VERITAS

Winter 2006

Earlier in the quarter, the income trust market declined by over $21 billion in just a few trading sessions after the federal government announced it was reviewing whether trusts should be taxed the same as corporations. This change would have made trusts far less attractive investment vehicles, resulting in the sell-off. In the end, instead of taxing trusts, the Minister of Finance announced a cut to the taxes on dividends, resulting in an immediate rally in income trusts and dividend stocks. The issue has become politically charged amid allegations that the Minister's decision was leaked early, allowing some market participants to unfairly profit from the news. While a leak might have occurred, it was already widely assumed by the investment community that any decision would not be detrimental to trusts, and the rally started the minute an announcement was anticipated. You can be sure that if the announcement was not as expected, the rally would have reversed itself in a second, and there would be no allegation of leaks. In other news, automotive history is being rewritten: the Honda Civic is overtaking the Ford F-150 pickup as the most popular car in Canada, Toyota is poised to become the largest car manufacturer in North America, and the Big Three now have less than 50% market share in Canada.

CURRENT SITUATION

Canadian equity markets finished the year at 11,272, close to the peak of the year, and up 22%, posting the best results of all the world's developed markets. As at the time of writing, the TSX is over 11,600, well beyond the all time highs posted in September 2000. A notable difference between this and the 2000 advance is that in 2000, only five percent of listed issues, most of them technology related, contributed to the rise, as compared to 70% today. The implication is that the current advance is much broader and sustainable. That said, and as we have mentioned in the past, with energy and financials comprising 59% of the index, and accounting for the majority of 2005 performance, any stumble in these sectors will be felt immediately in the market.

The Canadian dollar posted its fourth consecutive year of gains, finishing 2005 up just over three percent against the US dollar. Although the gain was muted as compared to prior years, so too was the Loonie's volatility, suggesting that its current trading range of US0.85 - 0.87 is fair value. There is support for the Loonie at these levels in the form of increases in the Bank of Canada rate, strong commodity prices, Canadian trade and budget surpluses and a fundamentally weak US dollar. Conditions should remain favourable for our dollar through 2006. The Bank of Canada is expected to continue to raise interest rates in response to the strength in our economy, which remains near capacity. Business spending has overtaken consumer spending and housing as Canada's economic growth driver, and the composition of this spending is substantially different than in previous cycles. Currently, spending is predominately resource related, to expand production, refining and transportation capacity. The spending also illustrates a shift in economic leadership in Canada from east to west, with BC and Alberta taking top spot at the expense of Ontario. This will prevail as long as commodity demand remains strong, and our dollar remains high, which, along with a weaker auto sector, is adversely affecting manufacturing in central Canada.

In the US, the S&P 500, although posting its third consecutive year of gains, had its weakest year since 2002, advancing only four percent. Converting to Canadian dollars, the advance was just under two percent. Even with the strength in the US economy, which, like Canada, is running at or near capacity, equity returns were negatively affected by many macroeconomic factors including inflationary fears, declining corporate profitability and higher interest rates. Interest rates in the US have been moving steadily higher over the past 18 months as their central bank executes against its stated policy of bringing interest rates to a neutral range where they neither stimulate nor restrict the economy. The size of the US deficits is also having a negative effect on US equities. As at November 30th, the US trade deficit, caused when imports exceed exports, was over $700 billion, a third of which represents energy imports. The current account deficit, caused when government spending exceeds receipts, is at a level now where the government must borrow $2 billion *per day* to fund it, much of which is going to pay for the referenced energy imports.

Given its huge need for capital, it is worth mentioning that the US relies heavily on foreign investment to fund its deficits. Asia, and Japan particular, is one of the largest regional lenders to the US, and recent developments in Japan could cause some serious problems for the US debt market. For the last decade, Japan has been fighting deflation by keeping interest rates at or near zero in an effort to stimulate the economy. Because of this, a great deal of investment capital has flowed to the US via the bond market in search of returns. On October 30th, the Japanese central bank announced that because of strengthening economic indicators, it would cease combating deflation, implying that the era of zero interest rates may be coming to an end. If this happens, and interest rates rise even modestly in Japan, it is conceivable that Japanese capital will not be as reliant on US debt because it can now be invested domestically, earning some return without being exposed to currency and political risks associated with investing abroad. This would reduce the flow of capital into the US, making it more difficult for the US to fund its deficits, and likely forcing them to print money at a faster pace than they are doing now. Printing money is inflationary, leading to higher interest rates, resulting in higher borrowing costs and requirements, and expanding the deficits further. If nothing else, this possible scenario serves to demonstrate that global markets are very much interconnected, and that nothing happens in isolation.

OUTLOOK

Concerns that we have articulated in the past are being carried forward for at least the first half of 2006. We see energy costs remaining at current levels or higher, interest rates have moved up in Canada and the US, and are expected to move moderately higher yet. Earnings growth momentum will be difficult to maintain as the effects of the 2005 and 2006 rate hikes move through the economy, coupled with the lingering effects of high energy prices, translating to lower forecasted equity returns. Furthermore, the bond market is signalling that US economic activity may slow this year. The combination of factors is not providing a backdrop for a repeat of 2005, and we counsel all our readers not to expect it.

STRATEGY

In the context of our very conservative outlook for 2006, we continue to look for opportunities to preserve portfolio returns, and reduce risk. As we suggested we would in the last edition of *Veritas*, we have made some changes in the portfolios including the removal of some long-held companies. It was our view that if these companies had not performed as well as had been expected when all was in their favour, then it was unlikely that they would be successful when conditions became more challenging. We will continue to evaluate the portfolios in this manner throughout the year with the expectation that overall equity returns, particularly at the index level, will be quite modest compared to 2005. This emphasises that picking the right companies with strong fundamentals will be critical to successful investing in 2006.

Please do not hesitate to call for discussion of any of the issues mentioned here.

And to all of our readers, our wishes for a happy and prosperous 2006.

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