VERITAS

Winter 2011

DID YOU KNOW...

- **V** Without fertilizer, 40% more farmland would be required to produce the same harvest yield.
- **V** It costs approximately 1.5 cents to produce a Canadian penny, a fact that has prompted the Bank of Canada to propose removing the penny from circulation.
- **V** MGM Studios, the studio symbolised by the roaring lion, and that brought James Bond to the screen, filed for bankruptcy in November.
- **V** The very last rolls of Kodachrome film were processed on December 30th, whereupon the last remaining processing machine was decommissioned.
- **V** At 23% of all sales, Canadians are the largest foreign buyers of real estate in the US.
- **V** The loonie coin is 91.5% nickel. The remaining 8.5% is the plating, and is predominately copper.
- **V** US household debt fell for the 10th straight quarter. Prior to this, US household debt had not declined in over 55 years.
- **V** Canadian household debt has risen to 148% of disposable income, higher than in the US for the first time since 1998.

CURRENT SITUATION

The TSX consolidated its third quarter gains and extended them into the fourth, finishing the year up 17.6%, including dividends. The fourth quarter advance was steady, with only one period of weakness evident in mid-November. While all sectors except for Information Technology contributed to the positive returns for the year, it was the Materials sector, which accounts for 24% of the TSX, that outpaced, gaining 37% as a result of surging gold and copper prices. The other two heavyweight sectors, Energy at 27% of the TSX and Financials at 28%, were up 13% and 11% respectively. US markets also fared well, up 15% in local currency, but our strong dollar reduced those gains to 9% adjusting for currency translation. Of note, the TSX has achieved a total return of 87% since bottoming in 2009, and even during the worst of the last couple of years, has never posted negative returns on a 10 year change basis. Unfortunately, the same cannot be said of US markets. In fact, the last 10 years have been referred to as the lost decade for US equity investors, or at least for those who were "buy and hold".

It was a relatively quiet quarter, certainly compared to what we have endured since 2008. Media attention shifted away from fomenting fears of another recession to predicting the implosion of the European Union, as it was certain to do given the dire straights of its member nations. When it became clear that the Eurozone would survive, all eyes were on China and accusations of its manipulation of currency and commodity markets. After stripping away the noise, 2010 was actually a fairly good year, and one of what could be referred to as normalising. Business capital spending continued to rise during the year, as companies reduced some of the huge cash reserves built up over the last couple of years. Global trade flows exhibited a trend towards rebalancing, particularly in the US where the trade deficit (imports minus exports) with China and Canada narrowed, and US exports to the rest of the world rose. Although our exports to the US declined, our global exports increased, both in raw materials and value added finished goods. Unsurprisingly, Canadian imports remain robust, thanks in part to our strong dollar.

Inflation in North America remains manageable, and it appears that fears of deflation have subsided. However, food inflation has become an issue for many parts of the world. Global food prices hit record highs in December, with prices for meat and sugar now higher than they were in 2008, a period that was punctuated by deadly food riots from Haiti to Egypt. With oil at a sustainable $90/barrel, and some of the poorest regions in the world enduring severe drought, food scarcity, and skyrocketing prices for what little is available, have created conditions worse than ever in these parts of the world. Even if perfectly equitable food distribution was possible, global food supplies as recent as 2008 were sufficient only to feed about 75% of the world's population. With three additional years of population growth, and no appreciable increase in global agricultural production, the global food crisis is likely to get worse long before it gets better.

And finally, quoting from a recent study conducted by the Chinese Academy of Social Sciences that is certain to raise a few eyebrows, "estimates from electricity meter readings [indicate] that there are about 64.5 million empty [new] apartments and houses in urban areas of the country [China], many of them bought by people wagering on a constantly rising property market". This offers yet another reason to be cautious, or even sceptical, when it comes to investing or speculating in foreign jurisdictions, especially where political and economic transparency have long been suspect, and where the rule of law is significantly dissimilar to which we are accustomed.

OUTLOOK

Looking at 2011, Europe for its ongoing sovereign debt woes, and China for its alleged currency manipulation and aggressive foreign direct investing, will likely dominate headlines, but it is the backup in interest rates that we will be watching. As rates rise, as we expect they will, especially in Canada, the attractiveness of equities will be reduced, and capital will shift away from this "risky" asset class to the relative safety of the now higher yielding bonds. This will put pressure on the equity markets, part of the reason we see moderating equity returns this year. Offsetting interest rate pressures will be the expected continued improvement in the US labour market, notwithstanding the ongoing risks posed to it by the lack of mobility of workers because of their inability to sell homes that are worth less than the mortgage on them, and the mismatch between skills available and those required by employers. Leading economic indicators continue to signal an extension of the global economic expansion, which in turn augers well for resource based economies including Canada. Global expansion is also good for sentiment, which in turn should be reflected in improving consumer confidence and spending, albeit not to the level witnessed prior to 2008. Happily, individuals now appear to be paying more attention to savings and buying the necessities than getting for the sake of getting. We believe that barring a severe negative geopolitical event, this year may well prove to be a stable and rewarding one for investors, but less so for players in the lesser developed markets and speculators in the junior markets as capital continues its migration to more value oriented, fundamentals based assets.

STRATEGY

Given what we expect to be a more modest year for equity returns, and the challenges to earning those returns, adhering to our discipline of keeping asset mix and weights tight to policy will remain as important as ever. We will likely remain more active in our clients' portfolios over the course of the year as we trade around core positions, taking advantage of unusual price movements. While equities will remain the preferred asset class, if there is a meaningful move in interest rates on the horizon, we will reduce equity exposure as appropriate, seeking quality yields where available. However, the rate move must be meaningful: buying a bond that yields 3.00%, which nets near zero after inflation and tax, is still not terribly attractive relative to the risk/return trade-off presented by a conservative, diversified, dividend paying and relatively economically insensitive equity portfolio, such as those of our clients.

As ever, we welcome your calls for further discussion on any of the topics touched upon here. Have a very safe and happy 2011.

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