Barrantagh

Investment Management

CAPITAL MARKETS REVIEW
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- Synchronized global economic growth continues to support the performance of equity markets. Economic growth may slow as the year progresses but not enough to undermine equity markets.

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- Corporate cash flow continues to grow in response to positive economic trends and improving corporate fundamentals.
- Throughout 2003, our focus on equities has produced solid returns. We continue to favour equities over bonds. In 2003 beneficiaries of an economic recovery performed well. Our focus going forward will be on companies with superior intrinsic capabilities to grow revenue and generate free cash flow.
- The recent consolidation of equity prices provides a strategic entry point for quality stocks.
- The Chinese economy plays a key role in global growth; our equity mix includes beneficiaries of industrial demand growth linked to China's investment boom.
- A reversal in Fed policy has been deferred but is inevitable in our view. As in 2003, we will emphasize corporate bonds where credit improvement will enhance yield but we have adopted an overall defensive posture.
- While Canadian interest rates have room to move lower reflecting the possibility of slower economic growth vis-à-vis the U.S., Canadian government bonds are expensive and we have reduced these positions.
- In general, income trusts exhibit higher values relative to underlying risk. We will continue to invest in trusts which meet our equity selection criteria.

Economic Update – Synchronized Global Growth May Slow

The Global economic outlook remains very positive with the U.S. and Asia being the main growth engines. The U.S. economy is "in transition" from "super" growth in late 2003 to slower but still above trend growth in 2004. High energy costs, a possible slowdown in consumer spending, and

potentially tighter financial conditions, may slow the trend, but not significantly. In Asia, China is the region's economic powerhouse while Japan's nascent recovery is also a factor.

Recent economic data, largely confirms the underlying strength of the U.S. economy. In the year to February, industrial output rose by 2.7%. In January, the ISM index of manufacturing activity edged up to a two-decade high and capital spending is accelerating. The basic strengths of the U.S. economy have been obscured by attention on the lack of job growth. March employment data may point toward job recovery at long last although businesses continue to prioritize efficiency gains, rather than job creation. Consumer confidence remains high but statistics indicate it is wavering. Therefore we are closely watching U.S. consumer spending (70% of GDP) which appears to be slowing after a very strong fourth quarter in 2003.

A longer term worry is the dependence of the U.S. economy on massive lending from the rest of the world to fund its huge deficit which is now 5% of gross domestic product. The central banks of Asia are financing about 50% of this imbalance by adding to their already huge holdings of dollar reserves. If China and Japan stopped their intervention for whatever reason, U.S. deficit refinancing would become a major issue. Furthermore, because of the large current account deficit and the loss of American jobs overseas, protectionist sentiment is influencing trade policy. The trade threats don't come from traditional powers or from NAFTA partners but from China and India with their skilled but low paid work forces. The Democrats and their leader, Mr. Kerry, are attempting to capitalize on these issues. Rising American protectionism (trade sanctions etc.) would be negative for global economic activity and capital markets.

On balance, weighing many factors, the positive economic trends easily outweigh the negatives and the U.S. economy will lead the world again in 2004 with significant growth, albeit at a more moderate pace.

In Canada, the repriced Canadian dollar will take a toll on exports offset partially by interest rate relief but growth will lag that of the U.S. by a substantial measure. Overseas, Japan's economy is in a recovery phase which may be more durable than previous attempts. On the other hand, the Euro zone is challenged by a rapid currency rise and areas of economic weakness. This hasn't escaped the Central Bank with even Trichet, the ECB president, now leaning toward monetary ease. Lower interest rates will allow positive growth in 2004.

U.S. Interest Rate Policy – A Key Variable

A primary threat to capital markets is the prospect of a reversal of the extraordinary amount of monetary and fiscal stimulus injected into the U.S. system since early 2001. The Fed has indicated it won't act until excess capacity (the output gap) has largely been exhausted. The economy's sharp rise has narrowed the output gap but faced with weak employment and low inflation, the Fed has so far deferred increasing rates. The ultimate impact of a prolonged period of historically low short-term rates on inflation is not clear, and the capital markets are wary. This uncertainty creates investment opportunities for 2004.

The "China Factor" – Central to Global Growth

Over the past 25 years China has been the fastest growing economy in the world, growing 9% per year since reforms began in 1978. With GDP of $1.4 trillion, China is the world's sixth largest economy. Estimates show that China has expanded at double digit rates over the past two years reflecting an

export and investment boom. In terms of its share of world imports, China now accounts for 7.5% of chemicals, 10.6% of iron and steel, 7.1% of office machinery and equipment and a significant share of other products. In 2003 China attracted over $52 billion worth of foreign direct investment (FDI) replacing the U.S. as the top destination for FDI. In this "supercharged" economy, expenses are building and rampant inflation is a risk.

