Barrantagh

Investment Management

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- The economy and markets have absorbed several exogenous events in the first quarter, including uprisings by the populace in several Middle Eastern and North African countries, dealing with the aftermath of the tragic Japanese earthquake and the continuing debt watch in Europe, as several European nations try to implement austerity programs. All of these events combined will slow forecasted global GDP growth of 4.5% but will not derail it.
- The situation in the Middle East and Libya is far from over, drawing the interest of every nation as energy prices spike, creating a drag on global growth. Establishing a new order in these states, whether peaceful or not, will take time, creating uncertainty which feeds the fear that a recession is just around the corner as energy shocks have historically been a catalyst for recessions. Today, energy prices would have to move much higher to create a recession, in part because we use less oil relative to GDP than we have historically.
- The devastation created by the Japanese earthquake, tsunami and nuclear disaster will definitely hinder Japan's 9% contribution to world GDP as it deals with what will almost certainly be a short term recession, post the tragedy. History shows that there is a large pickup in economic activity when the rebuilding begins. For Japan, many are hoping that this rebuilding will be the catalyst to higher long term economic activity after two decades of subpar 1% per year growth. However, large impediments such as a declining population, stiff global competition and low productivity suggest otherwise.
- Around the globe, the economic recovery is unsynchronized for various reasons. However, in Europe, it seems the progress or lack thereof, in dealing with the debt crisis, is the culprit. To date, markets have been willing to discount this risk but progress will need to be achieved far beyond the current piecemeal approach before we can be comfortable that stable European economic growth will be achieved.
- Equity markets have taken the headline shocks in stride as companies continue to report generally positive bottom line surprises while maintaining strong balance sheets. Bolstered by increasingly confident outlooks, equities should do well relative to other asset classes over the next several months. Inflation, driven by general economic growth, higher oil prices, higher food prices and the Japanese rebuild may begin to affect equity prices later in the year.
- In response to expected tightening monetary policy around the globe, we have moved to employ real return bonds and floating rate notes while de-emphasizing government bonds.

Economic Backdrop – Dealing With Headline Shocks

As commented upon in earlier reviews the global economy has undergone a significant healing process since the financial crisis/deep recession of 2008, and the forces underlying that process, including low interest rates, the second round of quantitative easing, a healthy corporate sector, and strong emerging economic growth remain critical. Unfortunately, global events occur from time to time in an economic cycle that defy quantification and bring to light the real risks of investing in a globalized world. Since the beginning of 2011 a bewildering number of cross currents in the world economy have developed, which the markets are attempting to grasp. The list includes the direct affects of Japan's earth quake, political unrest across a large part of the Middle East, the festering sore that is the European sovereign debt crisis, a new military action in Libya led by the U.S., the ongoing wars in Afghanistan and Iraq, the U.S. budget deficit and rising oil prices.

The Japanese tragedy has thrown one of the world's most important economies off its axis underscoring that even supposedly well-prepared regions are not immune from disasters. The horrors unleashed by the earthquake, tsunami and nuclear disaster are very real and the human cost is incalculable. Economically the disaster is already causing some disruptions to production in Japan and to global supply chains. Notwithstanding the scope of the tragedy, Japan accounts for a relatively small 9% of global GDP down from 18% in the 1990's. As well, because of the rapid acceleration of growth in the BRIC countries, Japan's potential contribution to global growth is marginal. History teaches us that in well-ordered economies, Japan's problems generally prove to be short term setbacks and the massive reconstruction required in Japan will spur global economic activity. Turning to the Middle East upheaval, President Obama faces the dilemma of becoming involved in a protracted military effort to oust dictators and help establish a new order, or witnessing from a passive standpoint the disintegration of Middle Eastern countries into civil wars and humanitarian disasters. The Middle East may be a political nightmare for Obama but it does not necessarily derail global growth. Meanwhile, in Europe, the sovereign debt crisis has become messier in the wake of the resignation of Portugal's government after failing to pass austerity program measures. No one knows how the crisis will be resolved but it seems reasonable to predict that a financial implosion in Europe is not likely. The stakes are simply too high. Euro zone members will likely bicker and dither for some time to come as they have in the past but eventually they will have to agree on bailout measures.

With regard to the U.S budget deficit, there are three distinct hazards. First, the current budget battle could lead to excessively large cuts in Federal spending at a time when the economy is still fragile. Gridlock will likely negate this outcome. Second, the failure to agree on a budget for fiscal year 2011 could lead to a temporary shutdown of the government as happened in 1995. In all likelihood any shutdown would be brief, making it a large political event but a small economic one. The third hazard, whereby the government runs headlong into the national debt ceiling, though unlikely, has deeper ramifications, which President Obama and Treasury Secretary Geithner have argued logically must be raised. The debate on this issue could cause investors around the world to question whether the U.S. has lost its grip. This would damage the dollar and U.S. capital markets.

In summary, these new risks pose some degree of potential for economic dislocation, but the markets, which are a good barometer in most circumstances, are telling us that these risks will not undermine the recovery and in the final analysis are more worried about rising interest rates, as inflationary risks increase and the probability that quantitative easing will not be extended beyond its original June 30th deadline. Capital markets are also taking comfort from the fact that the flow of news on corporate revenues and earnings is generally positive. Corporations, in sharp contrast with governments, are flush with cash and the next year or so should produce sufficient growth globally to keep corporate revenues and earnings moving higher. Accordingly, putting all the issues into prospective we believe carefully selected equities will outperform other asset classes over the next few months.

