Barrantagh

Investment Management

CAPITAL MARKETS REVIEW
FIRST QUARTER 2010

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- Although somewhat fragile, the world economy is making a transition to self-sustaining growth with large emerging economies displaying the best opportunities for growth. More importantly, the economic expansion continues to broaden globally.

- Concerns regarding sovereign credits have become a focus. The size of government debts relative to carrying capacity, not only become a drag on economic growth, but country defaults become a real issue. Portugal, Ireland, Italy, Greece and Spain (the PIIGS) are the latest examples.

- The US economy is being helped by industrial activity and exports but a muted outlook is still warranted given limited job growth and a fragile housing market. Should unemployment numbers and retail sales continue to improve, a more positive outlook would be forthcoming with the US contributing a larger part to the overall global recovery.

- Geopolitical issues such as currency, trade, and the aforementioned sovereign debt problems threaten to distract governments from focusing on economic healing while heightening protectionist policies.

- Much of the volatility witnessed in the first quarter of 2010 in the equity markets is due to economic, political and geopolitical events. As these events passed, investors focused on company valuations and their strength in the current economic environment, to help lift markets into positive territory.

- Canadian fixed income markets are reflecting a higher probability that our central bank will move rates up before the US, as indicated by the rising value in the Canadian dollar. With the possibility that rates do move higher, we remain committed to corporate bonds within our clients' portfolios to enhance returns.

Economic Backdrop – Growth Transition Broadens

Economic data through the quarter provides further evidence that the global economy appears to be making an important transition to self-sustaining growth, that is, growth no longer buttressed by massive government programs. Large emerging economies are in the best shape, with strong growth in domestic demand and scant spare capacity. Countries such as India and Brazil have put the downturn behind them. India expanded by 6% in 2009, supported by a strong fourth quarter boost in manufacturing. China's rapid economic growth continued in the fourth quarter of 2009 with an annualized GDP of 10.7%. Although China's economy is vulnerable to a clamp down by bureaucrats, there are few signs that the reigning in will be too much too fast. Importantly, the global expansion has become more broadly based as the year progresses. GDP in the Euro area grew by 0.1% in the last quarter of 2009 marking a fragile economic turnaround. Even the United Kingdom finally eked out a quarter of 0.4% positive growth while Japan's GDP expanded by 1.1% in the last quarter of 2009, led by a rebound in exports.

Unfortunately, in the world's richest economy there are limited signs of strong private demand growth. America's latest buoyant GDP figure (5.6% growth in the fourth quarter of 2009), while a positive development, does not likely herald a high growth trend. Much of that expansion occurred because of inventory rebuilding and a surge in business spending that are not believed to be sustainable. The two laggards, housing and the labor market, still stand in the way of a more robust U.S. economic recovery. Sales of new and existing homes fell in February indicating that the housing market, although slowly improving, still suffers from excess supply and low construction spending. At the end of March the Fed will withdraw its $1.25 trillion support of mortgage backed securities forcing housing to stand alone as employment picks up and the affordability index improves. On the jobs front, the U.S. recovery is not experiencing the degree of job growth seen in previous cycles as evidenced by only a slight improvement in the unemployment rate to 9.7% from over 10%. As well, Obama's newly approved health care plan, which forces coverage of some 32 million uninsured people will undoubtedly lead to a higher health care bill for America in spite of Obama's rhetoric to the contrary. Somewhat surprisingly, consumers, while still in "balance sheet restoration" mode, are becoming more confident and spending is picking up. Fortunately for the U.S. economy, industrial activity, exports, and business investment, are playing a greater role in this upturn than in past recoveries.

The economies around the world are clearly recovering, but considerable uncertainty exists. Most evident now is the issue of the deleveraging of marginal sovereign credits such as Portugal, Ireland, Italy, Greece and Spain (the PIIGS). For now, the agreement between European officials and the IMF on a credit support mechanism for Greece has staved off a debt crisis in the Euro zone but it remains to be seen how Greece and other debt laden countries fare in the capital markets in the coming months. Of course, America and Britain are not immune to concerns about debt dynamics (as well as economic growth issues). Across the world investors have begun to question the ability of governments to keep financing their deficits. On the re-regulation front, it will be important to see to what extent financial regulation inhibits lending to individuals and small businesses in particular.

In the area of globalization, the risk is that a long period of liberal trade policies will be reversed as countries vie with each other to achieve economic goals. For example, western companies are getting a cool reception these days in China as that country implements new trade, patent and procurement policies to promote its homegrown industries. Overall, recent months were characterized by an unusual degree of political policy making and the realization that low interest rates and massive Government stimulus are not permanent fixtures. Against this somewhat unsettled background, it is encouraging that global financial conditions are improving and capital markets have not become unstable. We believe that the positive trends in capital markets seen so far this year will continue but high volatility can be expected.

Equity Markets – Climbing Wall of Worry

The equity markets in the first quarter of 2010 seem to be reflecting the ever present battle between fear and greed. This phenomenon has been highlighted by uncertainty in the markets, developed as a result of the struggle between economic, political and geopolitical events and their affect on stocks around the globe. The last couple of years have set the stage. In 2008 the markets reacted negatively to the credit crisis and a synchronized global recession that affected all corporations, to varying degrees. In 2009, the markets reacted positively to the return of more normal credit markets and the hope that economic healing was just around the corner. The volatility witnessed at the beginning of 2010 is a result of investors torn between two scenarios; continued healing (2009) and suggestions of a double-dip economic scenario (2008).

