VERITAS

Winter 2013

DID YOU KNOW...

- For the first time since WWII, more bicycles have been sold in Italy than cars, the sales of which have fallen to 1970s levels.
- The average turkey weighed 20 lbs. in 1986, but has gained weight since then and now tips the scales at over 28.2 lbs.
- Within five years of retiring, approximately 60% of NBA players are broke—but within just two years of retirement, 70% of NFL players are either broke or in financial distress.
- Manganese Bronze Holdings, the manufacturer of the ubiquitous London black taxicab since 1958, has filed for bankruptcy.
- "Superstorm Sandy" is the first weather event since the 1888 New York blizzard to cause US markets to close for consecutive days.
- 40,000 miles of plastic wrap is used every year to package Hostess Twinkies.
- After one minute on the "average" floor, food has ten times the amount of bacteria on it than it does after five seconds—remember the "Five Second Rule".
- US housing prices are at their most affordable level in 40 years.

CURRENT SITUATION

North American equity markets closed 2012 on a relatively anaemic quarter, but with reasonable to very good growth overall. In Canada, despite another negative showing by the heavyweight energy and materials sectors, the TSX posted a total return of 7.19%. In the US, the broader S&P 500 posted a healthy 16% total return. The strong performance is reflecting increasing optimism that the US economy is getting healthier, leading to an upward revaluation of equities in general as markets perceive that economic risks are on the wane.

Part of the optimism stems from continuing, and what are becoming clear as more permanent, improvements in the US employment market. One of the most important improvements has been the increased mobility of the workforce. In previous editions of *Veritas*, we commented that one of the biggest challenges to an improving US labour market has been the mismatch between the skills required by employers, and those available to them. The mismatch could not be bridged because those with the required skills often were not able to relocate to where their skills could be used, typically because they were saddled with a home on which they owed more than the amount for which it could be sold. A steadily improving housing market, another worry that has been pressuring equity markets until recently, is helping to alleviate this condition. Adding to the optimism is the fact that a more mobile workforce is widely viewed as a signal of a healthier economy and future growth. Of note, the most current data we have on workforce mobility is from the 2011 US Census. Given the data lag, we could see further improvement in both the jobs and housing markets over the course of the year as 2012 data rolls in.

Improvements in the US jobs market are also coming from the expansion of the domestic manufacturing base as production is being increasingly "re-shored". Interestingly, it is not just hard goods manufacturing that is coming home: recently we were made aware that chemical companies including Dow Chemicals and Canada's Methanex are building US facilities to produce plastic. Given its wide use, it is evident that these companies are expecting domestic demand for plastic to increase, further supporting the thesis that less of the finished goods North Americans buy in the future will be imported.

Returning to the US housing market, because it plays such a significant role in that economy, economists and other market forecasters pay close attention to its condition, and changes therein. The recovery from the worst of the conditions subsequent to the 2008 credit market freeze has been steady, but in some of the hardest hit regions, painfully slow. A combination of factors including extremely low mortgage rates, and an increase in the formation of households has resulted in a sustained decline in the inventory of unsold homes, despite stricter loan granting regulations. This is occurring at a time when despite rising (yes, rising) prices, housing affordability is at its best level in forty years, providing real opportunities for qualified first time home buyers. Combining all that we are observing leads us to believe that the US housing market has stabilised, and is gaining positive momentum. This will be good for consumer sentiment, and is expected to translate into demand for household goods: another potential boost for domestic manufacturing, jobs, and the economy.

We are not ignoring Canada, but because we remain primarily an export economy, that which impacts our largest trading partner will similarly affect our economic activity. Accordingly, if the outlook is positive for our export destinations, it augers well for Canada. Our reliance on other economies was amply demonstrated as recently as late last year when a reported economic slowdown in Europe and China sent a chill through our commodities market, resulting in the Bank of Canada reducing its 2012 growth forecast for our economy.

OUTLOOK

While many of the global economic and political issues of 2012 are still present to some extent, the fact that they are being acknowledged and at least partially addressed is encouraging to investors and businesses. Given the evidenced reduction in economic and political uncertainty, we are expecting positive equity returns in 2013. Instead of the upward revaluation of the entire asset class, which was a significant component of 2012 performance, we anticipate that valuations will be more traditionally quantified, based on a combination of earnings growth and visibility, and business and management performance. More traditional company specific valuations will lead to more historical market returns, most likely in the single digits. If investor confidence continues to be restored, we expect capital will flow from the perceived safety of bonds back to stocks, further supporting equity returns. The capital flow could accelerate if interest rates rise later in the year as expected, putting pressure on bond prices, and making stocks relatively more attractive. Absent a significant and new geopolitical event, or the US defaulting on its debt because of political posturing over the debt ceiling (again), our sense is that markets will continue to normalise this year. As referenced above, this applies to the bond market as well, and because of this, our caution of owning bond funds in this environment remains in place.

STRATEGY

We have noticed that there has been a marked increase in the press recently on the importance of fundamentals when it comes to investing. Equally interesting is the commentary that over the last five years, fundamentals have been largely irrelevant, but now are set to outweigh the headline or macro factors that otherwise have been driving markets during that time. That fundamentals matter has always been our mantra, regardless of the macro environment. In fact, we believe they are more important when they seem to matter the least because if, as investors, we intend to own a company for a long period of time, we want to be sure that it is going to be able to weather the rough patches. This determination requires fundamental research into the nuts and bolts of the company and the industry in which it operates. And even when markets are on a tear, and everything is going up, fundamentals are still critically important in telling an investor whether the "tear" is warranted and sustainable. In short, fundamentals will always matter to us for our clients and their portfolios.

Wishing you the best for 2013.

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