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CAPITAL MARKETS REVIEW

FIRST QUARTER 2003

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Barrantagh Investment Management Inc.

Capital Markets Review

First Quarter 2003

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The War in Iraq – The U.S. Policy Gamble

We began preparing this capital markets review on March 18, the day after George W. Bush issued his ultimatum to Saddam Hussein to flee his country within 48 hours or face military action. Mr. Bush's critics wonder whether he has been candid from the outset about the purposes and goals of war.

Despite alienating many nations, Mr. Bush stuck with his view that regime change and disarmament were inseparable issues in the case of Iraq, advocating that removal by force rather than containment was the only way to neutralize Saddam Hussein's weapons program and the threat he posed as a renegade leader with no sense of reality or respect for humanity.

Our ongoing concern now is that the path Mr. Bush pursued to achieve his aims created a baffling array of global tensions. The Trans-Atlantic alliance was badly shaken with France and Germany clearly at odds with the U.S. The credibility and future usefulness of the UN Security Council has potentially been undermined. In the U.K., Tony Blair pushed his support of the U.S. to the point of a domestic political crisis. In the Arab world, leaders face the challenge of either facilitating the war and risking whatever popular support they have, or opposing the war and risking retribution from the U.S. Throughout the world, faith in the U.S. has receded, with increasing numbers viewing the U.S. as an agent of selfish imperialism and greater world disorder not stability. Accompanying the growing general resentment is an increasing risk of anti-American violence and terror, and a widening cultural and political divide between America and the Muslim world. In the final analysis there is a rising threat that militant Islamists rather than modernist democracy may emerge from the Bush approach to Iraq.

Mr. Bush's supporters (at least 50% of the American people according to the latest poll) advocate that America did not start a war with Iraq. The war was in fact begun by Saddam Hussein more than a decade ago when he invaded Kuwait. While America won the first battle, the war was never finished and Saddam Hussein has been violating the terms of peace (including 17 U.N. Resolutions) ever since. In the aftermath of the 9/11 terrorist attacks it would have been easy for the United States to have become aggressive and totally isolationist, lashing out at its enemies and anyone in its way. That did not happen. The U.S., with the unequivocal support of Tony Blair, attempted in good faith to engage the world through the United Nations in attempting to achieve its objectives. The U.S. administration lost patience with the UN process weeks before the ultimatum was issued but, mainly for the sake of Tony Blair, pursued it to the last.

In the final analysis, the divisions at the U.N. were more about strategy than values (Resolution 1441 required Iraq's unconditional and complete disarmament and was unanimously agreed to). Nevertheless the divisions were real. When it became apparent France, with support from Germany, was going to vote no to any resolution, the U.S. decided it was futile to push for a final Security Council vote which would have only led to more divisions. It may, of course, have been a failure in diplomacy to assume France would protest but finally capitulate, as it has in the past. After all, Chirac is a neo-Gaullist creature full of ambitions to lead Europe, to frustrate Britain's goals in Europe and to deny the U.S. an unchallenged role as world leader. As well, the economic tie of France to a status quo Iraq (arms for oil) was no doubt a factor. Mr. Bush concluded that delaying further was an unacceptable concession to Saddam Hussein's wiles and a pointless prolonging of the uncertainties plaguing the stock market and the global economy.

Of course, nobody wanted war. As that renowned military leader the Duke of Wellington observed, “Next to a battle lost, the greatest misery is a battle gained”. So far, while the war cannot be said to have been won, the application of America’s overwhelming military expertise and power is bringing it close to an end. By April 8, nineteen days after the fighting began, U.S. and British forces had secured much of Iraq, taken control of important oilfields, overwhelmed Basra, the country’s second city, used surgical bombing raids effectively on Baghdad, and positioned an effective army within Baghdad itself. All this has been accomplished with fewer than one hundred and fifty coalition casualties and, as far as we know, with only a few thousand Iraqi civilian casualties. Faced with the awesome military might of the U.S., some observers expected the Iraqi regime to collapse under the first heavy onslaught of coalition forces. While this did not occur, it is now evident large numbers of Iraqi troops and civilians are not prepared to fight. While it cannot be said the Iraqi people are openly welcoming “the liberator”, there are signs that they are withholding their true supportive feelings until the “invaders” prove that they are safe from the regime’s reprisals (i.e. the regime has been toppled and it is evident America’s will stay on to enforce a peaceful transition in the aftermath). The test will be maintaining control of Baghdad and installing a transitional government. So far, the Americans have not faced much resistance in Baghdad as they battle their way in. The campaign could still turn out to be a protracted and grisly but optimism is growing that the main battles are over and that regime change can begin which may lesson the tensions between the opponents of the war and its supporters.

Of course it remains to be seen whether winning the war in Iraq also represents any progress in winning the war against terrorism globally or in neutralizing other potential deployers of weapons of mass destruction.

Looking beyond the battlefield, the world must wait and see how regime change in Iraq will be accomplished and whether the hearts and minds of Iraqis and indeed other Middle Eastern peoples can be won over. Longer term, assuming regime change in Iraq is an initial step towards regional transformation, a huge long term commitment of resources, and staying power and hubris will be required of the American people or other people involved in the effort. Certainly, to make this goal more realistic the U.S. will have to do much to repair the collateral damage it sparked in the international community in the process of getting its way for dealing with Saddam.

As many political experts have commented, there have been few times in history when there was so much at stake and so much uncertainty. The world has never before been faced with the prospect of “weak countries (economically), with a history of instability and driven by extreme doctrines, being capable of wreaking considerable havoc on the strong.” Rules of the game have never been written to deal with those that have at their command international terrorism networks, weapons of mass destruction, or a nuclear capability. Nor is there a clear framework to achieve the loftier aims of a new order in the Middle East. These issues have no parallel in times past. All we know at present is that the U.S. selected a high risk and controversial solution to Iraq. Although it may not have had much choice, it has taken a huge gamble and we all have a large stake in the outcome whether we like it or not.

The Economic Recovery – Mixed Signals

U.S Recovery Slowing

A few months ago forecasters anticipated that the Iraqi crisis would prove to be a short-run issue for the global economy. This line of thought was based on expectations of a swift and decisive war, a successful transition to a new Iraqi regime and a united global effort on a "Marshall Plan" model for reconstruction of Iraq. As events have unfolded it increasingly seems that the war may not drag on for months, although suicide attacks on peacekeeping forces may be a significant ongoing threat. The larger question now is the aftermath to the military campaign. The political transition in Iraq will not be straightforward. In the meantime, the process of assessing the path of the U.S. and global economies has become progressively more clouded.

