VERITAS

Winter 2008

In what we view as a very important and likely overlooked piece of global economic news this past quarter, the International Herald Tribune reported that China appears to have become a net seller of US Treasury bonds. This follows last year's announcement by the Chinese National People's Congress of their intention to diversify China's foreign exchange reserves, and to "favour stronger currencies over weaker ones." On a related topic, government sponsored investment funds from Asia and the Middle East are making multi-billion dollar investments in a broad mix of North American businesses, including US ports, US banks and Alberta tar sands. BC made headlines last quarter by posting employment growth of 4% in 2007, ahead of Alberta at 3%, but trailing New Brunswick, the national leader, at 4.7%. Canadian consumers finally began to feel the positive effects of our strong dollar as retailers and auto dealers engaged in aggressive price cutting to better reflect their lower costs, and to entice Canadians to shop in Canada. Finally, the quarter was marred by the death of Benazir Bhutto, the leader of Pakistan's opposition. Her death has triggered a level of unrest in Pakistan that has not been seen in many years, the effects of which are being felt around the world.

CURRENT SITUATION

The S&P/TSX Total Return Index, which includes dividends, ended this very volatile quarter to finish the year up 9.80%. Between early September and the beginning of November, the TSX had retraced its summer rise, testing the August highs before correcting again, this time by 10 percentage points. From there, very choppy trading and another 4% pullback in December punctuated a muted recovery to the market's year-end close.

Global markets continue to work through sub-prime and ABCP issues, and will have to do so for the next couple of years. In the interim, as a result of the potential fallout from the tightening of credit markets, whereby it is more difficult for people and businesses to get loans, there is now speculation of a US recession, and a resulting economic slowdown in Canada. Traditionally, a recession is defined as six months of negative real economic growth, or economic contraction. By this definition the US has not entered a recession. However, if we use the contemporary, less specific National Bureau of Economic Research definition of a recession as a "significant decline in economic activity spread across the economy, lasting more than a few months", the US may be in a recession. In either case, there is undeniably some softness in the US economy, and as was the case with the previous economic strength, it has been consumer led, as they reduce their spending in response to lower property values and higher costs of living. However, the weakness is not widespread. What we are witnessing are the effects of the housing market enduring a correction in certain parts and demographics of the US, brought on by a combination of higher mortgage costs, a decline in demand as a result of stricter lending standards, and excess supply. Part of the excess supply problem has been caused by developers. Riding the wave of speculative demand, many developers contracted to build large multi-home projects at what turned out to be the peak of the housing market. Because of the subsequent drop off in demand for new homes, builders are now forced to auction the houses off at a fraction of what they were selling for at the height of the market.

We anticipate that the US housing supply and demand equation will rebalance, incorporating lower overall housing prices. A number of former and generally unqualified homeowners will return to renting, in turn creating demand for some of the foreclosures flooding the market. After a period of time, and this could be upwards of two years given the number of teaser rate mortgages that have yet to reset, a new equilibrium will be established in the housing and credit

markets. We hasten to remind our readers that problems in the US mortgage market are directly affecting only a small percentage of borrowers. The majority of US homeowners, depending on their market, will be largely unaffected by what is playing out today. They will likely see a decline in the value of their home, but only to the level before the artificial inflation started.

As to the impact on Canada, some say that because of the strength in other regions such as Asia and India, a US slowdown will not matter to us. While the comment does hint at our reduced reliance on the US for our exports, we cannot overlook that the US remains our largest trading partner. On a positive note, the Canadian economy is operating at above capacity, and has been largely unaffected by our strong dollar. Our manufacturing sector is the exception, but it continues to adapt. Labour is in short supply, consumption is strong, and if there is a cloud on the horizon, it is that our productivity continues to lag. Global economies are strong, and we should benefit from this, providing some offset to the expected near-term weakness in the US. For those who are concerned about a repeat of the events of 2002, the difference between then and now is that in 2002, an entire sector of the US economy collapsed after a bubble, which is not the case today.

OUTLOOK

2008 promises to be a challenging year for North American equity investors. The US credit crisis will continue to play out, further slowing the US housing market, and creating uncertainty in the markets. The Bank of Canada is concerned that the US weakness will have an impact on the Canadian economy, and in response has lowered interest rates for the first time since 2004 and will likely cut again. However, with the Canadian dollar once again below par after posting a record high of $1.10, it is no longer exerting the same drag on the economy as it was when the Bank of Canada initially cut rates. The implication is that future rate cuts may lead to inflationary pressures towards the end of the year which will be difficult to manage if the economies continue to be sluggish, and the rate cuts cannot be reversed. And while low interest rates are generally stimulative, there remains a great deal of uncertainty as to whether it is rate cuts that will solve the yet to be identified problems that are forecasted to be exported to us by the States, or if some other action needs to be taken, or if we will feel any meaningful impact at all. Because markets do not like uncertainty, they will experience more weakness and volatility until the problems are clearly identified. Notwithstanding the volatility, we still see positive returns for Canadian equities this year, but the gains will be modest given the real risks to the US economy, and the consequences of those risks, and the length of time required to work through them.

STRATEGY

At the time of writing, the TSX is already down over 5% this year in indiscriminate selling. If one believes, as we do, that this is not the beginning of a broad secular market decline, then there are a large number of very sound companies whose shares are oversold. But as long as market sentiment remains negative, we will be wary of saying the downturn is over. We have higher than normal levels of cash in client accounts, and are comfortable keeping the cash in reserve until we see a convincing bottom in the market. When we see this, we will start putting November profits back into the market. Overall, we continue to favour equities over bonds or cash in this low rate environment, and our discipline of buying defensive, conservatively managed companies for client portfolios has become more important than ever. Because capital appreciation will be harder to achieve this year, even with the return of positive market sentiment, preference will be given to companies paying a dividend.
We have touched on only a few of the topics that are impacting the markets. Please call for more detailed discussion.

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