Well aware of the need to maintain economic stability, China's policy makers have started to take action. The problem, however, for a country that has moved only partially from socialism to capitalism is that normal mechanisms which regulate a genuine market economy may not work smoothly. Policy makers are in part resorting to "communist solutions" by ordering their banks to curtail lending to overheated sectors.

Accordingly, China faces a precarious balance between uncontrolled growth and a destabilizing slowdown. There is a risk that any concerted attempt by China's leaders to control their economy may go too far and precipitate a major retraction. On balance, we believe the Chinese economy will slow in reaction to recent government policy initiatives but will continue to dominate the demand growth in many industrial sectors.

Equity Strategy – Cash flow drives further Gains

The bull market that began in 2002 has now lasted about a year and a half. Our portfolios have benefited from our call late in 2002 that equity markets would perform well. Our overall positive stance towards equity markets remains fundamentally unchanged in spite of the recent correction. The obvious catalyst for a sustained down draft in equity prices - deterioration in earnings and/or monetary policy tightening are not problematic in the near term. The Fed will probably sit on the sidelines for most of 2004, fuelling further economic gains and rising corporate profits. Our expectation for profit growth in 2004 is sufficient to drive stock prices to higher levels. We do not believe the peak of earnings growth has been reached which would dictate a defensive posture. Corporate profits benefited early in the cycle from margin improvement (a lower break even cost structure in many businesses) and now from advancing revenues. We are cognizant however that the pricing of equities assumes strong and sustained earnings growth going forward.

We continue to favour equities over bonds but we have become much more selective in our equity investments. Now that the economic recovery is established, we favour stocks that can clearly demonstrate improving operating results related to intrinsic strengths and are no longer dependent on corporate restructuring. As valuations have moved higher and in some cases are stretched, we confirm our bias towards companies with superior business models, clear competitive advantages and demonstrable ability to generate strong free cash flow.

We are cautious on companies which are sensitive to interest rate increases or are consumer-oriented. Specific examples of our strategy include our decision to shift into forest product stocks, (Domtar) and entertainment (Harrah's Entertainment). We continue to invest in natural gas producers to capture the strong fundamentals in that commodity.

Fixed Income – Challenging Markets

The strong global economy and the prospect of rising interest rates are two primary factors on a list of threats to North American fixed income markets. In the past, bond yields have risen sharply (prices have fallen) in advance of an initial rate hike and also through the subsequent year or so. The current cycle has not conformed closely to the norm. After climbing through the summer of 2003, North American bond yields drifted lower, particularly in Canada where monetary ease took place. The U.S. Treasury market continued to find support in the steady Fed funds rate alongside the persistent

disinflation trend and the sluggish labour market. As discussed, rate hikes will almost certainly come once employment growth becomes an established trend and the output gap closes. Other factors will magnify the upward move in yields once it occurs; namely the budget deficit (which is looking increasingly permanent), and our expectation of reduced participation from the Asian central banks. We have substantially reduced our holdings of U.S. treasury bonds as a step towards an overall defensive strategy.

With respect to Canadian fixed income markets we are less concerned with rising rates than in the U.S. because of a lagging Canadian economy and a more disciplined fiscal policy. Nevertheless, Canadian government bond prices are high and we have trimmed holdings to realize gains. We continue to hold Canadian Real Returns bonds which provide a stable platform, benefiting from the more volatile, inflation-sensitive fixed income markets.

The area of greatest opportunity over the past year in fixed income markets has been corporate debt (the credit markets) – an area where our demonstrable expertise has served clients well. Credit quality can be expected to improve in sync with companies improving financial condition. Of course spreads have narrowed as perceived risk in corporates diminished. We have realized gains on some corporate holdings. We continue to find opportunities in credit markets (for example Imperial Oil, floating rate notes) but are very quality conscious in our selections in anticipation of an increasingly challenging market.

Income Trusts

The 2004 Federal Budget introduced provisions to limit investments by pension funds in income trusts (other than real estate investment and resource royalty trusts) to 1% of their assets. We do not see this step as a major drag on the demand for income trusts since mutual funds; RRSP's and foreign investors face no limitations and have a growing appetite for the product. While many income trusts exhibit high income values relative to underlying risk we continue to find and invest in trusts which meet our equity selection and value criteria.

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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