Evidence is growing that the world economy is in worse shape than many forecasters had originally expected in late 2002. In the United States the employment picture, which had held up well going into the end of 2002, now seems to be deteriorating. U.S. total employment payroll fell 108,000 in March following a revised fall of 357,000 in February and a rise of 185,000 in January and the unemployment rate is now above 6% versus 5.8% in the fall of 2002. At the same time, jobless claims above 400,000 have been reported for six weeks in a row. Surveys confirm that companies have been trimming their work forces in response to overall cost-cutting programs and attempts to contain rising costs in a weak revenue/profit margins environment. A weakening jobs market, along with war fears, helps to explain why in February the Conference Board's index of consumer confidence fell to 62.5 from 64.8 a month earlier, its lowest level in nine years. On March 28 the University of Michigan's consumer sentiment index fell in March for a third straight month to 75.0 from 79.9 in February, the lowest level since August 1993. As we have pointed out many times, consumer spending (two thirds of economic activity) has been the main pillar of the American economy over the past two years.

In previous commentaries we referred to the risk that consumer spending might weaken further following on growth rates of 1.7% in Q4 of 2002 and 4.2 % in Q3 2002. Recent data indicate U.S. consumers did not increase their spending either in February (U.S. retail sales declined 1.6% in February) or in January ($7.5 trillion in aggregate), marking the first period of flat consumer spending for two consecutive months in many years. On the consumption side the buying of durable goods – including household appliances – fell by 2.2% during February although, spending on what is categorized as services, which includes gasoline, rose .05%. It seems that consumer spending is weakening even though incomes of Americans rose 0.3% in February after a 0.4% increase in January and the personal savings of U.S. individuals rose to 4% from 3.8% in January.

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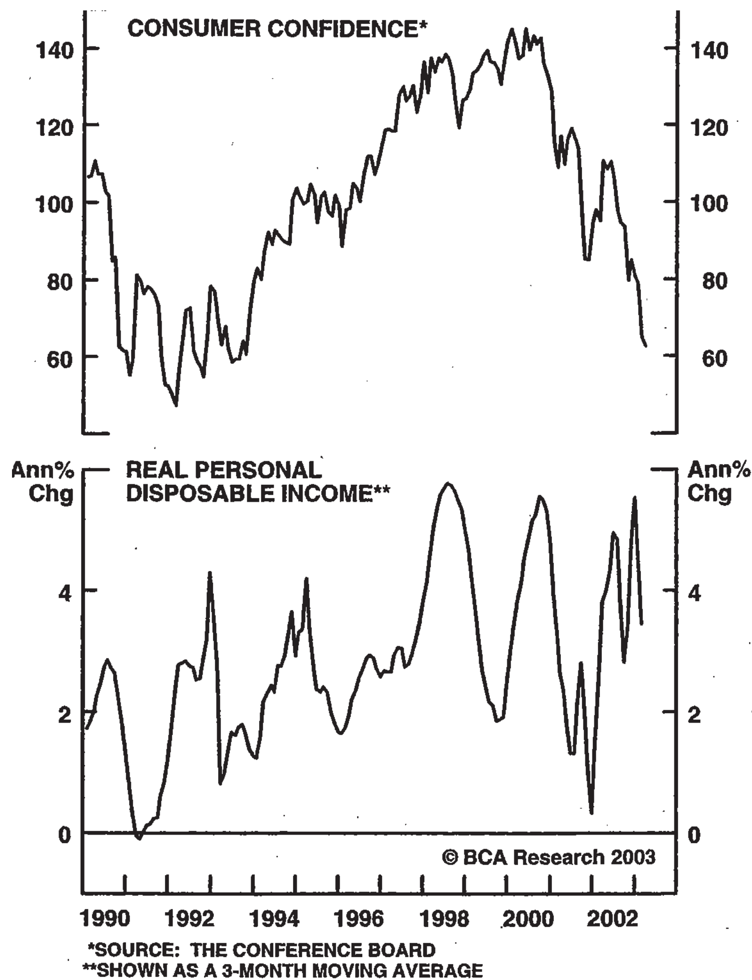

Source: BCA Research

Optimists point out that a consumer-led recession is still unlikely, pointing out that there is substantial monetary (low interest rates) and fiscal stimulus (one half of Mr. Bush's proposed $726 million in tax cuts were approved by the Senate) to work its way through the economy. They also tend to downplay consumer debt warnings since debt service is running at about 14% of disposable income and 72% of consumer debt is comprised of long-term mortgages. Apparently, the amount of mortgage refinancing over the last two years amounts to about 40% of mortgage debt suggesting that a large component could still be refinanced. Another plus on the consumer side is that the stimulus of rising employment (not yet evident) will supplant interest rate stimulus as the economy improves. Once employment resumes an uptrend then a self sustaining recovery is likely (consumption leads to production which fosters more employment and induces more consumption). Notwithstanding their demonstrated resiliency so far, we worry that consumers may be retreating somewhat at this time. If consumers pull back materially over the next few months then the U.S. economy runs the risk of much slower growth.

Turning to the business sector, it is apparent the inventory cycle in the U.S. has stalled due to a lack of corporate cash flow and the rising cost of credit, even though the inventory/sales ratio has fallen to its lowest level in years. On the manufacturing side of the U.S. economy, conditions remain

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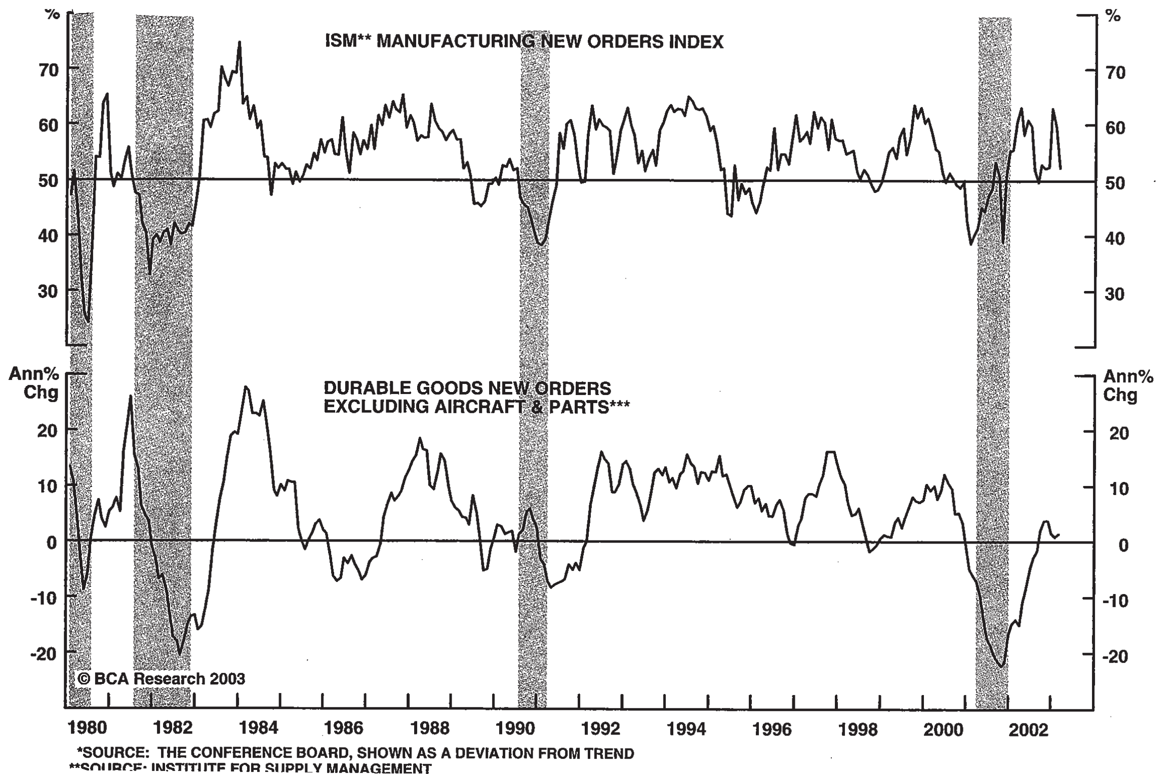
severely depressed, as evidenced by orders to factories for durable goods which fell 1.6% in February, unwinding part of the 1.9% gain reported in January. This weakness was broad-based with declines reported for computers, cars and metals. As well, America's industrial production, which grew by 0.1% in February after a 0.8% decline in January, fell significantly in March. On April 1st, the ISM's index of manufacturing fell to 46.2 from 50.5 in February signaling a sharp contraction in manufacturing activity. The manufacturing sector, hardest hit by the 2001 recession, has been a continuing drag on the economic recovery.



