Barrantagh
Investment Management

CAPITAL MARKETS REVIEW
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- Positive but sub-trend global economic growth rates continue to dominate economic thinking and policy reaction. China, which has contributed significantly in previous quarters to world GDP growth, is being compelled to stimulate growth in an effort to maintain greater than 7% growth rates. Even Japan has embarked on an expansionary program to try and re-inflate the economy as it emerges from a recession.
- In the U.S., the fiscal cliff fallout, resulting in tax changes and subsequent sequestration, has been more irritant than substantive, characterized by longer queues for government services. The U.S. will only feel the full impact as the second and third quarters unfold but most economists think that a normalized GDP will be reached by the fourth quarter.
- The U.S. Federal Reserve has voted to maintain the QE3 program while the recovery seems to be gathering momentum. The U.S. housing market is looking brighter, U.S. manufacturing is picking up and the news on the job creation front is slowly improving. However, the overall health of the economy as represented by PMI (Purchasing Managers Index) readings are mixed and consumer confidence has stalled. Time will tell whether we are witnessing the short term effects of the fiscal cliff, or if there is a deeper concern with-respect-to employment and income trends.
- Europe remains mired in recession, although the situation is looking brighter for the major economies such as the U.K. and Germany, with most participants expecting a return to growth by the end of 2013, if not sooner. However, just as the global markets started to get comfortable with the Euro zone and the seedlings of improvement started to take root, a minor player, Cyprus, joined the game. The Cyprus bailout crisis, along with the resolution incorporating a levy on bank deposits, serves as a reminder that Europe's problems are still unresolved.
- As global economic concerns seem to become "tail events", equity markets moved higher in the first quarter with the U.S. market reaching or revisiting new/old highs. The lack of volatility speaks volumes. After all, the U.S. budget ghosts have not disappeared, the Euro debt problems still haunt the markets as witnessed by the recent Cyprus debacle and global growth continues to be tepid. Based on valuation fundamentals and economic numbers which seem to be reflecting the Goldilocks story, not too hot and not too cold, the move in the equity markets seems justified. As investors we are reminded to focus on stock market fundamentals to judge opportunity rather than the milestone of achieving new highs.
- The yield curve has been steepening based on further economic growth and the possibility that rates are at their lowest point. As the government curve steepens and investors' risk appetite grows, the corporate market will offer participants greater potential for gain from tightening credit spreads.

Economic Backdrop – Tepid Growth Continues

The economic data points in the U.S. and policy reaction to economic events of the first quarter have given mixed signals to investors and business alike. The first threshold of tax cuts mandated by the "fiscal cliff" has been crossed by way of a zero sum compromise. This has led consecutively to sequestration, or the implementation of broad based spending cuts. To date, the impact has been more irritant than substantive, characterized by longer queues for government services. The U.S. will only feel the full impact as the second and third quarters unfold. Meanwhile, the Federal Reserve FOMC has voted to continue their program of quantitative easing ("QE3"). However, the path beyond this program may not be smooth, as voices of dissent grow among committee members as to the effectiveness of these measures. While the Fed continues to debate, the market is increasingly susceptible to hints in any direction. Worry is growing that the U.S. capital markets are being set up for a major correction if or when the Central Bank changes direction and begins the long process of unwinding what one observer has dubbed "financial heroin"; the massive dose of liquidity that has been and continues to be fed into the U.S. economy. Effective or not, the U.S. recovery seems to be gathering momentum. The U.S. housing market is looking brighter, with the existing stock of houses being absorbed and inventories below long term normal averages of 6 months. U.S. manufacturing is picking up, but it is important to look through the growth rate and recognize that the great recovery in manufacturing has not yet returned that part of the economy to pre-recessionary output levels. The news on the job creation front is slowly improving as well, with weekly jobless claims in a gentle but steady downward path, and non-farm payroll gains averaging close to 200,000 per month. While growth persists in personal spending and personal savings are at levels higher than market expectations, the overall health of the economy as represented by PMI (Purchasing Managers Index) readings are mixed and consumer confidence has stalled. Time will tell whether we are witnessing the short term effects of the fiscal cliff, or if there is a deeper concern with-respect-to employment and income trends.

