Barrantagh

Investment Management

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In This Issue:
♦ **Economic Backdrop – U.S. Leading the Pack** ♦ **Equity Markets – Fear has Abated** ♦ **Fixed Income Markets - Questioning Central Banks**

- Global growth continues to advance at a moderate pace despite the dampening affects from the European debt crisis and the resultant austerity packages. Beyond Europe, growth has been stunted by the Japanese nuclear disaster, Middle East political upheavals, the Iranian nuclear embargo and the U.S. budget deficit. Fortunately, year-to-date, there does not seem to be any new deterrents to growth leading one to believe that on balance the global economy seems poised to continue expanding regardless of the fact that growth in countries such as China and India has slowed, albeit to very high levels of 8% and 7% respectively.

- Following the marked slowing of growth in the first half of 2011, attributable to weaker prospects for emerging markets and well documented domestic factors, the U.S. seems to have stabilized. The all important consumer continues to recover with retail sales still growing supported by significant increases in durable goods sales (autos, appliances, etc.) suggesting the recovery is real. Unemployment has fallen, housing inventory is down to 6 months (which is the long term average) and credit seems to be improving. The U.S. economy may not have the highest growth rate with an estimated GDP forecast of 2%-2.5%, but the trend remains positive.

- The policy moves in Europe to deal with the debt crisis have brought positive results as banks are already talking about repaying the money borrowed under the Long Term Refinancing Operations (LTRO) by the end of 2012, not unlike what happened with the Troubled Asset Relief Program (TARP) in the U.S. during the housing crisis. Financial markets around the globe have felt the relief but this will not prevent Europe from falling into a recession. The depth and length of the recession will depend on factors such as the commitment to the austerity programs and the increased concerns regarding Spain's debt woes.

- As the macro concerns have faded, fear in the equity markets has been replaced by a view to the fundamentals as companies continue to report growing bottom lines. This has driven investors to buy riskier securities despite many concerns that may yet have a say in the performance outcome for 2012. Diversifying the portfolio continues to be paramount.

- Our view remains biased towards equities based on relative valuations and yields. With cost cutting becoming increasingly difficult, we continue to focus on companies with visible top line growth that should drive the bottom line. We have trimmed our energy weighting due to low natural gas prices and continue to underweight base metals until China's slowing growth outlook stabilizes and the demand for commodities can be more assured.

- Fixed income markets are focused on economic healing and generally remain skeptical that Central Banks will wait until 2014 to increase rates. As such, we have taken a defensive position in the portfolios with shorter durations and more corporate bonds to lessen the affects of rates rising and take advantage of any corporate spread tightening.

Economic Backdrop – U.S. Leading the Pack

The healing process in the global economy since the 2008-2009 recession has been buffeted by a series of exogenous shocks including Japan's nuclear disaster, political upheaval in the Middle East, the European debt crisis, the U.S. budget deficit and rising oil prices. Fortunately, in the last few months no new shocks emerged but the global economy is still heavily burdened by the aforementioned deeply entrenched issues. Nevertheless, within the group of advanced economies, the outlook for the U.S. seems to have stabilized somewhat. In the first quarter of 2012 a degree of confidence has developed based on a bout of stronger economic data. Consumer spending has picked up led by vehicle sales and the unemployment rate has fallen to 8.3% which may well be sustainable given the downtrend in unemployment claims and rising optimism among small businesses. Even the housing market seems to be improving with sales and housing starts up and inventory down, although prices generally are still weak. Growth in the U.S. economy could improve further as household deleveraging ends and a more durable housing recovery begins. However, three major issues heading into 2013 have potentially dampening effects. First, across-the-board tax hikes with the expiry of the Bush tax cuts, second, discretionary spending cuts due to the failure of the Super Committee, and third, the debt ceiling deadline in early 2013. A satisfactory resolution of these issues would require decisive action from policy makers which is not likely given their track record. Despite these potential drags, the possibility of organic momentum developing in the U.S. economy outside of policy events cannot be totally disregarded. Corporations in general have excess cash and therefore, the potential to invest in labour in addition to capital improvements creating new jobs which will increase income and create more job security fuelling consumer spending, a key element for more buoyant growth. Notably, Mr. Bernanke may share this optimism as his most recent comments suggest that quantitative easing is on hold unless the economy starts to show signs of slowing.