Source: BCA Research

For all of the above reasons, the U.S. economy does not appear to be moving ahead as originally forecast. In fact, forecasters have generally revised downward their projections of U.S. GDP growth in 2003. The March 10 Blue Chip Economic Indicators expect the economy will grow 2.6% for 2003, down from 2.8% expected in January and down from the more buoyant 3.0% + forecasts advocated in late 2002. In December, forecasters were expecting first-quarter GDP to advance 2.7%, (following weak fourth quarter 2002 growth of 1.4%) and that has been revised downward to a 2.0% rate. Second quarter consensus growth has been cut even more significantly to 1.0% or lower, compared with 3.2% forecast in December. In a $10 trillion economy reductions of this magnitude matter.

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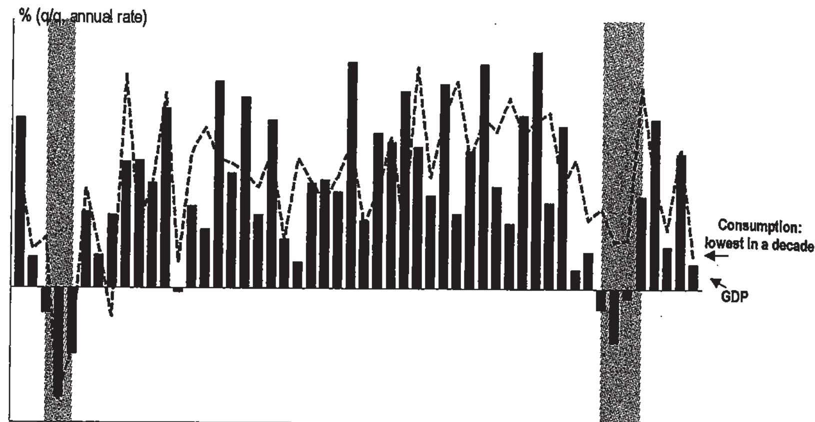


Source: National Bank Financial

Apart from the negative signs evident in the data, the pessimists among the economic community are gaining more attention. They argue that victory in Iraq, even if comes about in a few weeks, will do little to alter the tough fundamentals related to persistent post-bubble excesses, deflationary elements, low national savings, reluctance of businesses to spend, burgeoning budget deficits and the massive current account gap.

Ed McKelvey, an economist at Goldman Sachs, argues that the main reason for an anemic economic recovery is the weakness in private sector spending as households and companies attempt to deal with the huge debt they ran up during the irrational exuberance of the late 1990's. Households have extended their spending patterns by refinancing mortgages. Businesses have done much to cut costs and repair balance sheets, but they have further to go. A number of leading economists now expect zero growth in the second quarter, which would bring the three quarter growth rate to slightly below 1%.

A growing concern is the U.S. deficit which may crowd out other types of spending. In 2002, Washington operated with a deficit of about $160 billion, but in the first five months of the current fiscal year, the shortfall between revenue and spending came close to $200 billion and the U.S. government is now on track for a total deficit of more than $500 billion. The economic costs of war are large when the direct military costs and the indirect costs of peacekeeping, humanitarian assistance and reconstruction are taken into account. One economist at Yale University (William Nordhaus) thinks the tally could be $100 billion to $300 billion over the next decade (i.e., 1% to 3% of current GDP). Also to be taken into account is the macroeconomic costs of lost output especially if the reconstruction / regime change program is long and complicated.

Even the U.S. Federal Reserve Board seems to be divided on the probable impact of the key factors affecting the economy. Given all the uncertainty, Federal Reserve policymakers decided on March 21 to maintain the discount rate at 1.25% — a 41 year low. Obviously Mr. Greenspan is walking a fine line between cutting the discount rate in the interests of further monetary stimulus to the economy or holding off on the basis fiscal and monetary stimulus is sufficient. Perhaps reflecting a

degree of policy indecision, Mr. Greenspan did not provide the usual guidance on the state of the economy or monetary policy. Looking at interest rates from a broader perspective, it is significant that the yield curve is very steep (low short rates relative to long rates). Recessions are usually preceded by inverted yield curves not steep ones.

Summarizing the U.S. economy as it looks to forecasters in March compared to January, the indicators are not pointing towards a very vigorous recovery. Consumer confidence has waned and consumer spending, the most important prop to the economy, may slow significantly. Employment which fell in 2001 and early 2002, is moving sideways at best. The jobless rate, which was about 4% throughout 2000, has been around 6% for more than a year. Industry, which was running at 83% capacity in 2000, is operating at just over 75% capacity now with little sign of recovery. Industrial production, which declined sharply in 2001 eked out a small comeback in the first three quarters of 2002 but has recently resumed a contraction. The Conference Board's leading index of economic activity which climbed steadily in 2001 has been flat for the past year.

Europe, Canada and Japan

Of course, it is not only the United States economy where original growth forecasts are proving to be too optimistic. A year ago, GDP growth for the EU countries was forecast to come in at a respectable 2.8% in 2003 by the The Economist's poll of forecasters. Recently, that forecast has been revised downward significantly to just 1.1%, which represents an even more dramatic scaling back than in the U.S. economy. Germany's GDP shrank slightly in the fourth quarter and may well have contracted more decisively in the first quarter of 2003, signaling a recession is underway. While German industrial production rose a healthy 1.6% in January, this followed on a sharp 3.5% fall in December. Clearly, Germany's manufacturing sector, struggling to become competitive, is losing ground. Jobs are also a concern in the Euro area. Germany's unemployed ranks rose by about 135,000 in January and February and its jobless rate stands at about 10.5%. In France, surveys show that households are concerned about jobs. Consumer confidence in France has fallen to its lowest level in six years.

