Barrantagh

Investment Management

CAPITAL MARKETS REVIEW
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- The U.S. economy has deteriorated markedly as the worsening housing downturn and the deepening credit crunch begin to take a toll on employment, consumer spending and confidence generally.

- Globally, growth in developed economies with close economic ties to the U.S. is slowing while emerging economies, notably China and India, have so far largely escaped contamination from U.S. economic woes.

- The credit crisis has morphed from a credit quality/liquidity problem to a system-wide funding issue for banks and other financial intermediaries involved in structured credit markets. De-leveraging and a tightening of lending standards have raised financing costs for consumers, hedge funds and even corporations.

- A very determined U.S. Reserve has launched innovative programs of emergency funding to banks to underpin the financial system while also aggressively cutting interest rates. The resolve of the Federal Reserve should facilitate a normalization of credit markets in time and encourage an orderly recapitalization of the banking/mortgage industry.

- Equity markets are extremely reactionary to day-to-day events and the volatility obscures the fact that fundamental values are emerging. Over time we expect portfolios to migrate from the current defensive posture to more economically sensitive companies as the credit crisis abates and the extent of the economic downturn can be assessed.

- In fixed income markets we have prudently over weighted high grade government bonds for some time, but have been careful to avoid overpriced shorter term government maturities which have been overbought as investors rush to safety. In corporate bond markets, spreads have continued to widen and the repricing cycle is not yet complete. Accordingly, we have not yet committed client funds to corporate issues even though valuations in some segments are becoming more compelling.

Economic Backdrop – Economic Woes Build

The economic outlook has deteriorated significantly across North America and globally, in 2008, as contagion spreads to the broader economy from falling U.S. house prices, high oil prices and the deepening credit market crisis. The U.S. economy advanced a meager 0.6% annual rate in the fourth quarter of 2007 while Canada's economy grew at 0.8%, this country's weakest growth in over four years. Recent economic data suggests that a U.S. recession is virtually inescapable. Service sector activity in the U.S. has plunged to a decade low while non-farm payroll statistics for January and February indicate job losses of 74,000. The drop in home sales and house prices is unrelenting. Furthermore, retail sales fell by 0.6% in February and consumer confidence has fallen 29% since December to a five year low.

On the global economic front, growth is following divergent tracks this year as industrialized nations dependent on the U.S. gear down, while developing countries have so far escaped contamination from U.S. economic woes. It is apparent that developed economies outside the U.S. are not immune to a severe U.S. slowdown or the U.S. credit market turmoil. Worrisome signs of a U.S. led slowdown are evident in the Euro zone where trade has been slipping and in Britain where growth is stagnating. In Asia, Japanese growth has slipped into negative territory. Among emerging economies cracks are showing but China will lead the way with 9.4% growth expected in 2008. Several other developing countries will grow by 5% or more including Russia and oil rich OPEC nations.

Clearly the toxicity of misunderstood credit derivative products which originated in the subprime mortgage market continues to spread insidiously. The Federal Reserve's brokered sale of Bear Stearns & Co., the fifth largest investment bank, to J.P. Morgan Chase & Co. for a fire sale price demonstrates that debt market liquidity problems have morphed into a funding and solvency problem for banks and investment firms. The financial world has now entered a "black hole" of prolonged and painful risk aversion, de-leveraging and credit product revaluation. The longer term effects will be tighter lending standards, extended balance sheet rebuilding in the banking industry and increased regulatory scrutiny as the "shadow banking system" is exposed and reorganized.

A leading question is how effective the central banks will be in staving off a U.S. recession and its repercussions globally. Optimists point to the world's recovery from the 2001 recession when the U.S. Federal Reserve slashed interest rates from 6.5% to 1% while the European Central Bank lowered rates from 4% to 2%. This time the Federal Reserve has acknowledged the limitations of lower interest rates to mitigate the damage to the economy from dysfunctional credit markets and capital constrained financial intermediaries. It has attacked today's issues with an unprecedented double-barreled approach, coupling innovative ways to pump liquidity into credit markets, with the traditional monetary tool of lowering interest rates. So far a very significant $400 billion has been earmarked for emergency lending facilities including a $200 billion arrangement to exchange treasury bonds for risky mortgage backed securities. At the same time the Fed has aggressively cut the Fed funds rate by 200 basis points so far in 2008 with further monetary stimulus suggested if needed. In an even bolder move the Fed also invested $30 billion into Bear Stearns as part of the rescue by J.P. Morgan Chase, marking the first time since the 1930's depression era that the central bank has directly funded a financial institution.

Of course, these new liquidity actions alleviate panic and buy time in the short run but they cannot force markets to work or prevent the inevitable credit tightening that will follow from a more cautious banking sector. In the meantime, capital markets will remain nervous and extremely reactionary to events as they unfold. In the final analysis, market dynamics will play the major role in purging the credit markets but the powerful intervention by policy makers will be the catalyst for normalcy in the economy.

