VERITAS

Winter 2015

DID YOU KNOW...

- The version of the iPhone 6 sold in September contains 25 times the computing power the whole world had in 1995.
- Even though cross-border shopping by Canadians rose 72% between 2006 and 2012, it still represents only 2% of Canadian retail sales.
- It costs the US Mint l.83 cents to manufacture a penny, resulting in a $55 million loss on its production in 2013.
- Craft beer represents approximately 8% of the US beer market by volume, but uses almost 50% of the hops grown in the US.
- At $652 billion, Apple's market value is greater than the value of the entire Russian stock market.
- For the first and only time in history, the US national debt stood at zero—on January 8, 1935.
- A 30 second ad on NBC during this year's Super Bowl will cost advertisers $45 million, or $150,000 per second.
- According to a Gallup poll, text messaging is the most widely used method of communication by Americans under the age of 50, with average usage increasing as age decreases.

CURRENT SITUATION

Amid another spike in volatility, although not to the levels we experienced in the Fall, North American equity markets recovered from their third quarter swoon and finished the year with double digit gains. After posting another series of record highs, and comfortably pushing through and holding above the psychologically important 2,000 level, the broad US S&P 500 index ended 2014 with a 13.7% gain. Canada's resource heavy TSX Total Return Index, which includes dividends, gained 10.6%, despite negative performance from the Energy and Materials sectors. Notable positively performing sectors were Consumer Staples and Information Technology, but combined, they account for only 6% of our index. Arguably, if it were not for the weakness in commodities, which represent 50% of our index, the TSX might have outperformed the S&P for the year, a reminder of the risks of concentration.

One of the biggest newsmakers since the last edition of *Veritas* has to be the remarkably rapid decline in the price of oil, which is trading at six year lows. Conspiracy theories abound as to the cause, and one of our favourites suggests that OPEC, specifically Saudi Arabia, is trying to bring North American energy producers, notably the high cost shale producers, to their knees by not reducing output to support prices, thereby making shale projects uneconomical. Another favourite is that OPEC and the US are conspiring to collapse the Russian economy, which has become very reliant on energy exports. The reality is far less exciting, and it is simply that supply and demand fundamentals have caught up with the commodity. Global energy production has increased dramatically over the past decade, most notably from North American "unconventional" reserves, such as those found in the tar sands or shale formations, which have turned Canada into a net exporter of energy, and are bringing the US the closest it has been in history to energy self-sufficiency. If we add to the mix new technology that permits recovery from previously exhausted fields or from historically inaccessible structures, along with reserve discoveries elsewhere in the world, the supply side has experienced a material shift up. And while global energy demand remains robust, the increase in demand has not kept pace with the increase in supply, resulting in the current pricing environment.

Despite the negative impact the oil price decline has had on equities and our dollar, lower oil prices and the lower dollar are economically stimulative for most businesses that are not directly involved in energy exploration and production. Even companies involved in the transportation of oil and gas, like railways and pipelines, derive

some benefit from lower energy prices inasmuch as it takes energy, be it diesel or electricity, to move the commodities, and if input costs are lower, profitability should be higher, a relationship that applies to any energy consuming enterprise. Consumers especially benefit from lower crude prices when they fill their gas tanks: the price of a litre of gas has fallen over 30% over the past six month, which translates to additional discretionary cash in consumers' pockets. Granted, the lower dollar makes imports and travel more expensive, and lower commodity prices result in lower tax and royalty revenues for governments, but given that energy demand is not declining, rather it is the *growth* in demand that appears to be slowing, it is likely that the present extremely low prices, and associated negative effects, are temporary. Assuming that oil is oversold currently, a price rebound would not come as a surprise, but likely to levels below what we have experienced of late, owing to the increase in global supply and reserves.

There are a number of reasons why we believe that the current low price of oil is temporary, not the least of which is the price itself. Low oil prices tend to result in a reduction of production, but because low prices are generally economically stimulative, they also lead to a tighter market by way of increased demand and a decline in reserves, which, holding all else equal, results in higher prices. If this relationship holds, and we factor in the economic growth already being recorded in the US, one of the world's largest energy consumers, conditions are supportive of energy prices. To a greater or lesser extent, economic conditions globally are expansionary as well, further supporting an argument for higher energy prices. There are regional pockets of weakness, but the larger developed and developing economies continue to grow. Even China and India, despite recording slower growth as their economies mature, are not contracting. The combination of these and other factors lead us to believe that higher energy prices will return, but again, to lower levels because of moderating demand from a maturing global economy.

OUTLOOK

We still see higher interest rates on the horizon, despite the effect of lower oil prices. We would argue that the conditions that were in place for raising rates remain in place, and if economic activity picks up further as a result of the arguably temporary decline in energy prices, the conditions will become even more compelling. We have used the term normalisation in the past, referring to the return of historical relationships between various asset classes which has been absent from markets since 2008. Based on the combination of what appears to be sustainable economic expansion, especially in the US, and central banks implying that higher rates are imminent, we hope to see the normalisation process begin this year. This should result in lower bond prices, and muted, but still positive, equity returns for the year.

STRATEGY

Our strategy continues to be one of focussing on ensuring that our clients' portfolios are comprised of well managed companies operating in stable industries where they have an enduring competitive advantage. We have commented in prior editions of *Veritas* that we favour investments in needs-based industries, with a goal of minimising portfolio volatility by steering clear of companies and industries that are particularly sensitive to business cycles. In light of what we are experiencing today in the energy sector, one could argue that, based on our strategy, this sector should be avoided. But the need for energy is constant, with relatively little change in demand, regardless of economic conditions, and this is where the other part of our strategy comes to the fore: ensuring that our clients own the companies that lead the industry in terms of assets, production, and management and financial strength and stability. We have stressed in the past that we are investors and our long time horizon both forces us to look beyond current market noise, and allows us to use it to our clients' advantage.

Have a happy, healthy 2015.

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