The U.K. economy is faring better than the main economies of continental Europe but it is vulnerable and perhaps losing momentum. GDP was up a modest 1.5% in the fourth quarter and is running at a modest 2.1% over the last year. One issue is that exports are not growing , largely related to the U.S. slowdown, and the trade deficit has grown to about £3.5 billion. Slow export growth and very low levels of capacity utilization have combined to pull capital spending down for several quarters. A bright spot in the U.K. is that consumers keep spending buoyed by wage gains of 3.7% and modestly rising employment. All this leads forecasters to expect real growth of 2% in 2003 after growth of 1.9% in 2002.

Japan, for many years the economic laggard, was in the unusual position of showing economic recovery in the fourth quarter of 2002, fuelled by a rise in net exports, particularly to China where economic growth is robust. However, Japan's brief recovery appears to be unsustainable. Most forecasters expect Japanese GDP growth of about 0.5% in 2003 with no improvement in 2004.

Another concern for Europe (and Japan) is the weakening of the U.S. dollar against the Euro and the yen, which will dampen European/Japanese exports to the U.S. The correct response by central

banks in Europe and Japan to an appreciation of their currencies is to ease monetary policy. The Bank of Japan cannot cut interest rates, which are already at zero, but it has been intervening to push down the yen. The European Central Bank has more room to maneuver and did trim rates by 25 basis points on March 6 to 2.5%, but could go further.

One of the most interesting trends in the macroeconomic scene over the past two years has been the huge divergence between the economic performance of the U.S. and Canada. The U.S. struggled with recession in 2001 (albeit shallow and short-lived), and is now struggling with sustaining a recovery while the Canadian economy has kept expanding. The Canadian economy grew by 1.5% in 2001 and 3.3% last year, the best performance among the G7 industrial countries. In contrast to America's spiraling budget deficit, Canada's current account and budget remain in surplus and the Bank of Canada, concerned with inflationary biases, raised interest rates three times in 2002. Even the historically weak Canadian dollar has strengthened considerably against the U.S. dollar in 2003. A part of the relative strength in Canada is the consumer. Real consumer spending ended 2002 at a 3% rate of growth spurred by large gains in employment (467,000 people added to the payrolls over the last year) and modest wage growth. As in the United States, the consumer debt load is immense, but so far Canadians enjoy a high affordability level and are riding open mortgages to take advantage of a steep yield curve. In the business sector Canadian capacity utilization is higher (84% versus 75% in the U.S.) and rising and corporate cash flows are strong enough to fuel a reasonable level of business spending. Corporate profits in Canada have been rising on the strength of improving profit margins. These strengths prompted Finance Minister John Manley to describe Canada in his 2003-2004 budget address on February 18 as a "northern tiger" with the "capacity to control our own destiny". This may be easier said than done, given Canada's dependency on its southern neighbor America's share of Canada's exports has risen from 73% to 85% over the past four years. Of the exports, about 68% are autos and industrial goods. With U.S. industrial production retracting and the auto cycle getting somewhat overextended, exports may slow dramatically, accelerating the declines already seen over the last three months. The trade side seems certain to cost Canada significant GDP growth going into the fall.

Another difference between Canada and the U.S. is in government spending which account for about 18.5% of GDP. Between homeland security, the war effort and spending on healthcare, the U.S. has increased government spending by a massive 3.6% year-over-year compared to a 2.2% rise in Canadian government outlays.

On balance while Canada is not maintaining the strong pace of growth at 3.5% to 4% evident in 2002, it is still expected to show growth above 2.5% in 2003. Meanwhile the U.S. is barely holding on to a 2 % growth rate.

Equity Markets

Indicated Trends in Q1 2003

As we anticipated, stock market volatility over the past quarter has been severe as investors react to the ebb and flow of war news and the release of economic data. Between December 31, 2002 and March 31, 2003 the Dow declined 4.2% while the S&P 500 declined 3.6% and in the same period the S&P/TSX Composite declined 4.5%. (The one positive market was the tech heavy Nasdaq composite which rebounded modestly in the quarter). However, between March 7 and March 21 the Dow rallied 8%, the S&P rallied 9% and the S&P/TSX rallied 3.3%. In this time frame the market demonstrated one of the strongest rallies ever and converted a losing year to one of slightly positive returns at the time. The rally was triggered by early news of swift progress in Iraq including rumours that Saddam Hussein may have been killed, that pinpoint bombing in Baghdad was effective and Iraqi forces were showing little resistance.

The bounce was short-lived however. Over the weekend of March 22 the positive mood was overwhelmed by a sea of negative sentiment due to tough resistance from Iraqi special forces, a few U.S./U.K. casualties, graphic pictures of U.S. prisoners of war, evidence that Russia had supplied weapons to Iraq, concerns that Turkey might unilaterally move into Northern Iraq, and the U.S. budget debate that requested a war appropriation of $75 to $100 billion. Accordingly, on Monday March 24, markets globally suffered a relatively steep one-day sell-off which had the effect of undoing almost half of the gains registered in the previous eight trading days. Between March 24 and the end of March equity markets continued to weaken, weighed down by war news and disappointing releases of economic data. In this first week of April the tone to equity markets improved somewhat as incursions into Baghdad occurred with little resistance. While the Iraq war may continue to be an overriding influence for a time on market activity, obscuring fundamental underlying trends, investor attention is already shifting to the global economy and geopolitical issues beyond Iraq (North Vietnam, Israel / Palestine, regional Middle East etc).

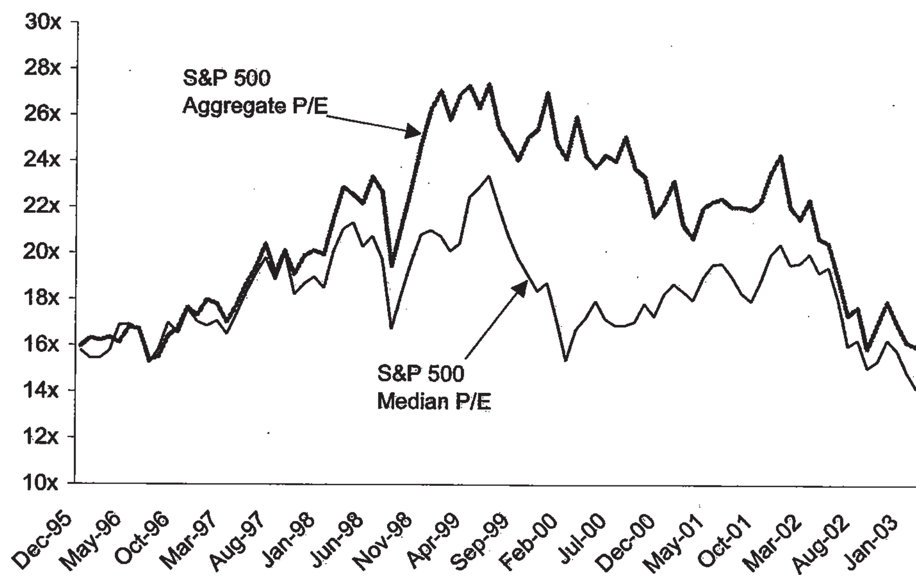
Comparing the Two Gulf War Eras – 1991 vs. 2003

As background information to our investment strategy in the current environment we analyzed the considerable differences between the war time environment we are now experiencing and the Gulf War environment (political, economic and stock markets) in 1990-1991.

