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- The second quarter of this year has brought the focus back on Greece. While negotiations, essentially between Greece, Germany and the IMF, ensue, it is important to remember that this is all taking place in a rarified and political environment. As we headed into the end of the quarter the Greek government was starting the imposition of capital controls and the scheduling of a referendum on whether to accept the bail-out terms currently proposed by the Troika.

- The rest of Europe is showing distinct signs of economic growth. For example, Ireland has repaid the current portion of its IMF funding and is poised to report greater than 4% real GDP growth year-over-year. This has moved their position on the scale from being one of the PIIGS nations to having the highest growth rate in the EU year-to-date. If one employs the Purchasing Managers Index (PMI), the strength of the EU economies is the highest in four years.

- China continues to worry the markets. This remains a quandary as the major Asian markets generated strong double digit returns up until early June and then changed direction suddenly and quite dramatically. In response, the Chinese monetary authority (the PBoC) has shown more of a willingness to loosen monetary conditions in an effort to prevent a more dramatic faltering of their economy.

- In the United States the broad range of economic measures is looking steadily better. The housing market continues to pick up, auto sales are still rising, and consumer confidence is also gaining ground. Meanwhile the markets are attempting to determine the course of U.S. monetary policy. The growing body of positive economic indicators suggests that liftoff is coming sooner rather than later.

- While the Greece predicament is well known, and in our humble opinion, will only affect markets over the shorter term, interest rates rising are a longer term issue. We think equity markets will continue to move higher despite rising rates. Our thesis is based on the belief that rates will rise from their artificially depressed levels due to a stronger outlook for the global economy with a broader array of countries participating in global growth. Although equity markets will move higher and most likely be one of the best performing asset classes, we believe the move higher may be somewhat more moderate than recent history.

- As rates move higher, investors will become more wary of high valuation multiple and high debt companies. There may also be differentiation between consumer related industries, and sectors such as industrials, as higher rates bring fears of higher inflation.

- Greater clarity in Europe's future would certainly make the U.S. Federal Reserve's decision on rates easier as we approach their September meeting. Since earlier this year, the September U.S Fed meeting has been targeted for the first rate move since December 2008.

- In Canada, economic data for the second quarter is starting to come in and the trend is weak. The April GDP measured month-over-month remained negative. The market is pricing in higher odds of a potential cut to the Central Bank rate.

- We are busy identifying bonds that are more cheaply priced than adjacent maturities to pick up incremental gains. While this has increased turnover, the current environment dictates this course of action.

Economic Backdrop – Growth Broadening

The second quarter of this year has brought the focus back on Greece. While negotiations, essentially between Greece, Germany and the International Monetary Fund (IMF), ensue, it is important to remember that this is all taking place in a rarified and political environment. First of all, one must keep in mind that a failure to repay a loan from the IMF is not a default (so one can put aside the rhetoric of largest default in history), it is a payment in arrears, and that can be allowed to persist indefinitely. The negotiations are essentially between Greece, Germany and the IMF. The IMF, largely because it is an unwieldy supranational entity with a broad range of members, is proving generally ineffective, so it really falls on Germany to reach a settlement. Simply put, if Germany wants to resolve the negotiations then they will be resolved and if not, then we will remain in financial and political limbo. It continues to appear that Greece will not be compelled to withdraw from the EU (keep in mind that the EU structure and rules does not contain a mechanism to force a country out of the EU), but there remains the possibility that they will be squeezed out of the Euro, and all those individuals and companies that have not already hoarded Euros outside Greece would be exposed to devaluation risk with a new currency (Drachma 2.0). As we headed into the end of the quarter the Greek government was starting to take the first steps in this direction, with the imposition of capital controls and the scheduling of a referendum on whether to accept the bail-out terms currently proposed by the Troika.

The ECB has remained in an aggressive easing mode.

An additional concern in Europe comes with the re-election of David Cameron as U.K. Prime Minister. In campaigning for the general election, the Conservatives promised a referendum on leaving the EU. The withdrawal of the UK from the EU would have much more far reaching impact than the loss of Greece. Greece contributes 1.3% of the EU GDP, while the UK contributes 16%.

In the meantime the rest of Europe is showing distinct signs of economic growth. For example, Ireland has repaid the current portion of its IMF funding and is poised to report greater than 4% real GDP growth year over year. This has moved their position on the scale from being one of the PIIGS nations to having the highest growth rate in the EU year-to-date. Of more concern are the continued high unemployment rates in Europe and the low, at times negative, inflation measures. The ECB remains in an aggressive easing mode, and has provided funds from the ELA (Emergency Liquidity Assistance) facility which is working. If one employs the Purchasing Managers Index (PMI), the strength of the EU economies is the highest in four years.

