Barrantagh

Investment Management

CAPITAL MARKETS REVIEW
SECOND QUARTER 2004

- Global growth continues at an above-trend rate but is decelerating. A maturing economic cycle influences our equity selections.

- The well telegraphed reversal in U.S. interest rate policy is now underway with a 0.25% Fed funds increase on June 30th.

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- We expect a gradual tightening cycle which will have less negative impact on stocks and bonds compared to prior periods when inflation was a greater threat.

- Greenspan is determined to remove excess liquidity from the system without undermining the all-important consumer or derailing capital markets. We see few reasons for him not to succeed.

- The stock market seems to be torn between several positives (above-trend global growth, positive earnings reports, low inflation, renewed U.S. job growth) and a number of negatives (rising interest rates, high energy prices, twin deficits, Mid-East turmoil and a beleaguered U.S. President).

- In equity markets we have become more wary, but we are taking advantage of the recent correction in prices to add quality companies to the portfolios. Although trading volumes are low and news flow is mixed, we expect a stronger equity market into 2005.

- The rise in bond yields in the countdown to the June 30th rate hike has created opportunity in fixed income markets. We will continue to emphasize corporate bonds and floating rate notes where credit improvement and capital appreciation is expected to supplement recurring yield.

Economic Backdrop – Global Growth Decelerating

Synchronized global growth continues at an above-trend pace although evidence mounts that slower growth is imminent. U.S. second quarter GDP growth is headed for a fourth consecutive quarter of 4% gains fuelled by the return of job creation, productivity gains, robust consumer spending and accelerating strength in Asian markets. All these factors lend credibility to a durable U.S. expansion into 2005 which may slow to a more sustainable 3.5% growth rate due to high energy prices, a slowdown in U.S. mortgage refinancing and the recent change in Fed policy.

With a 0.25% rate hike now implemented, the Fed policy debate shifts from guessing the timing of rate hikes to judging the ultimate degree of upward adjustment. Recognizing his primary goal is price stability, Mr. Greenspan's priority is to fend off the threat of inflation, but he must also avoid stealing momentum from a highly debt-leveraged recovery - a delicate balancing act. In mid-June Greenspan observed that the U.S. looks to be on track for a lengthy economic upturn, and added that inflationary pressures are not likely to be a serious concern in the period ahead. It appears that the Fed Chairman is content therefore with a series of easily digestible hikes to gradually wean the economy and the financial markets off their reliance on ultra-cheap money.

Regardless of inflationary indicators, the Fed must balance other factors. Relatively high unemployment rates and unused capacity levels suggest that slack remains in the economy, but the so-called "output gap" is narrowing. Furthermore, the continued increase in U.S. home prices is making it harder to rule out a housing bubble that could burst.

Turning back to the magnitude of rate hikes, it is likely that the Fed will move rates at least back to what is regarded as an equilibrium level, approximately 250 basis points higher than at present. Considering the many variables affecting inflation and interest rates we believe the process of rate adjustment will occur over a fairly long period, and markets will have reasonable opportunity to adjust to the new reality.

Canadian economic growth continues to be hampered by slowing exports. In a reversal from the 1990's, domestic demand has replaced exports as the primary driver of growth in the wake of the Canadian dollar's strength. In contrast to the U.S., fiscal policy has remained very disciplined although that may change under a Liberal/NDP coalition government. Canadian growth is expected to lag that of the U.S. in 2004 and 2005 by at least 0.5%.

On the global scene we are closely monitoring the risks of a sharp slowdown in China following restrictive credit policies being implemented to curtail perceived excesses in its recent expansion. A surprise among Asian economies has been the strength of the Japanese economy which grew at 5.6% in the first quarter of 2004. The Japanese recovery is being driven mainly by exports, particularly to China. As China's economy slows, so will Japan's and other Asian countries' as well.

China and the U.S. are not the only large economies to tighten credit. The Bank of England has raised rates three quarters of a point in the last six months, in part to cool a housing bubble.

On balance we continue to expect world GDP growth in excess of 4% in 2004, but moderating somewhat in 2005. This economic performance should allow many corporations to achieve strong operating results, a fundamental ingredient for further gains in equity markets.