The political situation is markedly different today. In 1991, there was an explicit, unanimous UN mandate to oust Iraqi forces from Kuwait. There is no such UN mandate this time. It was obviously easier for the UN to unite in a situation where a country had been invaded than to authorize the U.S. to depose by force a regime whose “imminent threat” to America was debatable. A long conflict throughout 2003 could lead to much more global geopolitical dislocation (pressure on WTO, NATO, and intra-EU). Some of the variables are obviously the speed of war, the level of military and civilian casualties, and whether the war or civil unrest spreads to other countries. As well, it has been made clear that Iraq is not the only target in the U.S. war against terrorism.

The economic backdrop is also greatly different today than in 1991. Today, there has been no immediately preceding U.S. recession from which a rebound would provide relief. Real GDP fell about 1.5% between the second-quarter 1990 and the first quarter 1991 and consumer spending had fallen at an annualized 3.3% pace prior to the commencement of Operation Desert Storm in January 1991. As discussed above, consumer spending has led the U.S. recovery throughout 2002 and, although stalling somewhat, is a large factor in expected growth in 2003. Moreover, in 1991 real wages were contracting by 1% a year in the U.S. compared to a positive rate of growth of 1% or so currently. In the aggregate the weak economic environment in 1990-1991 set the stage for a solid rebound in both employment growth and real wage growth after Desert Storm. Perhaps more critically, there was also plenty of scope for monetary policy response with the Fed fund rate at 5.1% in January 1991 compared to 1.25% currently.

Another substantial difference between the two Gulf War periods is stock market valuations. The S&P 500 was trading at 11-12 times prospective 12 months earnings at the start of the 1991 War and reflected a 3.9% dividend yield. Today, the S&P 500 is trading at about 17 times one year forward earnings and its dividend yield is about 1.84%. However, new accounting rules, large scale write-offs by corporations, low inflation and low real interest rates are all factors in today's environment that help justify the valuation difference between the two periods.



Source: Compustat, First Call, FactSet

Note: Both P/E measures are based on next-twelve-month estimates; aggregate P/E is sum of market caps divided by sum of earnings estimates.

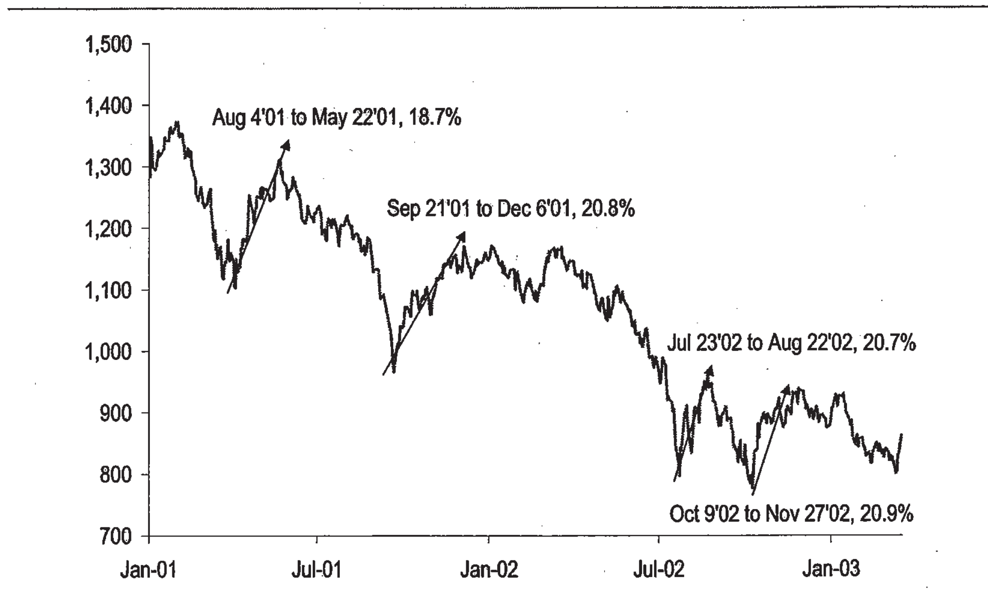
Source: Credit Suisse First Boston

The main conclusion from the comparison of the two war eras is that the current environment is relatively more difficult to read and the underlying risks are more difficult to assess. The markets are always reaching for clarity – in other words which way is the war going and ditto for the economy? Now that the initial euphoric early days of the war have given way to a more sober reality and the economy shows signs of weaker growth than originally forecast, firm answers are elusive on both fronts.

As well, the current releases of economic data may not be relevant to the longer term outcome on the economic front to the extent they are tainted by war concerns.

As we noted earlier, even the Federal Reserve Board appears to be struggling with an appropriate response to the many crosscurrents at present. Their conflicting interpretations reflect the sharply divided opinions among strategists on the importance of the war and the reconstruction period on the economy. On the one hand, the view is that war involves a stimulus from expenditures on Iraq which will pave the way for stronger growth in the second half of the year. On the other hand, an influential group of pundits believe that deeper problems unrelated to the war will continue to stifle a robust recovery.

In our view, investors cannot overlook the risks of a protracted and unsuccessful reconstruction regime change period in Iraq which will cause continuing trepidation among consumers, businesses and investors. We are not sure that investors have made their decision fully on the timing and nature of the ultimate U.S. – Iraq resolution and certainly the bet on the direction of the U.S. and global economies has not been made by investors. In any event, the scenario of buying equities on the basis of reasonable valuations in a long term context has not worked well in this bear market. As the chart below indicates since January 2001 there have been four bear market rallies prior to the March 2003 rally/reversal described above.



Source: Credit Suisse First Boston

Equity Markets Review – Investment Strategy

We recognize that it is futile to fret about the day-to-day gyrations of events in Iraq or the Franco-German rift with the U.S., but the stark reality is that Iraq related worries have been, and will be for some period ahead, a dominating influence on markets and that economic news (much of which is

negative at present) will gradually assume a larger role. Accordingly, we have adjusted for these scenarios in our asset allocation decision in equity and balanced accounts. We have a relatively low equity allocation at this time. As we monitor Iraq, North Vietman etc. and the major economies, we are spending our time researching companies and their sectors and meeting management teams in key businesses of interest. Our work is identifying companies which might benefit from likely business or consumer activity increases and whose prospects are not yet recognized appropriately or fully in their share prices.

