Barrantagh

Investment Management

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- The global recession, the worst in post war history, has probably advanced to the "eye of the storm" stage and may be at its lowest point.
- Through early 2009 President Obama and his team have taken bold action to grapple with the enormity of the economic and credit market crisis. The President's controversial $819 billion package of spending and tax cuts, central to his rescue efforts, recognizes that fiscal stimulus on an unprecedented scale while not a long term solution, is indispensable given the depth of the economic recession.
- Team Obama's bold policy initiatives imply a huge expansion of the Federal Reserve balance sheet as a policy tool now that conventional monetary policy has brought the Fed's target rate to zero.
- Economic reports will continue to be bleak in areas of employment, industrial output and global trade but with trillions of dollars now committed by the U.S. Administration and central banks globally, leading economies are poised for a recovery as the year progresses. Evidence of a recovery, albeit somewhat tentative, can be seen in the key areas of housing, retail sales and credit markets.
- The global de-leveraging process, a more frugal consumer, lower inflation, greater regulatory oversight and a hint of protectionism around the globe present headwinds for economic and earnings growth.
- Equity markets remain volatile and broad areas of the markets should still be avoided but we hold the view that, given the current valuations in the market, selective commitments to quality equities will be rewarded over a mid to longer term time frame.
- In the fixed income area, spreads in some subsets of the corporate bond market have narrowed and the opportunity to move selectively from government bonds to quality corporate issues has become more compelling.

Economic Backdrop – Obama to the Rescue

Economic reports over the last quarter confirm that the global recession is more severe and more widespread than originally forecast. Sharp GDP declines in the fourth quarter of 2008 evidence the extent of the downturn. For example, America's GDP shrank at an annualized rate of 6.2% revised down from 3.8%, while Asia's emerging economies experienced steep 15% GDP declines. China's growth fell to 6.8% in the fourth quarter, the slowest pace for seven years and a sharp drop from the 13% growth rate in 2007. Through the first quarter of 2009, the pace of global economic contraction has probably slowed somewhat but the cycle of extreme weakness in financial markets and global economies has yet to be broken. Looking ahead, the International Monetary Fund (IMF) and the World Bank expect 2009 to be the world economy's worst year since 1945. The IMF has reduced its forecast of global GDP to 0.5% from 2.2% predicted last November.

Clearly the links that bind economies and countries together are under strain. World merchandise trade is forecast to shrink 9% this year, the first decline since 1982, and global manufacturing is in decline. For instance, factory output declined over 7% in the U.S. in 2008. Around the globe only China was in positive territory. As well, net private sector capital flows to the emerging markets are likely to fall to about $165B from a peak of $929B in 2007. Most critically the labour market globally hasn't looked so bleak since the 1981-82 recession when the jobless rate peaked at 10.8%. At the recent pace of payroll declines, more than 550,000/month, America's unemployment rate is now above 8.0%. Unemployment is also rising around the world. Even in China, millions of migrant workers have been forced to return to their family farms as dozens of manufacturing plants become idle.

As widely reported, the U.S. administration and governments everywhere have stepped up their economic rescue programs. President Obama's massive $819B domestic economic stimulus plan is central to the strategy. About 40% of the package (about 2.5% of GDP) will be direct government spending and tax cuts in 2009 with the remaining 60% arriving in 2010 and beyond. Obviously the plan envisages an ambitious and costly expansion of the government's role in the economy. To pay for these plans and return the deficit to manageable levels, Mr. Obama will return top tax rates to pre-President Bush levels, reduce tax deductions enjoyed by the "wealthy" and increase corporate taxes. Underlying Mr. Obama's plan is the assumption that the economy will only shrink 1.2% this year and then grow by an average of 4% over the following 4 years. Hopefully these projections are not overly optimistic.

Stimulus packages are taking many forms. Initially there was TARP (Troubled Asset Relief Program) to promote financial market stability although the details were never clearly conveyed. The TALF (Term Asset-Backed Loan Facility) program was announced to assist the credit needs of consumers and small business. There is the PPIP program (Public Private Investment Partnership Programs) set up to further the clean up of toxic assets such as mortgage backed securities on bank balance sheets. "Quantitative Easing", a program employed by the Federal Reserve, whereby it will buy up to $300B of treasury bonds in an effort to pump liquidity into fixed income markets and bring down interest rates even further, especially on the long end of the curve. Many other programs with 3 and 4 letter acronyms exist or have been announced totaling $13 trillion or roughly equivalent to the U.S. GDP. This does not even consider what other nations are committing to resolve the crisis.

From an overview perspective, the trillions of dollars being committed by the U.S. and other nations globally to avert an even deeper recession and normalize credit markets will take time to work but it is difficult to imagine the results won't ultimately be positive. Given the enormity of the economic and financial systems problems, the U.S. Fed's innovative and bold use of its balance sheet as a powerful instrument of policy appears to be appropriate. In our analysis, the determination of the U.S. and other governments to succeed combined with the Fed's unique ability to increase money supply while leading other central banks by example, makes it a question of when, not if, these policies will work.