Meanwhile, Europe has made progress in assuring investors of the survival of the Euro and insuring that Euro zone economies retain financing for their debts at sustainable rates. Longer term refinancing operations (LTRO) engineered by the European Central Bank, have relieved pressure both on banks and financial markets including the markets for sovereign debt. In the two tranches of this operation, banks have borrowed more than one trillion euros for three years at just 1%. As well, European leaders have agreed on a "treaty on stability, coordination and governance", which is a sign that Euro zone members are attempting to work together even though the treaty focuses mainly on fiscal discipline at a time when austerity will act as a drag on growth. Of course, the crisis has not passed; to varying degrees the vulnerable countries are in lasting difficulties. At the time of writing, a conflict is brewing between the European institutions and the newly elected Spanish government of Mariano. The Spanish government has set a target fiscal deficit of 5.8% of GDP, well above the 4.4% agreed with the commission. For Spain, a sharp reduction in government borrowing could lead to a deep recession along with little progress in reducing fiscal deficits. The example of Spain suggests that a way has yet to be found towards the necessary rebalancing of the Euro zone economy and achieving a mix of reform and adjustment that will facilitate a return to growth. Accordingly, Europe will likely remain mired in recession for most of 2012 or even longer.

Turning to Asia, strong economic growth in China and India were important contributors to the global recovery in 2010 and 2011. In 2012 the contribution from Asia will likely be substantially less as China's tight monetary conditions to tame inflation and head off a property bubble are working. China's GDP growth, expected to be about 8% in 2012, still represents the fastest growth of the world's major economies, but less than last year's double digit performance. In India, growth has faltered since last summer to about 7% for the fiscal year ending in March compared to earlier government predictions of 9%. Inflation is persistently high, agricultural productivity has declined and foreign investment has waned. In fact India's prospects were never quite as bright as many had originally thought.

On balance, the global economy seems poised for a period of continued slow growth with a degree of renewed optimism about the prospects for the U.S. offset by weaker than expected growth in emerging economies and a recession in Europe. Much of this is not new to capital markets and investors and the evidence so far is that corporations seem to have an ability to grow earnings in spite of the lackluster macro environment. Accordingly we continue to advocate investment in equities which meet stringent investment criteria.

Equity Markets – Fear has Abated

Based on strong company fundamentals and low valuations, we suggested in the fourth quarter commentary that 2012 could be a recovery year for equities if the macro environment became more stable and Europe took action to solve its sovereign debt crisis. This prediction proved prescient but the speed at which the markets have reacted was certainly not foreseen. The equity markets have accepted all actions by Europe, to stem its debt crisis, in a positive manner but, as mentioned in the economic section, none as positive as the LTRO (Long Term Refinancing Operation) which helped stabilize the banks and moved the problem from a state of emergency to a long term chronic condition which must be monitored continually. The €1 trillion LTRO stimulus combined with first quarter global economic numbers that have not disappointed drove the markets to healthy gains. The S&P/TSX was up 4.4% for the quarter and the global markets as represented by the MSCI were up 9.8%.

Interestingly, the stocks showing the most gain for the quarter were the stocks that lagged the market during the previous 12 months suggesting that much of the fear which has been affecting the market during the last couple of years has abated for now. The volatility in the market place is also at its lowest since 2007 which again suggests that fear is no longer the driving force, but rather rational market fundamentals seem to be back in the driver's seat. As investors moved European concerns to the back of their minds and economic numbers imply the business cycle is still intact, valuation multiples quickly changed. The equity market was generally trading at 12 times earnings moving into the end of 2011 and has since moved to about 14 times as investors feel more comfortable with the risk in equities. This multiple expansion alone accounts for much of the move in the market place. To be sure, many risks are still on investors' minds including China's growth, Spain possibly requiring a Greek like bailout and austerity packages that will limit growth in an already moderate economic growth environment, but investors are weighing these concerns against low cash and fixed income yields. Year-to-date investors have chosen the riskier asset class which should be the logical direction in an environment wherein Central Banks are promoting an extended period of very high monetary stimulus. As long as the consumer hangs in, investors will probably continue to find favour with equities which suggests that equity markets can move higher. This combined with a low inflation environment, suggests multiples can expand further.