Equity Markets – Absorbing Black Swan Events

As mentioned in the economics section, headline shocks in the first quarter have been abundant. After a strong start to the year, equity markets sold off due to the headline shocks that these "Black Swan" events created, and eventually moved higher to finish the quarter with very strong gains. Global markets were up 2.3% for the quarter while the Canadian equity market increased 5.5% based on strong gains by the banks and energy companies. Every investor is asking why the equity markets have done well given the news backdrop during the first quarter and how can the market look through these events? The answer may be that the markets take a longer term view of the global economy, which continues to do well despite the tragic events, and companies such as GE and SAP, held by our clients, continue to report good bottom lines. If we look at several events separately it may help to reveal how the equity markets absorbed these in stride.

The uprisings which started in the Middle East and North Africa have shown contagion like symptoms, which many believe is due to the "Twitter" affect. News spreads quickly and demonstrations are organized easily along the newest communication routes… Twitter and Facebook. As a result of these uprisings occurring in energy rich states, the rest of the world remains nervous about oil supplies. Energy prices have spiked about 20% since the uprising started in mid February, but so far, it is difficult to find any immensely negative supply affects as other producers continue to meet the world's needs. However, higher energy prices lead to concerns that global growth will slow, similar to "energy shocks" in the past, but oil will have to be much higher to impact global growth materially at this time in part because the world uses much less oil relative to GDP than it did in the 1970's. As well, economists point to the long term economic growth implications. To quell these uprisings, change will be required and ultimately the young people in these regions will require hope, which should result in the need to create more jobs through economic stimulus.

The Japanese earthquake has had devastating consequences for the Japanese people and it can be tough to look beyond these images. However, if we look to history as a guide, catastrophic events such as these tend to decrease GDP in the short term but then as the rebuild occurs, there is a large spike in economic activity. Most economists suggest that the GDP slowdown in Japan may be a drag on global growth but targets for 2011 global growth of 4.5% are still above the 3.5% average growth witnessed over the last 20 years.

In Europe, the debt watch that first started to weigh on the markets in early 2010 has reignited in places such as Greece, Ireland and Portugal. All of these countries were part of the initial "PIIGS" grouping and therefore the market seems to be taking in stride the difficulties that remain for these states, especially in an environment of strengthening economic growth around the globe.

When we analyze the events in total, one common theme that emerges is energy. Japan will need to replace the lost power output from its devastated nuclear facility. Currently Japan is a large importer of natural gas liquids and oil for its power needs and it would seem that Japan will have to look to these sources as it rebuilds. As well, the Middle Eastern situation along with general economic growth continues to support higher energy prices. We have good weightings in energy for clients through names such as Canadian Natural Resources and Talisman Energy.

Of course another affect of higher energy prices along with the rebuilding in the Middle East and the rebuilding of Japan, is inflation. The knock on affects of Japan's earthquake, due to just in time inventory practices, implies that shortages may occur in some manufacturing items around the globe causing prices on certain items to increase as supply falls short of demand. We believe this will be a short term consequence but none the less adds to price increases at a time when the central powers are focused on maintaining inflation targets. Therefore, we remain cognizant of inflation affecting stock prices, as mentioned in the previous Capital Markets Review, and will be monitoring closely the bottom lines of companies as they report to gauge how much drag the Black Swan events may have on future cash flows.

Fixed Income Markets – Central Bank Watch

Throughout the first quarter of this year, fixed income markets have fluctuated. By the end of the quarter, the DEX bond universe had recorded a small loss year-to-date and the result is much the same in the US and elsewhere. Central banks around the western world are finally acknowledging that inflationary pressures are growing. This is particularly true when one looks at the measures the central banks claim not to follow, specifically food and energy.

Central banks are again talking about "exit strategies" and how they will withdraw liquidity from the economy. They continue to hesitate because the western economies give the appearance of fragility, and they want to ensure that events do not slip off the monetary leash. By many classic measures such as the Taylor Rule (which measures the relationship between targeted inflation and interest rates), monetary policy is far too loose. In Canada, the financial futures market is already anticipating action by the Bank of Canada as early as May. While this may seem aggressive due to the timing of the federal election, clearly portions of the market expect tightening to come soon. However, not everyone believes this is necessary, and participants point to the Canadian dollar, already very strong, as a warning of the consequences of the divergence of Canadian monetary policy from that of the U.S. The European Central Bank (ECB) has signaled a possible hike in their bank rate in early April, and this may well be the first in a widening trend.

U.S. and Canadian inflation linked bonds have recorded steadily widening breakevens. This indicates that nominal yields are rising faster than real yields, forecasting rising inflation. In conventional bond markets, rates are creeping upwards, slowly eroding the gains of the past years. Corporate credit spreads have tightened, although they are steadily approaching levels that no longer will reflect significant potential for credit gains. As we explained in previous commentaries, the markets remain buffeted between enthusiasm for risk and a strong desire to hide from the risks detailed earlier in this report. This same "risk-on / risk off" tendency has meant that volatility remains high, and returns harder to find.

In the quarter we experienced a small general flattening of the Canadian government yield curve, but more importantly an upward shift of around thirty basis points. On the other hand, we experienced a general tightening of corporate spreads that partially mitigated this rise in yields.

In the meantime, we are holding floating rate notes (FRN), real return bonds (RRB) and reducing both duration and the characteristics of the conventional bonds in the portfolios. FRN's are well suited to a period of rising interest rates. The interest rate coupon is typically reset every three months returning the bond to market rates. Similarly RRBs are well suited to a period of inflationary pressures. We have reduced our holdings of government bonds and increased the relative size of corporate debt holdings, while remaining underweight financial issues. We are confident that by containing risk in this fashion we will be able to continue to provide our clients with above average fixed income returns.

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