A part of our tactical approach at present in a market that requires highly specific stock selection is not to accept broadly held beliefs which have applied in prior weak markets. One of those beliefs is that it is now appropriate to shift assets from cyclical consumer-oriented stocks to those that are more tied to capital investment since consumer spending may wane for the reasons discussed above. For two years or more fears have grown that the consumer is on the brink of a spending collapse but that has not yet happened. Certainly, the stock prices of some consumer-related companies already assume peak earnings. On the other side capex-oriented stocks including those in the materials and industrial sectors are at multiples that assume a level of demand and sales recovery that is difficult to substantiate. Thus, we are looking beyond the idea of a "consumer for capital spending" swap or any other conventional sector rotation ideas, to the specifics of a company in its particular market and how it is positioned vis a vis its competition and industry issues.

It is our general belief that improving companies' fundamentals will eventually carry investors out of the bear market and that war anxieties will be overridden by economic factors and the progress of companies in improving their operating results and balance sheets.

Equity Markets Review – The Corporate Profits Picture

Before turning to specific sectors and companies where we see investment opportunities we should comment on our overall concern with the profits picture. While earnings have improved relative to recession lows, the earnings backdrop remains challenging in general mainly because top-line (revenue) performance by corporate America remains weak reflecting lack of pricing power in this low inflation environment and lack of final demand in many product/service areas. In addition, earnings growth is constrained by the requirement to amortize (expense overtime) the shortfalls resulting from pension funds actuarial deficit calculations. The earnings outlook is relatively more healthy in Canada than the U.S. reflecting the lower level of tech related companies, the positive contribution from energy and the recover in earnings underway in financial services.

The good news on the earnings front is that, despite the lack of pricing power operating earnings for the S&P 500 have risen by a very credible 20% since their lows in 2001. Upon closer scrutiny, it is apparent that much of the gain has come from improving profit margins (the ratio or revenues to costs).

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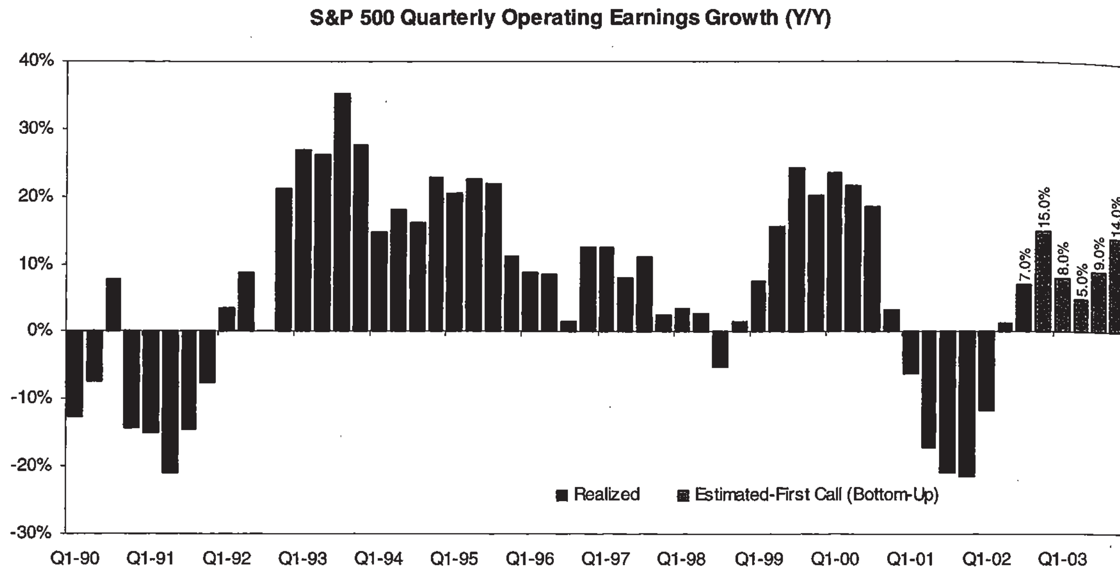


Source: First Call

While wage gains are still running in the 3% plus area, as mentioned previously, productivity growth has been the salvation for earnings improvement in many companies. As a result unit labour costs actually declined last year and are rising only imperceptibly on a year over year basis so far in 2003. Admittedly a lot of the productivity growth has come from the usual lag between the recovery and employment growth. As economic activity improves led by a turn in the inventory cycle (inventory restocking) and business spending pulls up, employment growth will resume (aggregate labour costs use) and productivity necessarily declines. However, productivity should benefit from a rise in capacity utilization; the theory being that plants operate much more efficiently (i.e. higher productivity) closer to fuel capacity than at the 60% to 70% level which is typical at present in many industries.

Of course once the initial earnings recovery phase, based on inventory restocking, has run its course, there is a serious question about just how much profits can expand without final demand and firmer output pricing playing a role. Once again we find value in digging beneath the macro statistics and searching for those areas of the economy and company beneficiaries within them that offer the best potential for profit growth and ultimately stock market appreciation.

Investment Opportunities Defined

With our expanded team, we are capable of conducting more internal research and arranging more management interviews than previously. The commentary below provides an overview of the sectors and some of selected stocks on our focus list. Several of the stocks mentioned are in client portfolios and others are being considered for addition to client accounts subject to valuation considerations and other factors implicit in our disciplined investment process.

Financial Services

A core investment area in our equity strategy is the financial services group which includes Canadian and international banks and insurance companies. We are currently focused on a number of Canadian banks which have the potential to generate excess capital which will likely be used to increase dividends and repurchase shares. We worry that the banks in general are vulnerable to stalling growth in consumer and corporate lending and weak capital market revenues, but we believe cost and risk controls will ensure profitability is maintained. We expect that the Royal Bank will continue its track record of superior profitability in F2003 benefiting from some improvements in credit quality and increasing contributions from its U.S. acquisitions. As well, it has a dominant franchise in Canada's investment banking sector. We are less interested in the life insurance companies at this stage given their reliance on equity – leveraged products for sales growth. Over time we may well position accounts in Manulife and Power Financial, two very different companies but each with compelling competitive strengths and excellent management.

