VERITAS

Winter 2012

Did you know...

- Ontario represents 40% of the Canadian economy, and is larger than the national economy of many countries.
- Despite the chaos in Europe, German employment is the highest its been since reunification in 1990.
- The US imports more oil from Canada than any other single country.
- As an example of the erratic equity markets, US stocks had daily swings of over 2% on over 20% of the trading sessions between May and October 2011.
- Consumer spending represents 70% of the US economy.
- Arizona, Nevada, California and Florida were the states boasting the largest housing bubble prior to the 2008 credit crunch, and now have foreclosure rates of almost double the national average.
- The current US economic recovery is the first since 1954 in which consumer debt has declined, in part explaining why this recovery feels so anaemic.
- The current cost (2011) of buying ***all*** the items referred to in the carol "Twelve Days of Christmas" is US $101,119.84, up 4.4% over 2010.

Current Situation

North American markets ended a very choppy year in markedly different fashion. Despite concerns about increasing government ineffectiveness and skyrocketing public debt, the US equity markets all turned in positive returns for the year. This performance is quite remarkable given the drubbing the US markets took in the summer when concern over the ability of the US to raise its debt ceiling was at its peak. Canada, on the other hand, saw the TSX slip 8.7% in 2011. Holding the TSX back was the overarching concern that a slowing global economy would negatively impact worldwide demand for natural resources, thus resulting in a decrease in our exports. As an aside, this had a negative effect on our dollar as well, taking it below parity for the latter half of the year. Translating the concern to the sectors that make up the majority of the TSX, the energy sector (27% of the TSX) declined 10%, even though oil is trading near or above $100/barrel. Materials (21% of the TSX) declined 21%, but in this case, the underlying commodities sold off as well as the stocks. Finally, financials (29% of the TSX) were down 3%, primarily as a result of very poor performance from the life insurance companies stemming from the unfavourable combination of low interest rates and volatile markets. Adding all this up, three sectors, representing over 77% of the TSX, accounted for 7.98 percentage points of the 8.7% decline in the market.

The political and economic issues in Europe continued to dominate headlines this past quarter, and markets continue to respond to that headline risk. However, there has been enough said about Europe recently that we will restrict our commentary here to the observation that there are issues in the region, and those issues are negatively affecting investor sentiment. Instead, it is worth looking at the region that probably had the more significant impact on Canada's markets in 2011: China. There have been reports that economic activity and growth in China is slowing. The fear is that, as the world's largest consumer of natural resources, if the Chinese economy falters in any meaningful fashion, Canada's ability to export energy and raw materials into the region would be severely curtailed, a certain catastrophe for our economy. However, the concerns should be tempered by a number of considerations, including the fact that the Chinese information regime is essentially controlled by the government, and is not as completely transparent as it is in the West. With this caution in mind, we note that data released by the government indicates that the Chinese economy is still growing at 8—10%. Another consideration is that if the Chinese economy is slowing as dramatically as feared, it is unlikely that the government there would be as active as it is in purchasing North American natural resources, either directly or by obtaining economic control of the domestic companies owning them. If the Chinese economy is indeed slowing, the more likely scenario is that it is evolving, moving away from the high growth emerging stage, and to a slower growth developing stage.

Looking to the US, our largest trading partner, which still takes around 75% of our exports, as compared to China at 3%, the picture there is much better than one year ago. Although conditions are not great, giving due regard to the severity of the last recession, there is an increasing number of signs that the US economy is getting back on track. Likely the most important indicator is the employment market, which has been steadily improving all year. Initial jobless claims are down, as is the unemployment rate. This decline must be discounted a bit because part of it is as a result of people exiting the workforce, generally as discouraged job-seekers. The housing market is stabilising, and new housing starts are up, as are mortgage applications. Granted, the improvement is from a very low level, but it is still an improvement. Corporate profitability is up, balance sheets are strong, and hiring intentions are at levels not seen since 2007. And if consumer demand continues to pick up, these intentions may become a reality. Recalling from an earlier edition of *Veritas*, US companies have taken advantage of low interest rates and certain tax incentives recently to ramp up spending on equipment, but they have yet to hire the people to operate it. All in, while risks certainly exist, if expectations are realistic, things may not be quite as bad as perhaps they are being portrayed.

OUTLOOK

Fundamental conditions remain constructive for equities going into 2012. The biggest risks to equity performance are a wholesale collapse of the European banking system, or a meaningful increase in interest rates, neither of which appear to be imminent. Central bankers have committed to a low interest rate policy for this year, but inflation is becoming increasingly visible. If the labour market in the US continues to improve, supporting increased consumer demand, inflation concerns may increase sufficiently to force a shift to a moderately more aggressive interest rate policy, despite current commitments. If this occurs, it could mute the potential upside in stocks. Offsetting the risk of marginally higher interest rates we hope will be the reduction in global headline risk. As markets become comfortable with the progress being made in resolving European economic issues, stocks should rally at the expense of bonds as the "risk" trade gains popularity. A further plus for stocks is the optimism that the current US economic expansion can continue without additional stimulus.

STRATEGY

Heading into 2012, our preferred asset class remains equities, with a focus on companies that produce the thing or service one has to have, regardless of economic conditions. If the world settles down, resource stocks likely will lead the Canadian stock market this year. This leadership notwithstanding, we will maintain our discipline of limiting our exposure to this sector through our oil and gas holdings. The reason for this is that experience has taught us that in the long term, one has to trade the non-energy resource stocks to make money: generally they are not buy and hold assets. But even a discipline of buying good companies and holding them forever does not eliminate risk. Occasionally we have to remove a company that, although demonstrating great promise, has not proved itself, or lived up to expectations. The silver lining is that despite the frustration of having to remove a disappointing holding, its removal creates an opportunity to further enhance the defensiveness and stability of our clients' portfolios with the replacement holding.

Please do not hesitate to call to discuss, and Happy New Year.

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