Barrantagh

Investment Management

CAPITAL MARKETS REVIEW
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- Global growth generally remained strong through the beginning of 2007 but worrisome fault lines in the U.S. economy (housing, industrial output and labour productivity) threaten to derail the trend.

- Following the steep decline in growth in late 2006, the U.S. economy is experiencing further duress from the housing meltdown, a potential consumer credit crunch and a weak manufacturing sector.

- A steep decline in U.S. labour productivity, until now a strong growth driver, is particularly troublesome.

- Mr. Bernanke faces the dilemma of a weak U.S. economy but persistent inflation above his target levels. Since June of 2006 he has put his tightening program on hold. Meanwhile, interest rate increases in Europe, the U.K. and China have been implemented.

- In our equity strategy, we have made portfolio adjustments which take into account the risks to the U.S. economy. Our holdings include companies which will prosper in a maturing to weakening economic cycle. We continue to find value in companies with global business reach, leading industry positions and free cash flow generating capacity.

- In North American bond markets we expect slowing economic growth to eventually reduce inflationary pressures and short term interest rates to fall as the Federal Reserve eases monetary policy. In the corporate market, spreads are beginning to widen. Near term, we have reduced exposure to corporate credits and repositioned in government issues to take advantage of what we believe are the highest overall return opportunities.

Economic Outlook – U.S. Weakness Accelerates

The global economy ended 2006 on firm ground, marking the third year of strong performance. This trend continued in the 1st quarter of 2007. As we study what may change, one country stands out – the United States where recession fears are mounting. Foremost among broadly-based statistics is the U.S. Conference Board's index of leading economic indicators (LEI) which has ground steadily lower (0.5% drop in February), to levels not seen since the 2001 downturn.

The most important factors working against the U.S. economy are homegrown. First, the downturn in housing and the subprime mortgage debacle remains a clear threat. The critical question remains as to whether this housing recession, will morph into a general economic retreat. In the fourth quarter, residential investment fell 19%, subtracting 1.2 percentage points from U.S. growth of 2.2%. A large concern is that a tightening of lending standards in the mortgage market will further exacerbate the downtrend in home sales and prices. Recognizing that housing cycles are typically long and the bottom of this one has probably not been reached, the U.S. economy could be faced with a protracted period of sub par growth, perhaps below 2%.

Secondly, the recent slowdown in U.S. productivity gains is a concern. Throughout the expansion, strong productivity gains have given the economy more scope to grow without inflation concerns. However, for the first time in a decade, productivity is declining. It is down to 2.6% per year at the end of 2006 from a peak of 3.4% in 2004, and the pace has dropped recently to only 1.6% annually, close to a ten year low. Reasons for the slowdown are complex but economists point to a slowdown in the pace of investment in technological innovation at a time when wage costs and employment are steadily increasing.

Another risk to the U.S. economy is a major swing in corporate sentiment that cuts into both capital spending and hiring. Corporate outlays have been a key support to economic growth but there are clear signs that capital spending is slowing. Capital goods orders fell 1.2% in February following a 7.4% slide in January.

Paradoxically, the U.S. consumer, so far, has proven to once again be largely impervious to worries over the housing slump and recession fears. This consumer strength appears to be attributable to a growing work force (jobless rate remains low at about 4.5%) and rising wages in most sectors of the job market. Finally, overall household balance sheets are also in excellent condition.

Over the next few months, the role of the U.S. Federal Reserve will be critical. Mr. Bernanke faces a daunting challenge posed by the gradual undoing of the high growth/low inflation utopia of the early 2000's and the shift to an environment of faltering economic growth but persistent inflation (2.3% rate in February) at higher levels than the Fed's comfort zone of 1% to 2%. The policy makers' March 21st statement indicated the Fed is still more concerned about rising inflation than it is about a weaker economy. Investors had been expecting the Fed to cut rates later this year but current forces at work in the economy may rule that out. For now Mr. Bernanke's monetary tightening campaign is on hold, but his rhetoric contains statements that inflation is "uncomfortably high", while acknowledging that economic uncertainties are increasing.

Balancing the pluses and minuses, the sustainability of the global expansion appears to be holding but cracks are showing. While we are not in the recession camp at this time, we are acutely aware of this economic backdrop when making investments for our clients.

Equity Markets – Selectivity Key

In our last capital markets review, we commented that markets seemed largely impervious to mounting risks and we pointed to a host of factors which dictated caution. We have also repeatedly commented that markets have become more volatile at this stage of the investment cycle. Of course, neither we nor anyone else had any inkling that a steep one-day global stock market sell off would occur (3.5% drop in the S&P 500) on February 27th, triggered by the 9% meltdown of the Chinese stock market.

