VERITAS

Winter 2016

DID YOU KNOW...

- For the princely sum of US $140,000, you now can have your dog cloned.
- 2015 was a record year for global mergers and acquisitions, with total deal values topping US $4.7 trillion.
- Consumer spending represented 72% of the US economy in 2015, but accounted for 100% of the growth in economic output (GDP).
- Road accidents kill an estimated 1.25 million people annually worldwide, with poorer countries having the highest fatality rate despite the fewest cars.
- As recently as 2014, energy represented approximately 28% of the total dollar value of Canadian exports.
- 2015 was the second worst year for the Canadian dollar against the US dollar, and marked its longest, steepest decline since becoming a free floating currency in 1970.
- 38% of US employees "put on the dog" last year and called in sick despite being healthy, representing the highest "hooky" rate in the US since 2005 (43%).
- Over 5 million litres of eggnog were sold in Canada in the month of December 2014, as compared to a total of 3 million litres for the rest of the year.

CURRENT SITUATION

Despite a promising rally coming out of the third quarter, Canada's S&P/TSX Total Return Index, which includes dividends, extended its third quarter losses, and ended the year down 8.3%, its first negative year since 2011. With the energy and materials sectors still representing 25% of the index, and given the weakness in commodity prices over the course of the year, it is no wonder the TSX was down. What is interesting is that the three month performance of the TSX was actually better in the fourth quarter than in the third: negative 1.4% versus negative 7.9%, and this in the face of some arguably dire headlines. What is happening now is that we are coming up on a full year since commodity prices started their steep decline, and it appears that financial assets are being re-priced on the basis of the current lower commodity pricing environment. If this is the case, and markets are pricing in worst case scenarios, evolving conditions could be setting us up for some positive surprises in the year ahead if there is any sustained strength in commodity prices, especially energy. In the US, the broad S&P 500 continued to outperform, and did so materially in the fourth quarter, gaining 7% and allowing it to eke out a modest 1.4% gain for the year. Finally, and sadly because we are in winter, and our thoughts naturally tend towards sun and sand, our dollar took it on the chin again this year, declining 16% against the USD. But as has been the case for the past 18 months or so, the Loonie has not fared as poorly against the Euro or the Mexican peso, so although perhaps Hawaii and Florida may be off the books for now, non-US sun and cultural destinations might not be.

Returning to the outperformance of the US equity markets, we have seen a number of factors that go to explaining this. Of course, the one event that garnered all the media attention was the Fed finally raising interest rates by a modest 0.25%. While not large, the move was symbolic inasmuch as it was the first hike since 2006, and punctuated two other equally significant US data points: the creation of 13 million jobs since 2009, and the decline in the unemployment rate from 10% to 5% in the same period. These are signs of an economy that, if not robust, is certainly reasonably hale, an observation that is borne out elsewhere. For example, the US has recorded wage growth of 3.9% before inflation, translating to increased discretionary spending which, at the risk of overwhelming with statistics, has an 86% correlation with the overall US economy. Moving away from the consumer, US industrial output, ex-energy, is growing by just over 2%. We cannot overlook energy, which does represent 25% of US industrial output, but the point to be made, we think, is that although this

industry is weak, the majority of the US economy is doing reasonably well. Lower energy prices will continue to be an added benefit to the US economy at all levels, except energy production, because it reduces the cost of that component of consumption, whether for industries or individuals. And recalling that Canada still does upwards of 85% of its business with the US, we will benefit from the US expansion. Furthermore, for as long as our dollar remains weak against the USD, the benefits will be amplified for Canadian companies and organisations that have their revenues in USD, but costs in Canadian dollars. It is worth mentioning here, as a reminder in the face of headlines that would tell you otherwise, that there is more to the Canadian economy than just commodities, and more to Canada than just Alberta. It is the "others" that will continue to benefit from the same factors that are harming the resource based industries and provinces. Interestingly, it is this change in fortunes that has brought Ontario back from "have not" status, a dubious distinction it received when it started receiving equalisation payments in 2009. In fairness, it is not that Ontario's economy has improved measurably, but rather that the economic disparity between Ontario and Alberta has diminished.

Because it has been in the headlines so much of late, we cannot ignore China, but our comments will be brief: China remains a closed economy, and 85% of the participants in its stock market are unsophisticated individuals who, because of a dearth of information and research, are essentially gambling with their trading. Because of this, and the very similar conditions we experienced in August, we believe that the headlines relating to the Chinese stock market remain no more than just headlines. And although the data remains suspect, if it is to be believed, China's economy is becoming more balanced between manufacturing and service, an evolution that should improve stability because of the less cyclical nature of a service based economy.

OUTLOOK

With markets largely ignoring the previously mentioned fundamentals in favour of reacting to headlines, the short-term outlook for equity markets, especially in Canada, is murky. We will be contending with elevated volatility until there is better balance in oil supply and demand dynamics, and China's equity market and currency stabilise. Longer term, and more our concern as investors, the outlook is quite favourable, and in fact might be more so than at this time last year. This year, we do not have the uncertainty of the first Fed rate hike, energy prices likely are close to as low as they are going to go, and the Bank of Canada has all but said that is not about to attempt further intervention in the market, despite weak oil. Given reduced central bank policy uncertainty and strengthening fundamentals, in part based on cheaper energy costs, 2016 could well be a rewarding year for patient and disciplined equity investors.

STRATEGY

Despite, or perhaps more accurately because of the market turmoil over the past several months, we have not made any changes to our investment strategy, nor will we. It is at times like these when maintaining investment discipline is most important so as to not become distracted by the headlines that sell newspapers. We have stressed before that our goal as portfolio managers is to construct portfolios for our clients that while not immune from the broader market movement, do not mirror it. And when we do engage in activity within the portfolios, whether it is for purposes of periodic rebalancing, or adding or removing a company, we do so with the objective of reducing portfolio specific risk. This can be as simple as ensuring that no single name represents too much or too little of the overall portfolio, based on the client's personal investment objectives and risk tolerance. Fundamental to this is building portfolios that hold shares in companies about which we, or our clients, do not lie awake worrying.

Please do not hesitate to call for further discussion.

Have a happy, healthy 2016.

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