Healthcare

A core sector in our investment thinking has been healthcare which includes pharmaceuticals, healthcare equipment and services, and biotechnology. In the 1990's and into 2000 the defensive portfolio attributes of pharmaceuticals stood out, but in 2002 pharmaceuticals and biotechnology stocks declined in line with a falling market as they went through a period of product patent expirations, a new drug drought, negative news on drug safety and concerns as to the regulation of drug pricing and medical cost reimbursements. Other industry-specific issues continue to give the pharmaceutical industry a negative tone including generic risk, manufacturing issues, and a slow drug approval process conducted by a conservative Food and Drug Administration. It is our view, however, many of these issues are already priced into the stocks and there is evidence that new drug pipelines are improving and operating issues are being addressed. There are a number of high quality companies such as Merck trading at a low price/earnings multiple relative to the S&P average which represents sound value. As well, there are medical products companies such as Beckton Dickenson on our focus list. Performance of these stocks has been flat recently but we believe that trend will reverse as the capacity of leading companies to record steady earnings growth becomes recognized.

Consumer Related

Consumer discretionary stocks (autos, consumer durables, hotels, media and retailing) generally do not meet our test of strong fundamentals at this time. U.S. retailing has been a relatively strong performer in a stock market sense in March, but there are concerns from a macro viewpoint which prevent us from committing funds in this area. U.S. consumption growth may well be slowing, as consumers react to weak job markets and the need to bolster savings. Media has also experienced relative out performance in various periods over the past two years. OisOisOur concern is that almost 35% of U.S. ad spending comes from autos at a time when auto sales are slowing and advertising (including direct-mail) is back at mid-cycle levels. We believe that ad growth is priced into the media stocks, but we continue to search for value overall. We are also very cognizant that the slump in consumer confidence recently may reflect only war jitters and is not necessarily indicative of the consumer's real propensity or capacity to spend. Accordingly, we are analyzing consumer trends and the valuation of consumer related stocks to gauge whether our concerns are overly pessimistic.

Turning to the consumer staples group (food, tobacco, household and personal products), several leading companies have relatively predictable earnings and benefit from strong branding to ensure their competitive positions. They have defensive characteristics which are compelling in a difficult economic environment. Included in that group are the food and drug retailing companies and we continue to favour Shoppers Drug Mart in Canada which has a strong and growing national presence and has consistently delivered solid operating results.

In household and personal products we have included Johnson & Johnson on our focus list recognizing the power of its brands and that it has a large and growing medical products business to accelerate its growth.

Industrials

The industrial sector (capital goods, electrical equipment etc.) is closely tied to global economic performance and industrial production in particular. On that score, based on signs of weakness in industrial output recently, we are cautious on the group in general. Of course, there have been substantial divergences in the returns of different subgroups with industrial conglomerates and electrical equipment rising while aerospace and defense-oriented stocks are lagging. The underperformance of aerospace and defense has been prompted by the struggles of commercial/civil aerospace carriers. The near bankruptcy of many airlines (such as UAL) will lead inevitably to deep capacity cuts in the current depressed travel environment. Accordingly, we do not foresee a recovery in most stocks with commercial aerospace exposure in the near future. In Canada we are accumulating Bombardier, which we believe is an exception in an otherwise troubled industry. Bombardier is undergoing a complete overhaul under Mr. Tellier (a skilled executive who turned CN around). Another potential bright spot is the defense contractors which have suffered because of their commercial airline exposure. The U.S. defense budget should continue to rise at a 9-10% rate for the next few years and eventually earnings growth should overtake the multiple contractions witnessed over the past several months in defense stocks.

Energy

We will not accumulate a higher weighting in energy companies until we are satisfied that oil prices are no longer in a downtrend. Canadian Oil Sands Trust and Petro-Canada are two companies on our focus list. We remain strong proponents, as we have been over the past two years, of natural gas which has experienced very high prices throughout the winter but some seasonal weakness in April. Typically, when natural gas prices exceed the cost of other energy forms (oil) "demand destruction" occurs and that is occurring to some extent. However, competing fuel inventories are low and the price of oil (the main gas substitute) is relatively high. More importantly U.S. and Canadian gas supply is failing to keep up with demand. Exploration drilling is not resulting in significant new reserves and existing producing fields are declining at twice the rate (30%) of five years ago. Accordingly we will continue to hold selected gas producers in equity accounts with above average risk tolerance.

Basic Materials

In the basic material group (construction materials, chemicals, metals and forest products) we have a positive oolong-term bias toward low cost commodity producers in sectors that haven't experienced recent capital expansion. In metals and mining, despite gloomy economic data in the U.S. and Europe, rising Asia Pacific demand for metals is positive and many metals producers have healthy cash flow profiles, and balance sheet strength.

In this area Inco, the Western world's largest nickel producer, is on our watch list. Despite a mixed operating outlook for 2003, we believe Inco, and other metal producers (Teck Cominco included) will benefit from stronger prices and operational improvements in 2003/2004.

Of the various forest product categories we believe uncoated freesheet has the best fundamentals. Our top selection in this sector is Domtar, North America's third largest producer of uncoated freesheet. Domtar has the lowest-cost system of mills, a strong balance sheet, free cash flow and low mandatory capex.

Information Technology

Our approach to the tech area is to screen out companies with superior business models and dominant positions, with free cash-flow. These companies can launch new products and gain market share at the expense of less capable competitors. Dell Computers is an example of a company which meets these criteria. A stumbling block continues to be it's elevated forward P/E ratio which remains high relative to other areas of the market.

Contrary to the basic materials industries, which have been deprived of capital for a decade, many information technology companies were clearly over capitalized in recent years. As well, the potential for continuing exponential growth for technology products / services was overblown. The result could be a prolonged period of low demand for many technology products and, low capacity utilization by suppliers. Companies like Dell buck this trend by focusing on products with an established replacement cycle which provides a strong revenue base.

Telecommunications Services

By our definition, telecommunications services includes diversified telecom services (the regional bell companies for example) and wireless. The industry is now characterized by much lower growth than in the 1990's (1-2% versus 8-12% in the prior decade) as well as few bankruptcies of "new entrants" and a strong cash-flow focus at the expense of aggressive capital expenditures. As industry revenue growth will remain challenging in 2003, operators will focus on cost efficiencies to boost margins and restructuring. In general, we are cautious on the sector in spite of its recovery mode and good dividend yields.HH However, we continue to favour BCE in Canada which has devised a turnaround plan and is under new skillful management that should provide clarity to investors and improve free cash-flow yield over time. In addition, BCE's dividend provides a reasonable carry while the turnaround is implemented. Given the regulatory framework and BCE's dominant position, it is very difficult for incumbents to grow reserves in the largest wireline segment, local telephony. A potential positive catalyst over the longer term is industry consolidation.

Income Trust Update

In general, the high prices of many trust units have moderated somewhat in the quarter reflecting declining oil prices (affecting the oil and gas trusts), weaker real estate fundamentals (affecting REITS) and the increase in interest rates in Canada (many trusts are interest rate sensitive). As well, a few trusts underperformed compared to analysts expectations. Over time we expect differentiation between the best managed trusts in the most stable businesses and the laggards. In the latter part of 2002 we reduced our exposure to income trusts, particularly in the oil and gas and real estate sectors. We have conducted extensive internal research on the income trusts as an asset class, and have identified a small number of them across different businesses which meet our investment criteria. We will rely on these vehicles to supplement cash returns in portfolios requiring regular income and to diversify returns generally in many accounts.