Equity Markets – Encouraging Rebound

Following the steep sell off in late 2008, equity markets have continued to trade with a net downward bias although various markets and sectors have seen a recovery off their lows of last November. Year-to-date the MSCI World Index has declined 11% and the S&P 500 about 10%, while the S&P TSX Composite faired better with a 3% decline. At this juncture volatility remains extreme with markets highly sensitive to any announcements on Team Obama's various rescue programs as well as news flow on the state of global economies and credit market conditions. Investors are also reacting to specific developments on the fortunes (or lack there of) of leading companies in finance, the auto industry and industrial products. For example, at the macro economic level, Mr. Obama's fiscal stimulus program was initially perceived as unfocused and lacking in detail and therefore was not well received by the markets. A week later the U.S. Treasury private/public equity plan to rid the banks of toxic assets received a favorable reaction from markets and the S&P 500 surged about 7%.

What recent market moves demonstrate is the major role played by confidence (or perhaps, the lack of it) in equity markets. Fear and uncertainty has sent investors into retreat and restoring confidence may be more difficult than in past recessions because the economies recuperative powers continue to be undermined by the financial crisis. Washington's far reaching policies are critical to the economic healing process and the restoration of capital market confidence. Meanwhile, there are signs, albeit somewhat tentative, that investors are looking through the recession and looking for opportunities to deploy the hoards of cash that have built up since the recession began. More importantly, better than expected U.S. February retail sales data along with a significant upward revision to January spending reinforces our view that the consumer has stabilized somewhat. As well, data on the U.S. housing market indicates the worst of the housing collapse may have passed, even though housing prices are still eroding. We recognize that these early signs require much more positive confirmation from other areas to confirm a healing economy. In that regard, early indicators like the Institute for Supply Management Manufacturing Index and the Conference Board's Index of Leading Indicators, which track changes in economic output, are beginning to plateau after many months of steady downturns.

On the corporate front, the latest message from leading indicators is that corporate earnings will most likely suffer in 2009 relative to 2008 as profit margins narrow and revenues are more difficult to generate. As for TSX listed companies, those engaged in commodity businesses face a sharp earnings downturn, reflecting the collapse in commodity prices and the gathering slump in the domestic credit cycle. More broadly, the global de-leveraging process, a more frugal consumer, lower inflation, greater regulatory oversight and a hint of protectionism around the globe present headwinds for economic and earnings growth. Accordingly, selectivity is all important but does suggest that for the longer term, larger companies with dividend paying stability may be in vogue.

Building on this and recognizing that equity markets anticipate recoveries as discussed in our last review, we have been actively screening markets for companies that meet our investment criteria including a healthy dividend yield with growth and/or share buybacks; a high quality balance sheet with the ability to self finance; high barriers to entry and pricing power in a low inflation environment which usually coincides with aggressive inventory management; and long term potential to improve their competitive position and grow cash flow. Ironically, many of these characteristics were ideal for the defensive investing environment we just encountered.

Typical of companies that have made our focus list is VISA Inc. a name which is familiar to most people around the globe. VISA generates revenue through both credit and debit transactions. The company has no credit exposure, which is maintained by its distribution partners; the banks. VISA has displayed historic growth rates in excess of 20%, has a solid balance sheet with a growing dividend and strong competitive advantages. The company is currently buying back shares and has positioned itself for continued long term stable growth as on-line purchases and plastic transactions worldwide continue to grow.

Fixed Income Markets – Spotlight on Corporate Issues

The Bank of Canada has inched away from its previous optimistic forecasts for the Canadian economy, and has cut administered rates further. Discussion now centres on whether "Quantitative Easing" will be employed in Canada. Rumours abound that the Bank of Canada may try to buy corporate issues in reverse auctions similar to those employed in the U.S.

The Canadian government bond yield (GOC) curve, while slightly steepened from the end of 2008, is little changed through the quarter. However, this description masks the underlying activity during the quarter. In the first two months, 2 year through 30 year yields rose significantly as the market struggled with inflationary worries and an overly optimistic Central Bank. In March, yields fell back to roughly the same levels seen at the end of the year. Price volatility was unusually high, despite the apparent small yield movement.

As we anticipated at the end of last year, the corporate market in Canada has begun to offer some attractive opportunities. There has been some improvement in credit markets with lower inter-bank lending rates and declining spreads in some areas of the corporate bond market. Canadian banks have issued Tier 1 innovative capital debt and the major life insurance companies have issued new senior and subordinated debt. All of these new issues have come at fairly compelling spreads (amount of excess yield above GOC bonds) and have seen successful launches. New issues have generally met with strong buying interest causing much buyer disappointment with the allocations or the limited amount of bonds they ultimately receive versus what they craved. Furthermore, the success of these new issues has been given a boost by the substantial new issue concessions (enhanced yields) paid by the issuers. Only one Canadian bank has not issued in the Tier 1 market, despite a shelf filing some months ago. Bank of Nova Scotia remains on the sidelines, but may yet bring an issue to market.

Despite the activity mentioned above, the non-financial corporate market in Canada has remained constrained by limited new issue supply causing investors to hoard older or existing non-financial corporate bonds. This has created a tightening (lower yields) in non-financial issues because of the lack of supply and has also created a relatively illiquid market demonstrated by low trading volumes.

We have increased our investment activity in the corporate bond market and remain very aware of the importance of buying issues that offer true value. We expect there will be more opportunities to buy good quality corporate issues at attractive new issue or secondary market spreads as investors continue to assess the ongoing coordinated credit and economic stimulus efforts by governments around the globe.

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