Despite the rapid positive move in equities for the first quarter driving investors towards exuberance, one cannot help to be mindful that the macro environment is still one of slow growth and "profit taking corrections" generally follow such moves. Also, fears can quickly reduce investor confidence should Spain become a larger issue or growth stumble at some point. We are therefore mindful to keep clients portfolios diversified. Stocks such as BCE, which have underperformed year-to-date for no other reason than investors rotating to more economically sensitive names, continue to have a place in portfolios. We have also continued to de-emphasize basic material plays until there is clarity relating to China's slow down. Relating to commodity exposure, we have reduced the energy weighting, specifically natural gas related exposure. For instance, we sold Celtic Energy due to the warmer than expected winter which has driven natural gas prices to multi year lows. As well, we remain cognizant of corporate earnings. As mentioned in the past, companies have done a herculean job of maintaining earnings growth over the last several years through cost cutting and driving efficiencies. However, to continue growing the bottom line, the top line must grow which means that consumers (70% of the economy) and businesses must continue to participate in the economies healing. We continue to favour equities that have strong balance sheets and visible top line growth. Names such as SAP which is a multinational software company developing, marketing and supporting enterprise software solutions for businesses, governments and educational facilities around the globe is a good example. The company should be able to grow the top line by 10 to 12% over the next several years which will drive the bottom line by a comparable amount. With companies continuing to focus on cost savings, software will continue to be an area where spending will occur. Discover Financial Services is another prime example of a company that due to superior credit performance and asset growth is able to increase the top line and therefore the bottom line in excess of 10%. Discover Financial Services is a diversified financial company but issuing credit and debit cards are its primary business. The company seems to be in a sweet spot with-respect-to the credit cycle and as long as the consumer continues to maintain financial discipline, Discover should benefit.

Fixed Income Markets – Questioning Central Banks

Little has changed from 2011 as the first quarter of 2012 has unfolded. Greece has survived a restructuring of their outstanding debt, a near default, and the financial markets are holding their collective breath to see if that was enough. In turn Spain has assumed the role played by Greece in European markets, having announced that they would miss the agreed debt reduction target for the quarter. On the domestic front for a change, the long end of the yield curve did not lead in performance, governments turned in a weaker result than corporate bonds and the short term market segment outperformed the longs. The typical corporate treasurer has an appetite for fresh cash at low interest rates, but the market has not been encouraging. Due to this appetite we had expected the new issue volume to pick up in the corporate space accompanied by a wider concession on spreads, but the market remains product constrained. The funds are available but not at the low pricing or tenor the would-be issuers expect. We did not get the increase in volume and generally what new debt issues came to market were priced less aggressively to ensure success and therefore traded well out of the starting gate. However, only a few issues held on to these newly tightened spreads or gains. As the quarter came to a close, the level of new issuance remained low and product hungry bond managers' dragged secondary spreads slowly but steadily tighter as demand outstripped supply. We are reaching a point at which the spread between higher quality corporate bonds and provincial issues is too tight to be sustained. In the shorter term, we would expect this to correct, most likely through a widening of corporate spreads. We take some comfort in this call as the credit rating agencies try to show that they are relevant in the post financial crisis. They are being more aggressive in their methodologies, resulting in increased credit rating downgrades in the quarter, which should drive corporate spreads wider.

The bond market has become more wary of the Central Banks and their monetary policy intentions. The mix of bullish and bearish economic data has ensured that rates remain volatile, and generally directionless. We have witnessed a number of sharp price reversals driven by data or comments. Year-to-date the government bond curve in Canada has moved upwards approximately 20 basis points in the long end and 35 basis points in the short end, so that what little direction there is remains bearish. In particular the market is watching the employment data, purchasing manager indices and retail sales, which have supported the notion of strengthening economies. Meanwhile, the flight to safety motivation remains strong as news from Spain deteriorates. This together with growing concern about the slowing Chinese economy has kept a bid to the government market. With spreads on Spanish new government issuance continuing to widen and the market's declining appetite for sovereign risk, we expect further disturbance to come from this area. Many think this may keep high quality government yields from pushing upwards much before the monetary authorities move from the current holding pattern, which has been broadcast to remain until 2014. However, even with inflationary affects benign at this point, the market does not necessarily agree. There is broad expectation in the bond markets that the Central Banks will not be on hold as long as currently anticipated. The U.S. economy appears to be picking up and rates will anticipate an eventual tightening on the part of the Central Banks. Therefore, in the longer term, as rates start to inch up, the much anticipated new issuance of corporate debt should come to market, as corporate treasurers realize that they are missing out on low all-in yields. In anticipation we are positioning the portfolios by shortening duration and will be increasing the weighting of corporate debt further as spread opportunities materialize.

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