China continues to worry the markets. In recent days the Chinese stock market has fallen over 7%. This remains a quandary as the major Asian markets had generated strong double digit returns up until early June and then changed direction suddenly and quite dramatically. In response, the Chinese monetary authority (the PBoC) has shown more of a willingness to loosen monetary conditions in an effort to prevent a more dramatic faltering of their economy. Further complicating the picture in Asia is the growing military capability of China as the major Asian powers struggle for hegemony. There has been an ongoing, while largely non violent, dispute over ownership of the various islands and consequently natural resources. China's growing military capability is shifting the balance of power.

Globally, the decline in the price of oil that we commented on in the first quarter commentary has stabilized in the $55 to $65 range. This is starting to positively impact auto and gasoline sales, giving additional impetus to economic growth.

In the U.S., the broad range of economic measures is looking steadily better. The housing market, whether starts, completed new homes or existing homes, is picking up, and more importantly, first time buyers are emerging. This is a very important aspect to the recovery that has been missing until recently. Auto sales continue to increase, and consumer confidence is also gaining ground. There is a growing appreciation that some form of resolution of the Greek crisis will refocus investors' attention on the positives in the U.S.

Meanwhile, markets in the U.S. are attempting to determine the course of monetary policy. The relatively dovish tone from Janet Yellen earlier in the year had encouraged many forecasters to adjust their expectations for the beginning of the much anticipated tightening to dates later in the current year if not 2016. The growing body of positive economic indicators together with public statements by two of the members of the FOMC (one of whom has previously been tagged as a policy dove), have now encouraged a majority of economists to forecast the tightening move to come following the September meeting. Yellen persists in her stated commitment to a discipline of "data dependency", but it is becoming harder to fit policy to economic measure, indicating liftoff is coming sooner. The Fed also has to balance the inevitable strengthening of the dollar that will come from tightening and its negative impact on exports.

Equity Markets – Focus on Fundamentals

As most investors have come to realize, despite the markets moving higher, there always seems to be something for the equity markets to worry about and digest. During the second quarter, two themes, although not new or unexpected, have become a focus. One is Greece, a European focal point affecting global markets with their imminent debt deadlines and the question of whether or not they will remain in the EU. The concern over Greece may be warranted, but the circumstances have changed dramatically since the last Greek debt crisis. The PIIGS (Portugal, Italy, Ireland, Greece, Spain) acronym, used previously to group European countries with the greatest investor concerns, would probably not apply today. As well, enough time has passed to allow countries and banks to limit their exposures to Greek debt, lessening the previous concern that a Greek default would cause a domino effect. The other theme causing more uncertainty than concern is U.S. interest rates. Investors are not debating whether or not rates will rise, but rather when and by how much. This unknown generates varying views on the ultimate effect on the markets and creates the uncertainty. Due to the Greek debt and U.S. rate concerns, global equity markets moved slightly lower during the second quarter. Global markets were down 1.1% during the quarter in Canadian dollar terms, in line with Canada's performance of negative 1.6%.

While the Greek predicament is well known, and in our humble opinion, will only affect markets over the shorter term, interest rates rising are a longer term issue and there are several themes that may unfold over the next couple of years that we will be monitoring. First and foremost, we think equity markets will continue to move higher despite rising rates. Our thesis is based on the belief that rates will rise from their artificially depressed levels due to a stronger outlook for the global economy with a broader array of countries participating in global growth. Although equity markets will move higher and most likely be one of the best performing asset classes, we believe the move higher may be somewhat more moderate than recent history. This reflects a constant concern of a cyclical end which may be extended in this environment. Rising rates will have different impacts on various industries. For instance, consumer related securities may witness some valuation multiple contraction, as investors anxiety with rising rates possibly slowing consumer spending, grows. Meanwhile, end of cycle industries which typically benefit from higher inflation and are more economically sensitive, such as commodity related securities or industrials may benefit. Other themes to monitor will be high versus low valuation multiple stocks. In a moderate economic growth environment, as rates rise and the inevitable concern that the "end is near" continues to unfold, higher multiple stocks are apt to see their multiple flat line or compress as others see multiple expansion. We mentioned in a previous BIM Quarterly the market as a whole is not terribly overvalued given the current economic conditions and rate environment. However, there are certain quality companies that are trading at premium multiples, and these may be vulnerable. Alongside this theme are entities that have high debt. While the vast majority of companies have excellent balance sheets, in a low rate environment it has been easy to overlook players with subpar balance sheets. With concerns over rising rates, forgiveness may be short lived for high debt entities potentially causing valuation multiples to contract. Finally, one theme to scrutinize is the relationship between revenue growth and margins. As the economy grows and inflation starts to move higher, margins may be difficult to expand but revenues should grow allowing the bottom line to increase for the most disciplined of managements.

Focusing on fundamentals and leaving the rate guessing game to others, allows us to protect and grow clients capital.