In Canada it seems inevitable that we will have to adjust to slower economic growth. With the U.S. moving towards energy self-sufficiency, Canadian exports to the U.S. are shrinking, and the economy is slowing. While the Bank of Canada continues to maintain a tightening bias in their policy, few participants expect any action at least prior to the selection of a new Governor to replace the London bound Mark Carney. In the meantime, inflation is creeping upwards. While inflation is still well below the government's or the Bank of Canada's target, the shift from the previous levels is concerning. It is hard to call it a trend on the evidence of one month's data, but it does bear watching.

Europe remains mired in recession, although the situation is looking brighter for the major economies. The division along geographic lines remains but the economic indicators for the U.K. and Germany are slowly improving, with Germany's unemployment rate showing steady improvement. Just as the global markets started to get comfortable with the Euro zone and the seedlings of improvement started to take root, Cyprus joined the game. The Cyprus bailout crisis, along with the resolution incorporating levies on bank deposits, serves as a reminder that Europe's problems are still unresolved. The nature of the banking sector in Cyprus clearly alarmed the EU and the Troika as banking sector assets represented over 700% of Cypriot GDP which compares poorly to the EU average of 340%. A seemingly straightforward €10 Billion bailout became a great deal more disruptive due to initial mismanagement and German influence. The first draft of the bailout, rejected by the Cypriot parliament, called for a tax on all deposits held by Cypriots with no minimum. As the EU provides a guarantee on deposits of €100,000 or less this was clearly unacceptable to Cyprus, which should have been anticipated by the EU team. This was clearly an accident waiting to happen. Finally, an agreement was reached, but by that point market confidence had been shaken. One very significant element of the bailout of Cyprus is the imposition of capital controls. There are limits on the movement of funds, foreign investments and the enforced sale of off-shore branches of Cypriot banks.

Obviously the capital markets have looked through the many uncertainties as a "risk on" drive has dominated the first quarter. While the world is arguably improving in an overall economic sense, readers must remember that there may be sufficient negative news in coming weeks to dampen investor enthusiasm and induce at least a pause in equity market appreciation.

Equity Markets – Milestones Revisited

The first quarter of 2013 witnessed a continuation of equities moving higher, culminating in the U.S. markets reaching all time highs and many wondering if the fundamentals justify such a move. What many forget is that these same markets reached these levels in 2000 and 2007 suggesting that over the longer term they have been flat and investors have clipped dividends while they waited. As the S&P/TSX gained 3.3% for the first quarter and global markets gained 10.3%, as represented by the MSCI in Canadian dollar terms, we are not left wondering if fundamentals justify new highs for the U.S. markets but rather, where did the volatility go that the markets have become accustomed to riding and when will the widespread expectations for a pullback be realized?

The greatest reason we believe the U.S. markets new highs are a milestone rather than an event is that when comparing fundamentals over the longer term, the markets moving higher seems justified if not overdue. For instance, if we review the valuation metrics today versus the peaks 6 or 13 years ago, the markets are currently 10% to 25% cheaper depending on what commonly used metric you wish to examine – price/earnings, price/cash flow or price/book value. During this period of time, not only have companies increased their earnings power as the valuation metrics suggest but corporate debt levels are half of what they were and managements in general are far more disciplined. Dividend yields are higher today than at previous peaks and yet interest rates are far lower, helping to drive the valuation bias to equities versus bonds. Probably the largest factor in driving the markets to more reasonable fundamental levels was mentioned in our last report – macro has taken a back seat. As long as the market continues to focus on the fundamentals rather than macro factors, volatility should be lower and the market can move higher based on several rudimentary basics. First and foremost is valuation. We continue to uncover good valuation opportunities with a bias to finding more foreign opportunities than Canadian names. This remains a function of our continued bias away from commodity names, as mentioned in previous reports, rather than an overall conclusion that Canada is expensive. Secondly, 75% of companies reporting throughout the first quarter beat expectations indicating that fundamentals continue to improve. Admittedly, we need to focus on the future not the past. Companies have done a great job of increasing margins by enhancing efficiencies through cost reductions in several forms, however, as referred to in previous pieces, the top line or revenue needs to grow rather than stagnate. To gain some confidence in this area we look to economic indicators to gauge the consumer's health. Inflation is in check, helping companies and consumers. Disposable income has grown and debt levels are flat to down. Savings are up and retail spending has been good. Meanwhile consumer confidence indicators and PMI's (Purchasing Managers Indices) have paused but are at supportive levels. The third important factor to help markets move higher is the current low real interest rate environment. Investors, who are skeptical of the equity markets' move to higher levels, can take some comfort in the "real growth" in the top and bottom lines of corporations. Inflation can be very helpful to grow the top line for corporations no matter how poorly they perform. Recently, inflation is very low suggesting that any revenue or earnings growth is a result of good management practices.

