of his followers, Mr. Arafat was considered an extremist by the outside world, and with his death, there is the hope that there will come the opportunity to renew peace talks in that region. What dominated headlines at the end of the quarter, and continues to do so, is the tragic disaster that affected South East Asia. This disaster has prompted the largest outpouring of international aid on record, especially from individual donors. For example, at the time of writing Canadian individuals have donated more than $150 million, and donations globally have topped US $5 billion. These donations, along with the recently announced largest ever moratorium on debt payments, will greatly assist local governments in their reconstruction efforts.

CURRENT SITUATION

North American markets ended the year higher for the second year in a row. However, as expected, returns were more modest than those recorded in 2003. US equity returns, as measured by S&P 500, for Canadian investors were negatively impacted by the strong Canadian dollar. In US dollars, the S&P 500 was up 10.90% in 2004, but converting to Canadian, returns dropped to 2.70%. Canadian equity returns were up 14.50%. For an indication of how returns have moderated from 2003, note that the S&P gained 29% (unconverted) in 2003, while the TSX was up 26%. We commented one year ago that because of their volatility, the strongest sectors of 2003, Information Technology and Mines/Metals, likely would not repeat their spectacular performance, as was the case. Returns for these two sectors for 2003/2004 were 67.1/11.6% and 34.0/2.1% respectively. In light of this, it should not be a surprise to see TSX returns lower in 2004, but even with the decline, returns remain above historical averages.

North American economies continue to grow at moderate levels. US growth was held in check by a weak US dollar, increasing the cost of imports, including oil, and the weight of an historically large budget deficit. Conversely, Canada's growth was moderated by a strong dollar, impacting our export sector. However, in both countries there is sufficient evidence of economic growth to cause our respective central bankers to continue to articulate their policy of higher interest rates. One of the most closely watched indicators of economic growth is employment: the US added 2.2 million jobs in 2004, the first year of job growth since 2000. In Canada, 228,000 new jobs were added, a 1.4% increase over the number added in 2003. Although our numbers may appear small, keep in mind that our population is one-tenth that of the US, and while the US was shedding jobs in 2000—2003, we were adding them.

Oil prices and currency related issues remain a concern for policy makers and investors. The most noteworthy development since we last commented on oil prices is OPEC's new position that they are committed to defending US $40 oil, $12 higher than the previous target price level, and have gone so far as to cut production by one million barrels per day to achieve the goal. Higher oil prices, while good for producers and therefore Canada, will continue to be a risk to both economic growth and inflation. Furthermore, as oil markets remain very tight, with very little excess production capacity and demand rising, there is no relief in site. Of note in all this is that China has recognized its vulnerability to volatile oil prices, an issue magnified by their currency being pegged to the declining US dollar. Consequently, China is actively pursuing the purchase of foreign oil production to satisfy their domestic needs.

The Canadian dollar ended the year at US .8319, up 7.9%, and marking its third consecutive annual increase. The higher dollar prompted the Bank of Canada (BOC) to pause last month in its process of raising interest rates in order to determine the extent to which the economy had been slowed by the currency. However, backed by the strong 2004 employment numbers, it is evident that overall the Canadian economy is adapting to a stronger dollar. The notable exception is the export portion of the Canadian manufacturing sector, especially autos and auto parts, but this so far is not causing the BOC concern. In November, BOC governor David Dodge stated that "...we have no target for the dollar… exports have strengthened, and… net exports have made a major contribution to growth." Given Dodge's comment and what prompted it, and a $9.1 billion budget surplus in Canada, we expect to see the dollar continue to trade at over US .80 in 2005.

OUTLOOK

Borrowing rates in China have been increased for the first time in nine years in a bid to control growth in the region. As the growth rate in China moderates, and the rest of the world continues to chug along at 3% growth, growth in demand for raw materials will decline. We expect that base metal prices will fall further as growth in global demand for the commodities falls to a level consistent with global GDP growth. This will have a ripple effect, and although Canada will continue to enjoy the benefits of being an exporter of raw materials, the benefits will be partially offset by continued strength in our currency and modestly lower raw material prices. Strong dollar aside, there will continue to be sufficient strength in the economy to warrant further interest rate hikes. Interest rates will rise in the US as well, responding to inflation concerns arising from the weak dollar and high energy prices. Canadian equity returns will soften from 2004 levels, primarily from weakness in the materials and technology sectors. Rising interest rates will have a modest impact on other sectors. For these reasons, 2005 will be a stock picker's market, where buying the index will prove not to be as successful as it has been in the past. In an environment where historical single digit equity returns are expected, there will be an increased focus on defensive companies. We do not believe that 2005 will be a year of remarkable returns, but nor will it be a year of broad-based sell offs: some sectors will shine as investors rotate out of others. But as markets move higher and higher, it becomes increasingly difficult to match previous period returns, which have been robust in the last couple of years.

STRATEGY

Despite disappointing results from two companies that were removed from the portfolios in the Fall, our clients' portfolios enjoyed strong returns in 2004. Our discipline of diversifying portfolios across a broad range of what we view to be well-run companies in stable industries means that if fortunes change for one or two of those companies, the negative effect on the portfolios is far less severe than would be the case without diversification. Given the selectivity of asset returns we anticipate for 2005, this discipline will be even more critical. Equity investments will again be favoured this year, but if interest rates rise as expected, bond prices will fall, possibly creating the first opportunity in three years to add bonds to those portfolios requiring exposure to this asset class. Our overall portfolio strategy for 2005 will emphasise defensive equity holdings and focus on a reduction of the variability of portfolio returns.

Finally, we would like to wish all our readers a very happy and prosperous 2005.

Happy New Year.

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