Equity Markets – Values Emerging

As pointed out in our last investment review we expected a high degree of volatility and commented that volatility would create opportunities. Accordingly we have been closely monitoring the market correction and are engaged in a disciplined process of scoping out specific stocks where valuations are compelling from a longer term perspective because of the dichotomy that the volatility creates. We believe that with the benefit of hindsight, it will become apparent that the current dire environment has created unusually good values in certain companies. That does not mean that equity markets as a whole do not have the propensity to decline further from here which is a compelling reason to stay patient. The constructive array of monetary tools unleashed by policy makers will take time to work. As well, traditional monetary policy will eventually stimulate the economy, and fiscal policy measures, as outlined by President Bush, will also provide support. Furthermore, as pointed out in our last review we expected earnings disappointments to become more common, and they have, with average estimates of 8% declines in the first quarter of 2008, replacing previous average estimates of 5% growth. Certainly the rising level of earnings warnings by reporting companies is disconcerting. All economic downturns are characterized by shrinking profit margins and we believe margin contraction is just beginning for many companies. Accordingly, valuation ratios, though lower than in 2007, may still be unreliable when using analyst's forecasts as a denominator. Therefore we continue to prudently project our own estimates for companies using a much longer term view.

The energy industry is a good example of the dichotomy in the market. With oil prices having soared well through $100 per barrel many investors feel that it is a great time to invest, while others feel that the commodity has peaked and it is time to sell. Upon closer inspection, fundamental analysis reveals that not all companies have been treated equally in the energy sector. Natural gas companies have been hit particularly hard. In Canada, natural gas producing companies have had to deal with the rising Canadian dollar, high drilling and maintenance costs and non-complementary royalty rate changes similar to oil companies. However, unlike oil companies which benefited from increasing commodity prices to offset escalating costs, gas companies have witnessed depressed commodity prices, resulting in the widest historic spreads ever witnessed between gas and oil prices in North America. This was the result of perceived, large LNG (liquefied natural gas) shipments, discoveries in the Gulf of Mexico and surprising shale gas discoveries and production in the U.S. We do not believe this spread can continue for the long term simply because oil and gas are direct substitutes for each other. In other words, in the short term prices may vary, but in the long term, each commodity will be affected by the others actions. As these short term changes work through the system, gas prices should increase to levels which better reflect the substitutability with oil and will accordingly reflect positively on natural gas producing companies such as Celtic Exploration and Galleon Energy Inc.

Other attractive long term opportunities have developed in the media sector. Companies such as Telefonica, a global telephony player, or Shaw Communications, a Canadian cable operator exhibit great value. In the case of Shaw, the company is trading at 6.5 times cash flow which compares favourably to average historic multiples of 9 to 10 times cash flow. As a cable company, Shaw has grown its cash flow by over 20% per annum over the last five years and currently supports free cash flow levels of over $1 per share or more than $450 million per year. Excess cash flow gives the company ample opportunity to use this capital in value enhancing ways such as paying down debt, continuing to increase the dividend per share, buying back shares or growing in attractive, complementary areas such as the wireless space.

Although the press suggests that the situation is dire, we believe the cure is already in the system and patient investors will be well rewarded.

Fixed Income Markets – Defensive Stance Remains

The combination of a difficult phase for North American economies, and ongoing stress in credit markets has driven fixed income investors deeper into safe haven investments. Consequently, the demand for government bonds is virtually insatiable, especially for issues of short term maturity, causing yields to continually move down. In the U.S. two year treasury rate now offers a yield of less than 2% down from 3% at the end of 2007 and less than half the yield of one year ago. The ten year treasury has also declined, albeit less dramatically, to 3.9%. Bond markets have also reacted strongly to the rapid adjustment by the U.S. Federal Reserve away from its historical gradualist approach by implementing deep cuts in quick succession to the Fed funds rate.

The behavior of investors and the actions of the Fed have prompted both a pronounced steeping of the yield curve and a downward shift in yields across all maturities. The slope, as measured by the spread between 2 years and 10 years is now about 192 basis points.

In the Canadian government bond market, bond price movements have been less dramatic reflecting the fact that the Canadian economy does not face a housing crisis and the credit crunch is not as threatening as in the U.S. As well, domestic demand remains strong and the commodities boom has greatly benefited the economy. Nevertheless the new Governor of the BOC, Mark Carney, recently expressed concern with the vulnerability of the Canadian economy to U.S. and global weakness. On March 4th the BOC cut its target rate 50 basis points to 3.5% in what was regarded as an uncharacteristically bold move. The yield curve in Canada has also steepened, albeit less dramatically. The 2 year to 10 year spread is about 100 basis points with two year yields around 2.5% while the yield on ten year Canada's is about 3.5%. This compares to a relatively flat yield curve at the end of 2007 when two year Canada bonds traded above 3.75%.

Turning to the corporate bond market, we anticipated a dramatic widening in spreads for some time and that has now occurred as investors react to the deepening turmoil in credit markets. Spreads on even the highest rated bonds have widened from 54 basis points at the end of 2007 to about 83 basis points today while spreads on lower investment grade bonds have ballooned to 250 basis points from 158 at year end. Credit markets are still inclined to reprice issues downwards (i.e. – spreads continue to widen) driven by the ongoing unwinding of leverage on structured investments vehicles and ongoing ratings downgrades of bond insurers and credit products.

Reflecting the divergent trends in government vs. corporate bond markets, we have been very careful to position client portfolios in areas of the government market that mitigate the steepening of the yield curve and offer a reasonable tradeoff between yield and capital protection. Our current durational exposure remains markedly lower than that of the broader market. On the corporate bond front, we do not yet see sufficient signs of stabilization in markets and a return of confidence in the quality of the issues (for example the debt of our banks) to justify commitments.

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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