As the equity markets have moved higher not all industries screen well. For instance, the Canadian grocery segment continues to be a very tough sector. Efficient competition from existing players and new entrants, a well advised and value oriented consumer, and low inflation, makes for difficult growth comparisons. However, we are able to find consumer staple companies such as Johnson & Johnson (JNJ) that do meet our criteria. The new CEO is an extension of the previous CEO who moved to Chairman, so the company's strategic framework of delivering sustainable growth and increasing the dividend has not changed. Recently, the amount of large pharmaceutical drug patents expiring, which allows generic competition, has passed, leaving JNJ with a robust pipeline of drugs. With this patent exposure bubble behind them they have continued with strong sales growth in developed and emerging markets and continue to complete strategic acquisitions and collaborations to drive sales further. The company's valuation multiples are below historic trends, significant free cash flow continues to support the AAA rating from the credit agencies and the company's return-on-equity remains north of 20%. With a dividend yield over 3% Johnson & Johnson continues to play an important role in our clients' portfolios.

Fixed Income Markets – Credit Spreads Grind Lower

Bond performance in the first quarter of 2013 was generally better than many anticipated when we closed out 2012. Corporate credit spreads continued to grind downwards as the appetite for risk improved. The U.S. Fed has continued to maintain an expansionary monetary policy, through the continuation of both quantitative easing and the purchase of mortgage backed securities. To all appearances the U.S. monetary policy will remain on hold into 2015.

The Bank of Canada remains sidelined with a mild tightening (increasing interest rates) bias even while the Canadian economy slows. The Canadian dollar remains overvalued and the combination of our strong dollar, the push to U.S. energy self sufficiency, and the continuing debate over the various pipelines to the U.S. and the west coast, has meant that exports from Canada have slipped. Canada, despite the slowing economic performance, continues to attract funds seeking safety. Canada is one of the last remaining AAA credits in the world, and episodes such as the Cyprus crisis continue to trigger significant inflows and a matching rally in the Canadian dollar. Ultimately the impact of stronger economic growth in the U.S. will outweigh any other pressures, eventually causing rates to rise.

Picking up on a trend started at the end of 2012, and continuing through much of the first quarter, the Canadian yield curve has gradually steepened (difference between short term interest rates and long term interest rates). This has refocused attention on the short to ten year segment of the yield curve, and significantly reduced the volume of new issuance, after a new record was set in 2012. As evidence of stronger and sustainable economic growth in the U.S. builds, Canada's interest rate structure is feeling the heat. On the other hand there still appears to be substantial pools of cash in Canada that need to get invested. This has meant that new issues which were issued in the quarter had little trouble raising the targeted levels of funds required and beyond. In addition, there is still a substantial inflow of foreign investment capital, but it is focused on the mid-term segment of the yield curve rather than the long end which it had sought in the past. Concern about the pick-up in U.S. growth will ultimately begin to drag Canadian yields higher, and this will reflect in bond market absolute performance. We expect the curve to return to the steepening trend with slow but steady grinding upward pressure on yields.

As the government curve steepens and investors' risk appetite grows, the corporate market will offer participants greater potential for gain from tightening credit spreads. There has been more interest shown in the higher beta issuers (which are also the lower credit issuers) such as BBB corporate bonds and high yield bonds. Participants are keeping a close eye on the U.S. Fed in an effort to anticipate the onset of the coming monetary tightening cycle.

We continue to be heavily overweight in corporate debt, with a bias to higher beta, investment grade issuers. We expect that the corporate new issue calendar will pick up this coming quarter. There is a substantial list of maturities this year, and corporate treasurers will ultimately have to look through timing the market and simply take advantage of historically low funding rates. Therefore, we look forward to more opportunities to earn concession spreads on new issues, while we also try to benefit from tightening secondary spreads.

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