VERITAS

Winter 2010

CURRENT SITUATION

The TSX continued to enjoy a broad based rally through the end of 2009. Putting numbers to the year's movement, excluding dividends, the TSX ended the year up 31% from January 1, 2009, and up 57% from its March low. While the last 18 months have been gut-wrenching, it is worth looking back to the end of 2007 to give some perspective to our recent experience. As at December 31, 2009, the TSX is down 15% from its 2007 close. Given that at the end of 2007, conservative market participants, us included, believed that markets were overvalued and poised to correct, present market levels are actually quite reasonable in the context of a normal correction and recovery. Arguably, the issue lies more in the process that got us to where we are today, not the level itself. This is particularly so for investors who had the misfortune of selling into the falling markets in 2008 and 2009, and who did not re-establish their holdings before the rally took hold. For these individuals, the losses are real, and largely unrecoverable.

Aside from economists saying it is so, there is increasing evidence that the global economy is emerging from recession in varying degrees. We are seeing reports of improving consumer, investor and business sentiment in almost all developed countries, and many developing economies, including China and India, are posting some of their strongest growth numbers ever. There is no question that government stimulus has driven recent improvements, but likely the effects of the stimulus spending would be less profound if people were not feeling increasingly confident about their own circumstances.

In North America, a closely watched economic indicator is employment, which typically lags economic changes, and is thus considered a confirming economic indicator. For example, when the North American economy contracted, and job losses began to mount, we were likely already three to six months into recession. Although we are not seeing hiring yet, what we are seeing is a reduction of job losses. We are also seeing reduced inventories, which in turn has led to an increase in manufacturing activity, particularly in the US. At risk of oversimplifying the connection, as long as demand holds up, manufacturing will continue to expand to rebuild inventories, and as spare capacity is used up, hiring will be the next step. If we see net hiring in upcoming jobs numbers and history holds true, this should serve to confirm at least modest economic expansion. There will be regional differences, and certainly differences between Canada and the US, the largest being that in Canada, we had significant excess

DID YOU KNOW...

- After over 300 years of use, British banks have decided to phase out cheques, with windup of the cheque clearing system targeted for late 2018.
- Based on current demographic trends, women will become the majority of the US workforce later this year.
- US government investigators are discovering that state and federal regulators knew lending institutions were engaging in hazardous practices as far back as 2002, but failed to act. "… regulators acknowledge they should have been more vigilant."
- Canada officially exited recession in the third quarter of 2009, largely as a result of a 20% rebound in exports.
- For the superstitious in our readership, the S&P 500 index bottomed at 666 on March 6, 2009.
- According to Peter Lynch of Fidelity, you will never be right 90% of the time in the investment business, but if you are good, you are right 60% of the time.
- For the first time since 1970, over 1 billion people worldwide are hungry and undernourished.

capacity, even before the slowdown. This slack combined with the strong Canadian dollar will dampen inflation pressures, allowing the Bank of Canada to keep interest rates low, perhaps even beyond mid-year, the earliest at which, according to the BOC, they might be increased. The capacity picture in the US is different inasmuch as while utilization and productivity is higher than in Canada, actual capacity is constrained. This is a double edged sword: lack of capacity can limit economic growth and heighten inflation risks. But it can also virtually eliminate the risks of deflation, create long-term opportunities in innovation, technological development and jobs.

Much of the global stimulus effort has come in the form of near zero interest rates. Prolonged very low interest rates was also a significant contributor to the recent economic malaise. Policy makers have a very fine line they must walk between leaving rates too low for too long, thereby creating another asset bubble as was the case in the last cycle, and raising rates too early and too quickly, potentially pushing economies back into recession. On a related topic, we wonder if any lessons have, or will be learned about the hazards of excessive leverage if bailouts become the norm. It is almost as if policy makers are encouraging borrowers to be irresponsible with the use of debt, given the overall lack of consequences of its abuse. On a positive note, Ottawa is recognizing that rising household debt levels are posing an increasing risk to financial market stability. As a result, Finance is considering increasing the required down payment on home purchases, as well as decreasing the allowable mortgage amortization period. Again, a fine line between curbing demand and killing a market.

OUTLOOK

Our outlook and expectations for the coming year are perhaps best described as being more normal than they have been for the last couple of years. Although there remains a substantial amount of stimulus funding that has yet to find its way into world economies, given the strength of the rally thus far, future spending or project announcements likely will have only a muted effect on equity markets. Given that equity markets are accepted to be forward looking, and tend to discount six to nine months into the future, it is possible that they have already priced in the totality of the effects of all stimulus spending. Even this, combined with continuing high but moderating unemployment, low but improving consumer sentiment and the spectre of higher interest rates later this year, should still allow for modestly positive equity returns for 2010, and returns ahead of other traditional asset classes. There are still elephants in the room that can negatively affect the markets, but the sense is that their nature is now better understood in contrast to a year ago. We continue to believe that the largest risk to the markets today is that stimulus measures are removed too aggressively, stalling the nascent economic recovery.

STRATEGY

Given our conservative but positive outlook for financial markets, we remain committed to our equity strategy. If interest rates do increase later this year, bond prices will decline. Alternatively, if rates remain at present levels, after tax and inflation, bond returns are near zero or worse. The positive side to this is that more yield oriented portfolios may be able to generate modest positive cash flow later this year if rates do rise. At the asset level, any changes that are contemplated for our clients' portfolios will be made only to improve the quality of holdings, even if that involves removing an existing position, as was the case late last year. We still believe that diversification is crucial, including at the geographic level. Given that our clients' portfolios are domestically orientated, we endeavour to achieve geographic diversification through Canadian companies with international operations, including our banks, SNC Lavalin and Saputo. These companies also have the common characteristic of operating in needs-based industries, a favourite theme of ours. Please feel free to call for discussion. Have a happy, healthy 2010.

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