Barrantagh
Investment Management

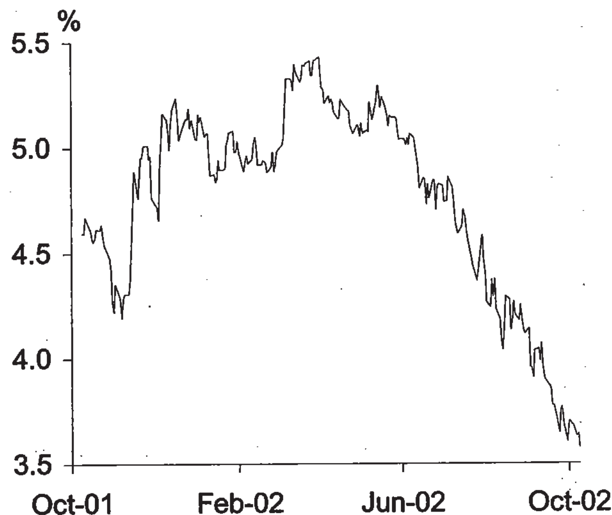
Fixed Income Markets

Corporate vs. Government Bonds – An Update

In our last capital markets review we drew the distinction between opportunities in the government bond market and those in the corporate market (the “credit market”). We concluded in late 2002 that government bonds were offering a diminishing potential for total return because the end of the central banks’ easing cycle was in sight. We also pointed out that the shape of the yield curve was steeply upward sloping, a typical structure at the end of a period of monetary easing. As well, bond prices had been bid up to very high price levels reflecting unusually strong money flows into them at a time of war, a lackluster economy (at this time) and volatile stock markets. In the late fall, the ten year U.S. treasury offered a very low 4.2% yield, perhaps 1% lower than warranted by purely economic fundamentals.

On the other hand we described the compelling investment opportunity in corporate bonds where the spread in yield over government bonds was at its highest in over three decades. Our early 2003 reading on the direction of the bond market was generally correct.

The first quarter of 2003 has seen the US treasury yield curve steepen marginally, with the long end of the curve up about 12 basis points in yield, most of which has occurred in March. In fact, in the period from mid-March to late March yields on U.S. treasuries rose by more than a quarter point reflecting initial euphoria about the prospects for a swift military victory in Iraq. At that point the market signaled an end to the three year rally during which long-term U.S. rates fell by some three percentage points.



Source: Goldman Sachs

It seemed for one brief period that the flight to quality and safety, which had lifted bond prices, pushing long rates lower, had reversed its course. However, the release of generally negative economic news into April has rekindled the "flight to quality" somewhat and prompted a steady bid for treasuries. Notwithstanding these very short-term gyrations we believe we have seen the lows in yields in the treasuries market for this cycle, barring any dramatic reversals in the war in Iraq. The bond market always looks ahead, as do equity markets. Postwar (i.e. early summer hopefully) economic data should point toward a significant improvement in economic growth compared to the dwindling pace that seems probable for the first half of the year.

Of course, until the Iraq situation appears to be under control, the government bond market should continue to trade in a range around its current level. The decision of the Federal Reserve to hold rates steady at its latest meeting has taken the bullish pressure off the short end of the curve, although the market is becoming less certain that there will be no further rate reductions.

In Canada, the government yield curve has experienced more pronounced change with a flattening trend clearly in evidence and rate increases occurring across the curve. Canada has already experienced the onset of central bank tightening, with the Bank of Canada having increased the Bank Rate from a low of 2.25% to the current 3%, and the indication of further hikes to come. The Canadian economy has significantly outperformed the U.S., and its inflation (CPI) is now rising at a 4.5% annual rate at the latest measurement. In the quarter, yields on short to mid term government bonds rose nearly 0.5% to the 3.1% to 4.4% range depending on maturity. At the same time the ten year yield rose over a quarter of one percentage point. Obviously, these yield changes translated into declines in bond prices, particularly among shorter maturity issues. As discussed in last quarter's report we have moved funds out of the short end of the bond market but still hold longer maturity government bonds for yield-conscious portfolios.

Although movements in the government bond markets have been important, the more dramatic shift occurred in the corporate bond market. The average corporate credit spread has tightened a surprising 50 to 100 basis points since the beginning of the quarter. This is a highly significant shift.

A number of factors seem to have been influential in bringing about this spread narrowing. The corporate issuance calendar has certainly picked up, but net of maturing debt, issuance of new debt remains weak and therefore, the lack of supply has squeezed corporate yields as investors bid up existing issues. Apart from this technical factor there are more fundamental reasons why investors are more actively pursuing yield in credit markets. Investors are recognizing that corporations are restructuring and implementing cost cutting programs. In that process businesses are emphasizing free cash-flow and return on equity over capital spending and business expansion. In many businesses balance sheet repair is underway with creditworthiness being emphasized over future investment. Investors are becoming aware that corporate bonds are the way to take advantage of improving credit quality while equity upside is still limited. Corporate bonds offer a better risk/reward tradeoff than equities in many recovering sectors. In fact, U.S. speculative grade bond performance (note that we only invest in investment grade debt) has outperformed equities over the last few months. Merrill Lynch points out that from November 30, 2002 to early March, the Merrill Lynch index of the U.S. high yield bond market generated over a 6.5% return. In contrast the small cap Russell 2000 equity market index posted a 6% loss in the same time frame.

The Canadian corporate market has to a degree mirrored that of its southern neighbour. Corporate credit spreads have narrowed significantly as investors have sought to benefit from improving credit quality and higher yields. Again there has been little new supply in the corporate market (apart from the mortgage issuers) to meet the rising demand. The net result of this narrowing of spreads over the government curve has been stable to slightly lower yields in the corporate market even as government rates have risen.

It should also be highlighted that yields in the government market have risen faster in Canada than those in the U.S., with the long end up 20 basis points in the quarter, and the shorter end of the curve up over 60 basis points, already discounting a further rise in the Bank Rate in April. The Canadian curve is now over 125 basis points above the U.S. yield curve, which is historically wide. Looking ahead, rates in Canada may therefore not rise as quickly as those in the U.S., allowing this spread to narrow to a more reasonable level. Provincial spreads have widened somewhat as the market anticipates weakening financial conditions in many of the provinces' finances.

Turning to bond market strategy we continue to apply a dual strategy of short and mid term corporate bonds and longer term government bonds in structuring fixed income portfolios. This was the strategy recommended late last year and it has been effective. The overall direction of our thinking on the bond market has not changed over the quarter. We remain convinced that government bonds offer little opportunity for gain beyond their running yield and that the opportunity in corporates remains, even though spreads have narrowed. Investment grade corporates can be found which offer the opportunity for superior current yield and capital appreciation as the underlying credit improves.