As market participants continue to guess on the direction of rates, our research will continue to focus on undervalued companies with good balance sheets and proven management. Firms such as Flowserve Corporation, which offers premium, highly engineered valves and seals. Flowserve generates industry leading returns on invested capital at roughly 18%, driven by superior cost controls, best-in-class manufacturing and a premium product offering which commands above-average industry pricing. The company is levered to the oil and gas, industrial and chemicals cycle all of which we believe will benefit as energy prices move higher and stabilize. Due largely to the decline in oil prices Flowserve's shares have pulled-back roughly 30% over the last nine months. We view oil's pullback as temporary and took advantage of the opportunity to add Flowserve at less than 15 times reduced 2016 earnings estimates. Over the cycle, Flowserve has shown it can achieve consistent earnings growth, margin expansion and industry leading returns. The Company targets 7% organic growth which it will supplement with acquisitions and share buy-backs to drive superior earnings growth over the longer term. Focusing on fundamentals and leaving the rate guessing game to others, allows us to protect and grow clients capital. This is a balance we constantly try to achieve.

Fixed Income Markets – Corporate Headwinds

After the largest volume of bond issuances in Canada ever, for the months of February and March 2015, the corporate market slowed down in April and May. The first two months of the second quarter saw the lowest amount ($12.1 billion) of new supply for that period in the past five years. However, the month of June was a banner month with $12.8 billion in new supply, more than the previous two months combined. This new supply has proven a headwind for corporate bond performance in the short term.

Until the Greek referendum announcement at the end of June, there was a lively debate on the potential for two rate hikes in 2015.

Greater clarity in Europe's future would certainly make the U.S. Federal Reserve's decision on rates easier. Since earlier this year the September U.S. Fed meeting has been targeted for the first rate move since December 2008. For the better part of six months the Fed has made it clear that it is in data dependency mode and cleared the way for future rate hikes. The Fed considers a zero target rate policy an emergency position and would like to return to more normal levels as soon as possible. U.S. economic numbers have been encouraging, and most give a 40% to 50% probability to a rate increase in September. In fact, until the Greek referendum announcement at the end of June, there was a lively debate on the potential for two rate hikes in 2015. European events and U.S. economic data will determine that result.

In Canada, economic data for the second quarter is starting to come in and the trend is weak. April GDP month-over-month remained negative, and the market is pricing in higher odds of a potential cut to the Central Bank rate. This has created an inversion of the Canadian curve with the Canada 1.5% August 2015 maturity yielding 0.63%, while the Canada 1.5% March 2017's yield 0.45%. It is not until the June 2019 maturity that we can receive the same yield as the Aug 15's. Therefore, we have no holdings in 2017 or 2018 maturities. We are looking for higher yields in the shorter end of the curve, or in the 2019 to 2025 maturities.

In May, Alberta held an election with the NDP party winning a majority government, removing the Conservative Party from power for the first time in over 40 years. The new government has promised to review the current energy royalty structure with the aim of raising additional funds. We are also closely watching the utility sector in Alberta as the regulator has created a more difficult business environment. In addition, a critical court case began in early June in front of the Alberta Supreme Court regarding asset disposals. We are confident these events and risks are favorably reflected in the price of our holdings in AltaLink, AltaGas, and Canadian Utilities.

The financing details for the Enbridge drop down restructuring were announced in the closing of its deal in June. The final financial arrangement was a surprise and resulted in credit spreads of Enbridge Inc. increasing by about 10bps. We hold Enbridge Inc. 5 year debt, and will wait to see the performance of the new structure. The fundamental business has not changed, and owning Enbridge Inc. debt looks favorable compared to similarly priced entities.

General Electric (GE) has continued its stated goal of raising US$100 billion through sales of non-core businesses and divesting its previously substantial finance operations. This is creating a new GE with an increased industrial sector focus. Credit ratings agencies see this as a positive with industrial businesses having more stable and less risky performance. GE credit spreads have tightened through the big Canadian banks. As holders of 7 year GE debt we have been enjoying the outperformance.

Rogers was the successful bidder to purchase defunct wireless carrier Mobilicity. The purchase price of $465 million came with some useable tax loss credits and additional wireless spectrum. Rogers was also able to purchase some spectrum from Shaw, and had to sell other spectrum to Wind Mobile. The credit rating agencies stated that Rogers is at its maximum allowable leverage for its current rating and expect the communications company to pay down debt in the coming quarters. We are looking to capitalize on Rogers growth and deleveraging as owners of their 2021 bonds.

Generally we are identifying bonds that are more cheaply priced than adjacent maturities to pick up incremental gains. While this has increased turnover, the current environment dictates this course of action.

Barrantagh Investment Management Inc. provides disciplined portfolio management to institutional and individual investors. The firm is committed to a high level of client service provided directly by its experienced partners. We are dedicated to preserving our clients' capital while generating growth through consistent application of our value-based fundamental investment philosophy. We manage portfolios on a segregated basis to meet our clients' investment objectives. Because the firm is owned by our professional staff we maintain a completely independent and objective perspective.

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