Barrantagh

Investment Management

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- Continuing strong economic growth is now overshadowed by U.S. deficit management, rising interest rates, inflation concerns and high oil prices.

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- Rhetoric has shifted from raising rates at a "measured pace" to inflation worries. Higher U.S. interest rates are assured even though inflation concerns may be premature.

- The U.S. consumer and Asian demand remain key to global economic performance. U.S. personal spending may slow as interest rates and high oil prices register. The Chinese economy is slowing but shows no potential to sink into recession as has occurred in past cycles.

- Equity markets have made the transition from undervalued and in recovery to fairly valued and more vulnerable to negative developments.

- Corporate cash flow (earnings) growth is peaking and management's guidance on future cash flow is becoming more conservative. Nevertheless, the ability of companies to generate free cash flow is at a highpoint.

- We have selectively decreased interest sensitive issues, while focusing on companies with pricing power, quality operations and a cycle of free cash generation.

- Long bond prices have remained surprisingly resilient in the face of rising short-term interest rates and inflation rhetoric. Corporate bond spreads have narrowed to the point where valuation is a concern.

- We have adopted a somewhat defensive position, investing in high grade government issues in the mid term portion of the yield curve, and are considering Euro and pound sterling denominated issues.

Economic Headwinds – Inflation Risks, the U.S. Dollar and Oil Concerns

Economic activity is still expanding at a healthy above-trend pace even though global economic growth is moderating, Within this context we anticipate that the U.S. economy will grow in 2005 by about 3% (versus 4% in 2004) while Canada's economy will advance more slowly at around 2.5%. More importantly, the risks to growth are now skewed toward the downside, reflecting three factors:

a) The volatile nature of global currency realignments.
b) Tightening global monetary conditions led by the U.S.
c) Rising oil prices.

With respect to currency movements, the burden of U.S. dollar weakness has fallen on the shoulders of America's major trading partners. For example, the Japanese economy slid into a mini recession late last year, the Canadian economic performance has slipped, and two large Euro zone economies, Germany and Italy, posted negative growth recently.

The most worrisome issue however, is the gap between the Bush administrations expansive and expensive geopolitical goals and its apparent disregard for financial stewardship. The dollar is weak because the U.S. is running such huge trade and budget deficits. The U.S. borrows nearly $2B a day abroad, with much of it financed by foreign central banks, particularly Japan and China. This co-dependency magnifies the currency cycle with the cheaper Asian currencies exacerbating the U.S. trade imbalance and necessitating still more borrowing. The U.S.'s growing reliance on foreign central banks creates economic dependencies and capital market risks inconsistent with the nation's status as a bulwark of international stability.

The U.S. administration relies on the ongoing "stability" of these international relationships. An unnerving reminder came on February 22nd when a report by the Bank of Korea referring to diversification of its currency holdings away from the U.S. dollar created a brief panic in financial markets. Clearly creditor nations are loath to dump greenbacks since they would be cheapening the U.S. dollar further and undermining their export markets. There appears to be sufficient excess savings around the globe, particularly in Asia, to continue financing the U.S. deficit at relatively low interest rates. The Chinese economy for instance is slowing but shows no potential to sink into a recession. For now, the finance mechanism is working and well known. However, if creditors decide to change policies, it would likely precipitate a dollar crisis which might trigger a recession.

With respect to the second issue, tightening monetary conditions, the Fed has clearly stated its intention to renormalize interest rates. Capital markets have come to expect the Fed to lift rates at a "measured pace", presumably until rates reach a "neutral level" that neither helps nor hinders the economy. Of course the market doesn't know where the neutral rate lies or what range the Fed may be targeting but we believe the U.S. economy may now be entering a phase where the lag effect of higher interest rate increases will finally begin to slow U.S. and consumer spending and perhaps cool off the housing bubble. If the U.S. consumer retrenches at a time when global currencies are strong, the global economic outlook could under perform our outlook.

In the most recent monetary tightening phase, the build up of any inflation pressures has been cited. The weak dollar and rising commodity prices have combined to lift core CPI inflation from 1.1% at the end of 2003 to 2.4% in early 2005. Most economists suggest that core CPI inflation will not likely rise above 2.5% by mid year and around 3% by early 2006. Total core inflation does not appear to have "runaway" characteristics. Critical to inflation is the way that technology, productivity improvements and global competition have structurally transformed corporate pricing behavior. Influenced by these factors, it is not likely that pricing pressures will become destructive. It is a little puzzling, therefore, that FOMC statements should have alluded to inflationary pressures. In doing so the Fed has caused enough concern to cause capital market jitters. We expect the Fed to continue raising rates slowly and will monitor the accompanying rhetoric for clues as to when "normalization" of rates has been achieved.

With respect to the third concern, rising oil prices, it is surprising how well global economies are coping with oil increases. Obviously, structural shifts have occurred in the U.S. and other economies which allow high oil prices to be absorbed without runaway inflation or recessions such as occurred in 1974, 1981 and 1990. The resiliency of today's economies to high oil prices is also supported by empirical studies. According to the

International Monetary Fund, oil would have to rise to around $80 U.S. before undermining the global economy because energy isn't as large a proportion of consumer and business spending as it was historically. Energy accounts for 7% of gross domestic product in the United States today versus 14% in 1981. Furthermore, energy costs take 5% of personal disposable income today versus 8% in 1981. With low interest rates and rising incomes, Americans may flinch at higher gasoline prices but there is no sign they are about to adjust their behavior by driving less or buying smaller cars. In the business sector, U.S. government statistics suggest that energy accounted for an average of just 3% of manufacturers cost between 1997 and 2001. Certainly there are negative effects of high energy costs filtering through the systems but energy price increases are simply not as shocking as they were in previous cycles.