Markets started the year on a positive note until mid-January when President Obama, concerned about his status in the polls and his health care plan, started to make campaign style speeches designed to toughen his image for the electorate and promote his promised medical reforms. Following on the heels of Obama's reinvigoration, the story of the five little PIIGS broke in the press, detailing the bailout required for these countries that had fed at the debt trough for too long and could no longer support the weight of their sovereign debt. Meanwhile, the economic backdrop to these events is trying to digest a concern that interest rates may rise after a long period of accommodatingly stimulative low interest rates. Of course, low interest rates were a key policy designed by the central banks around the globe to support the economy. Any scent of change in this policy creates uncertainty which the markets do not like and is expressed through volatility.

In the background to all of these concerns, and somewhat overlooked, is the surprising health of corporations. Companies are reporting bottom line numbers that are beating expectations because of the adjustments they have made within the economic environment. This, along with the approval of Obama's medical bill and the coordinated support shown for the Greek debt problem by the Euro countries and the IMF (International Monetary Fund) has lifted the performance of equities helping the markets to climb the wall of worry in the first quarter. For instance, the MSCI global index is up 3.4% (US$) while the S&P/TSX is up 3.1%. US markets have also performed quite well generating returns of 5.4% for the first quarter. At one point during the first quarter, each of these markets was off at least 4% before they recovered.

Our general thesis from the fourth quarter of 2009 is still relevant and has some support in recent economic data releases. We suggested that, given the vigilance which companies have exhibited during this downturn, if consumers start to increase spending, it will show up immediately in the bottom line numbers for corporations. Recent retail numbers as well as unemployment figures show indications that the consumer is very much alive, and maybe even better than many economic soothsayers would have you believe, suggesting that the market has some constructive support. In this environment, we have been patient while attempting to use the market's volatility in our clients favour. For instance, during the first quarter, the stock of Toyota Motor Corporation fell under the strain of a large recall, due to acceleration problems with which most readers will be familiar. Our analysis on auto companies over the last two years suggested that Hyundai and Toyota were the best opportunities for our clients. With the selloff in Toyota we were able to purchase the number one global car manufacturer at a cash flow multiple of 5 times. This compares extremely favourably to the historic valuation of greater than 10 times cash flow. We believe the company can define and resolve this issue and will in no way impair the balance sheet. This example illustrates our investment philosophy very well. Our primary job is to identify those companies that offer the best investment opportunities for our clients in the current economic environment. To do this, we will continue to use the market volatility to focus on what matters…. buying well run businesses, at valuations that support great long term returns, while minimizing volatility.

Fixed Income Markets – Intrinsic Value Key

The U.S. and Canadian yield curves are starting to reflect positive economic recovery but timing bias for the outlooks is apparent as the strength in the Canadian dollar seems to support. In the U.S. the economic data remains soft enough for the Federal Reserve to stay the course and basically use the same strategy as last quarter, leading the bond market to continue to expect administered rates to remain unchanged for some months to come. However, in Canada, the bond market is beginning the transition to higher short term rates as it absorbs the most recent comments from the Governor of the Bank of Canada regarding the conditionality of short term rates remaining unchanged to economic indicators remaining subdued. The movement to higher interest rates we wrote about in the last quarterly letter has begun in Canada. The Canadian yield curve has started to flatten, with most of the activity in the short end of the curve. Two to five year rates have increased as much as 40 basis points from the end of 2009 levels. On the other hand, long rates have actually declined very slightly. The Bank of Canada is now widely expected to start raising the bank rate in June or July and continue raising the benchmark rate at each meeting through the end of 2010. This will move the bank rate from the current 25 basis points to possibly 1.5 percent by the end of the year.

This new vigilance on the part of our central bank has removed some of the worry about inflation which has in turn brought down long rates, and reduced the breakevens in Real Return Bonds ("RRB"). RRBs do well when the central bank appears to be distracted from the task of fighting inflation, perhaps concerned with the need to stimulate the economy, as they have been the past few months. An environment in which the central bank is talking about a concern with inflation and the need to slow economic growth by tightening monetary policy may not be conducive to strong performance in the RRB market but we continue to diligently monitor this opportunity.

A combination of solid economic growth and a lack of significant new supply have continued to drag corporate spreads tighter. The lack of supply has meant that a growing pool of investment funds are chasing an ever shrinking number of primary and secondary issues which has ensured that there is a steady bid for most issues. Corporate spreads in Canada have retraced most of the way back to longer term (pre-crisis) levels placing renewed emphasis on the importance of credit analysis to ensure that the issues offering good intrinsic value with solid outperformance potential for returns are separated from those simply borne higher by the broad market trend.

The Maple market has returned as participants seek supply from any source including foreign issuers. As before, this market is principally the domain of foreign financial institutions, and holds little promise for value investors. To refresh: Maple issues are bonds issued in the domestic Canadian market by foreign issuers, with the proceeds normally swapped to eliminate the exposure of the issuer to the Canadian dollar and Canadian interest rates. As such it is an arbitrage market for issuers that troll the world's major bond markets seeking the cheapest swapped funding and leaves little to interest our clients.

We expect credit spreads to continue to claw tighter in our market, and believe that this will offer further opportunities to enhance fixed income returns. We remain significantly overweight in corporate debt versus governments, and do not expect that to change in the coming months.

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