At first glance it is comforting that a week after the February 27 correction, the world's main stock markets had made up much of the lost ground and have shrugged off some of the negative economic data that has come to light recently. Weakness in durable goods, a sharp decline in fourth quarter productivity growth, and rising unit labor costs have been largely ignored. Even more puzzling to us is that some areas of the market appear reluctant to factor weak economic prospects into their earnings expectations. While fourth quarter earnings for S&P500 companies demonstrated an impressive 11.7% increase from a year earlier, the earnings outlook ahead for many industries is much more subdued.

On the surface, North American equities may look inexpensive. However, margins are at historically high levels and investors must remember that profits are cyclical; running above the long term trend as the economy peaks and below trend as it bottoms out. It follows that investors need to discern which companies are reflecting an overly optimistic view of their potential and therefore are overvalued versus company stock prices which do not currently reflect their long term potential. This approach inevitably helps to limit the downside during volatile periods.

In our view, those equities most likely to outperform the market in this environment are well established, stable entities that continue to have prospects for growth. We have positioned the portfolios we manage in stocks exhibiting these features, for example – FNX Mining Company Inc.

FNX is a nickel producer in the Sudbury region which spawned from Inco, one of the worlds largest nickel producers. FNX first caught our attention back in early 2005 because of its valuation and potential production growth profile which is highlighted by the estimated 40% rise in ore production for 2007. FNX has benefited from the rise in nickel prices as the endless need for stainless steel (the primary use for nickel) from newly minted manufacturing facilities in developing nations such as India and China continues to grow. The company continues to have well delineated growth opportunities within its exploration development limiting the need to seek growth through acquisition while commodity prices are high. FNX has also benefited from the takeover euphoria which has developed in the commodities market. As more and more players consolidate, it leaves FNX as either a target or a stand alone, pure producer, with one of the best growth profiles in the industry trading at one of the lowest valuations.

Another company that exhibits good fundamental parameters is a well known brand, McDonalds Corporation. When we first researched McDonalds Corp three years ago, consensus suggested that the company had little growth opportunity and was under attack by consumer food groups (remember the movie Super Size Me), so it was trading at very cheap valuation multiples especially when you consider the value of its global brand. Upon further investigation we realized that a major overhaul was taking place throughout the company. Management, restaurant design, menu and locations were all being reviewed with an eye to change. In fact, normally thought of as a US company, our analysis suggested there could be a large growth opportunity in Europe and Asia. We are gratified to see that recent company financial releases support this view and it is being reflected in a strong stock price.

Fixed Income Markets – Remaining Defensive

Fixed income investors are paying particularly close attention to the Federal Reserve Board's outlook for inflation versus the state of the economy. However, in this cycle, reading Mr. Bernanke's next move is particularly difficult. The Fed faces the classic dilemma of persistent inflation and slowing economic growth. Looking at the personal consumption expenditures deflator, a closely watched core inflation indicator, it is apparent that inflation is accelerating. The PCE measure reported on March 29th was above expectations and pushed year over year inflation to new highs for the current economic cycle. At the same time, for all the reasons discussed earlier, the U.S. economy is slowing. In response to this scenario, commonly called stagflation, the Federal Reserve has a quandary. If it cuts rates too soon, inflation is likely to accelerate further, while raising rates places additional pressure on an already weak economy.

The response of the Federal Reserve so far has been to suspend its monetary tightening campaign and leave the Federal funds rate at the level of 5.25%. On the inflation front, Mr. Bernanke has reiterated that the Fed's current monetary stance is likely to foster a gradual ebbing of core inflation to less than 2% in 2008. However, the Fed Chairman has also emphasized that he has not shifted away from an inflation bias, leaving bond investors in a quandary as to which direction the Federal Reserve will take over the next several months. It is this uncertainty that has led to a steepening of the yield curve during March. (i.e. two to seven year rates have fallen while longer term rates have risen).

Specifically, the yield on two year U.S. treasuries has declined over 20 basis points from 4.8% to about 4.58% while the yields on ten year and thirty year bonds have increased about 10 and 17 basis points to 4.65% and 4.85%. At first glance this shifting of interest rates over various terms to maturity does not appear to be overly significant from an investment point of view, but there are strategic implications to these shifts. Recognizing that the U.S. economy is in a state of flux with a rising risk profile, and bearing in mind that the Fed remains "data dependent", the most important strategic focus has been to reduce the portfolios vulnerability to unforeseen negative influences. Accordingly, we have taken steps to raise the average credit quality of the holdings by selling lesser rated credits and replacing those bonds with higher rated governments. We have also reduced the dollar weighted duration. While we have established small positions along the yield curve from 4 to 22 years, the bulk of active investment is in the five to seven year area. As the policy direction of the Fed becomes more transparent we will make adjustments as required.

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.

For more information contact:
Barrantagh Investment Management Inc.
(416) 868-6295

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