Equity Strategy – More Challenging

In the past, equity markets have experienced the worst performance when one or a combination of the following conditions developed; deterioration in corporate cash flows (margins under pressure, demand weakness) or increases in interest rates leading to an inverted yield curve and recessionary economic trends. While none of these conditions are in place today, it is difficult for us to characterize the present environment as particularly conducive to above trend equity market gains. Equity markets appear to have completed a transition from an undervalued point earlier in the economic recovery to a fairly valued level, creating vulnerability to negative news. One of our main concerns is the growing recognition that cash flow growth has begun to peak for the cycle and could moderate. Corporations face mounting cost pressures as materials and unit labor costs have risen and squeezed profit margins. As well, consensus estimates have turned out to be optimistic with management often guiding the streets lower with regard to future earnings. Nevertheless, we believe equities will outperform bonds and have positioned the portfolios to address the major risks as we see them.

Yield sensitive equities, especially income trusts, have performed well in a decreasing rate environment, causing excessive valuations. Going forth we believe selected business trusts will fair better than the more interest rate sensitive power and pipeline trusts, depending on the strength of their businesses at this stage of the economic cycle. Many of the power, utility and pipeline trusts have minimal growth, almost 100% payout ratios and trade at yields that would suggest they are as safe as owning a 10 year government of Canada bond. Above average in-flows into the trust sector in the RRSP season and the development of new trust funds likely contributed to rising trust prices. Given this backdrop and the current rising rate environment, our fundamental analysis supported reducing our allocation in the income trust group, specifically the utility and pipeline area. We favour business trusts such as Yellow Pages Income Fund and Liquor Stores Income Fund due the stability of the businesses and the opportunity for above average growth.

To deal with the possibility of a decline in strong oil and gas prices, we look for well run companies with significant underdeveloped land holdings, giving the potential to rapidly grow production volumes (mostly by drilling) at a reasonable cost. Cyries Energy Inc. is a good example. Even if commodity prices retreat somewhat this company can achieve cash flow growth (create shareholder value) because their high production growth can offset the impact of lower product prices.

In an environment marked by rising interest rates and slowing cash flow growth, valuation multiples will likely come under pressure. The result may be that stock market returns fall short of cash flow growth. It is important therefore in selecting equities to look for companies with pricing power. The material sectors stand out in this regard. Given current levels of commodity prices, producers of basic materials such as metals are able to generate significant cash flow for redeployment into projects or in other ways to enhance shareholder value. Companies such as FNX Mining Company Inc. stand out in this regard. FNX can self finance the development of its' producing reserves in the Sudbury area, if it so chooses, while taking advantage of the existing infrastructure that exists in this area for mining companies.

For a more detailed explanation of our commodity view and long term outlook, we encourage readers to peruse an article we authored for the December 2004 issue of Benefits Canada Magazine entitled, "Capital Cycles 2005". You can find a copy on our website at www.barrantagh.com.

Fixed Income Strategy – Corporate Market Overbought

The big surprise in fixed income markets is the failure of long term rates to rise as fundamentals suggest they should. As discussed, the U.S. economy is strong, core inflation has risen, the twin deficits have widened, the U.S. dollar is weak and the Fed has raised rates 175 basis points. So far given these trends, long term U.S. interest rates should have risen more convincingly. At 4.5% U.S. ten-year treasury yields have barely changed from a year ago. The "conundrum", to quote Fed Chairman Greenspan, of intransigent long rates has several explanations. First, pension funds are active buyers of safe long-term assets to match liabilities and there is a lack of long bond product. This creates upward pressure on bond prices and therefore downward pressure on yields. Similarly, professional market participants are still taking advantage of the opportunity to borrow short and invest in the long end of the yield curve (the "carry trade"). More Machiavellian is the possibility that the bond market has doubts as to the sustainability of the economic expansion and whether inflationary concerns are warranted. We believe there is some validity to the argument that the flattening of the U.S. curve reflects the fragility of the U.S. economy. Finally, and most importantly, foreign central banks continue to be enormous buyers of U.S. bonds. Total central bank dollar reserves have risen by more than $1 trillion dollars over the past three years.

The failure of long rates to rise has undoubtedly been an important contributor to the solid U.S. economic performance over the last year or more. Low long rates have also induced credit spreads to narrow and have been a factor in the strength of the stock market. To this extent, Fed tightening so far has not in fact resulted in much actual tightening. We expect these conditions to change to some degree in the future. If the long end continues to resist, the Fed will have more work to do at the short end.

Turning to Canada, the Bank of Canada does not share the precarious imbalances whose eventual unwind represent a major risk to the U.S. treasury market. Canada enjoys both a budgetary and current account surplus (at the Federal level) with no savings shortfall in evidence. In our view, domestic fundamentals should be broadly neutral for the Canadian bond market and the primary risk to the Canadian market derives from the far more uncertain U.S. outlook to which Canada is unavoidably tied.

Strategically, the corporate bond market has served us well. But corporate spreads have narrowed to the point where valuation has become an issue. In fact, we have been taking profits on some of our corporate bond holdings. At the moment, corporate bond markets reflect a degree of indecision with credit spreads perhaps in transition to a widening phase reflecting rating agency warnings and peaking corporate performance. We expect better priced investment opportunities in corporate bonds to emerge over the next six months. In the meantime we have adopted a somewhat defensive position, investing funds in high grade government issues largely in the mid term portion of the yield curve. The recent scrapping of foreign content restrictions in registered pension plans and savings plans will likely lead to greater Canadian interest in global bond markets and to greater interest in Canadian markets by foreign issuers. A time will undoubtedly come when foreign fixed income markets will demand consideration. At present, Canada's relatively favorable bond outlook is compelling but we are beginning to consider Euro and pound sterling denominated issues.

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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