VERITAS

Winter 2007

There was no missing the biggest Canadian business headline last quarter. Widely referred to as the "Halloween Trick", the Federal Minister of Finance announced on October 31 that income trusts would be taxed as corporations effective in 2011, catching investors and the markets by surprise. When the markets opened on November 1, the trust sector declined by over 20%, and has yet to recover to pre-announcement levels. In the US, it was the outcome of their mid-term elections that made headlines worldwide. In a decisive shift in voter sentiment, the Democratic party won control of both the House and the Senate from the Republicans, thereby effectively tying the hands of the incumbent Republican president. On the topic of control change, Alan Mulally replaced Bill Ford, Jr. as CEO of Ford, putting a non-Ford family member at the helm of the company for the first time since 1946. Also on cars, last year, for the third year in a row, Ontario produced more cars than Michigan. On a side note, China's foreign exchange reserves topped USD 1 trillion (that is 12 zeros!). Finally, in sadder news, Milton Friedman, economist and the 'grand master' of free-market economy theory died in November at the age of 94, and former president Gerald R. Ford died on December 26 at the age of 93.

CURRENT SITUATION

North American markets had a strong finish to 2006. The TSX posted a total return, including dividends, of 17.3%, lagging 2005, but well ahead of expectations. As a point of interest, the TSX is now up 108% since its 2002 bottom. Furthermore, 2006 represents the fourth consecutive year of strong double digit gains for the TSX, resulting in a five year compound annual return of 13.1%, and amply recovering from the 25% decline experienced over 2001—2002. The TSX advance was more broadly led in 2006 than in the few years prior, with no single sector posting negative returns. The oil and gas sector gave up its 2005 lead, only posting a modest 6.1% rise for the year, reflecting an equally modest 5.53% rise in the price of oil, which was offset by a 40% decline in natural gas prices. The metal sector was the standout for 2006, rising 40.4%, propelled by continued strong demand in emerging industrialised economies.

The US S&P 500 gained 15.8% in 2006, well ahead of the 4.9% gain of 2005. The strength can be attributed to a combination of stable, yet still low interest rates, continued robust but perhaps unsustainable US consumer spending, and increased labour productivity. For comparative purposes, the S&P 500 is up 75% from its 2002 bottom, posting a five year compound annual return of 6.20% in US dollars, but a much weaker –0.20% if measured in Canadian dollars.

Canadian economic activity moderated somewhat towards the end of the year, partially due to a similar moderation in the US. However, as a result of developing deeper trade links with other countries, especially in Asia and Europe, we are less dependant on the US for our exports. In fact, only 76.5% of our 2006 exports went to the US, a 13 year low. This means that although we will feel the effects of a US slowdown, we will feel them less than would historically have been the case. That said, we remain largely a resource exporting country, and global demand and pricing of those commodities will impact our economic activity and currency. We felt the effect of this phenomenon in 2006 as the Canadian dollar declined 0.3%, responding to muted metals and natural gas prices. This is in sharp contrast to 2005 when all commodity prices, and our dollar, were on the rise.

Our twin federal budget and current account surpluses helped our economy outpace those of all other G7 nations. Conversely, the US ranked poorly because of its high budget and current account deficits, and higher inflation, coming in just ahead of the worst performing country of the G7, Italy. The strength and stability of the Canadian economy has been attracting the attention of foreign investors,

who have helped to push the TSX to record highs and, with their investments in Canada, have also helped to eliminate our net foreign debt. Unfortunately, this investment activity comes at a price, and in 2006, it was the sale of some of Canada's most historic companies, including the Hudson's Bay Company, INCO, Falconbridge and Dofasco, to non-Canadian interests.

Returning our focus to the US, there is more evidence that the consumer there may be fatiguing. For example, in this past quarter, Starbucks posted its first ever decline in same store sales growth, and Wal-Mart had its weakest monthly sales results in over 10 years. It would not be a surprise if there is more news like this in coming months because of increasing evidence of weakness in the US housing market, and the fact that much of recent consumer spending strength has been facilitated by the ability of the US consumer to use their house as an ATM. What we are seeing now however, is a 50% year over year decline in mortgage equity withdrawals, and a doubling in the level of delinquencies of sub-prime mortgages. To make matters worse, over 30% of all sub-prime mortgages are for 100% of the purchase price of the home. This collection of data is worrisome for many reasons, not the least of which is the fact that consumer activity accounts for 70% of US GDP, as opposed to 58% and declining in Canada . It is evident that the US economy relies heavily on the support of consumer spending, which it is at risk of losing.

OUTLOOK

There is a sense in the market that investors expect earnings growth and market strength to continue unabated. We do not agree. While conditions remain overall favourable for equities, we expect increasingly muted global economic activity, if for no other reason than the cost of energy. Catalysts for earnings growth are disappearing or have already been anticipated by the market. Costs of production have risen over the last several years, but have yet to show up in the price of finished goods. This lack of pricing power implies that these costs are being absorbed by manufacturers, depressing profit margins, and ultimately translating to lower stock prices. A further implication of the lack of pricing power is that corporations are recognizing the increasing fragility of the consumer, and that any price increase will likely result in substantial sales losses, an outcome far worse than simply depressed margins. These, and several other factors, lead us to look for much lower, but still positive equity returns for 2007, and equally significantly, potentially lower interest rates in the US, as the Fed attempts to keep the US consumer solvent. As we make these forecasts, we were interested in the results of a recent RBCCM/ Russell Investments survey that showed 86% of surveyed US asset managers expect markets to be positive in 2007, but by less than 10%.

STRATEGY

At the risk of sounding like the economist who has predicted ten of the last two recessions, we continue to believe that this year will be weaker than the last several, and continue to position the portfolios accordingly. Equities remain the favoured asset class but sector and security selection will define the defensive portfolio. We expect that there will be several market pullbacks this year, precipitated by negative earnings surprises, and unexpected and unwelcome corporate developments. These will be used as opportunities to add to our existing holdings, and also to provide an entry point for new names that we would consider in our continued effort to reduce the variability of portfolio returns. We were presented with such an opportunity in November when the trust sector declined. We were able to step in and purchase at a significant discount a company we had targeted for inclusion in client portfolios because of its conservative business model and stable cash flow. Throughout 2007, our investment discipline will remain defensive, and our focus on stability of returns.

Have a safe and happy 2007.

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