Equity Strategy – Catalysts for a Renewed Move Upwards

Over the last quarter equity markets were volatile and eventually retreated 4 – 7% from their highs. Clearly, the negative influences of expected interest rate increases, high energy prices, rising twin U.S. deficits, Mid-East turmoil and skepticism toward President Bush have contributed to investor apathy at present. Reviewing historical equity markets since WWII there was only one period, the late 1990's, when markets experienced several consecutive years of better than 20% annual rates of appreciation. That era ended in the bursting of the tech bubble in the early part of 2001 and into 2002. The current environment has turned less bullish for equities at the margin, but in our view the changes have not been dramatic enough to call an end to the cyclical bull market. We continue to adopt a positive stance towards equities based on what we believe are several catalysts for a renewed upward trend over the next few months.

1. As discussed, global economic growth provides a favorable background to equity markets, particularly since the likelihood of a durable U.S. recovery remains high.

2. We continue to believe that the most important catalyst to equity appreciation will be corporate profits and cash flow. By the first quarter of 2004, earnings in Canada and the United States had risen to record highs fuelled by major cost cutting initiatives and productivity improvements. As well, companies are benefiting from revenue growth, now that pricing power has returned to several sectors. Positive surprises have been significant and frequent. Investors continue to underestimate the powerful combination of accelerating revenue growth and historically wide profit margins. In our view earnings power should continue to outweigh the impact of rising yields as long as the Fed sticks to its stated slow-but-sure mode. Accordingly, stock prices will appreciate if multiples hold fast while earnings rise, as we predict.

3. There are a number of other factors which should lay the ground work for a rally in equities as the year progresses including moderating oil prices, a more stable U.S. dollar, a temporary reprieve in the bear market in bonds and elimination of excess pessimism towards geopolitical events.

The prices of income trusts and high-dividend-paying equities have corrected over the course of the year, reflecting their correlation to interest rates and more realism as to the appropriate yield in relation to underlying risks. This has attracted us to a number of securities where distributions are relatively secure, such as **Yellow Pages Income Fund** and **BCE Inc**.

In the oil and gas sector, the high price of oil at present is likely unsustainable although the longer term fundamentals suggest a new era of strong prices has begun. We continue to focus primarily on junior natural gas producers which have deep inventories of exploration prospects which will lead to low cost production growth, such as **Duvernay Oil Corp**. and **Progress Energy Trust**.

Going forward, we look for positive, but somewhat lower, total returns from equity markets and more frequent periods of volatility. Many of these expectations are typical of a maturing bull market where mispricing is no longer obvious.

Fixed Income – The Challenge Continues

Fixed income markets became more difficult in the second quarter. The first step in the Fed's pre-broadcasted policy modification came at the end of June with a 25 basis point rate hike. Consistent with the market's expectations and the Fed's open policy, bond yields have since rallied, because the Fed will likely move more slowly than previously anticipated by bond markets. This view has been supported by stronger bond markets since Mr. Greenspan made his first move.

In Canada, secular forces continue to favor tight Canada/U.S. yield spreads. GDP growth in Canada has been considerably weaker and is likely to remain so over the next 18 months. This together with the tame inflation outlook in Canada would suggest that the Bank of Canada could wait out the early rounds of Fed tightening. Given our expectation of a relatively passive Bank of Canada, mid-term Canadian dollar bonds appear to offer reasonable value. As well, our holdings of Canadian real return bonds have performed well, offsetting the more volatile inflation-sensitive fixed income instruments.

We expect the slope of the yield curve to continue to flatten in both Canada and the U.S. going into 2005, largely as a result of the tightening U.S. monetary stance. The opportunities to make good returns in the Canadian bond market remain principally in the corporate market. Economic growth in Canada should lead to improving corporate balance sheets and cash flow, in turn leading to improved credit quality. We have seen already in the first half of this year a tightening in credit spreads, particularly for less highly rated issuers.

As discussed in our First Quarter Review, corporate debt has been a relatively attractive area of fixed income markets. Corporate credit markets are positively correlated to economic activity and robust corporate cash flow growth. Over the last two years, rebounding corporate profits and improving balance sheets have fuelled dramatic narrowing of spreads between the yields on corporate and government debt. Our expertise in credit markets has contributed to our record of top quartile returns on our fixed income portfolios. While we have realized gains on some corporate holdings we continue to find opportunities in credit markets. For example we have broadened our exposure to floating-rate notes including **MBNA Canada** and **GMAC Ltd**. These issues, because they reset the coupon on a periodic basis, offer considerable protection of capital in a time of rising interest rates.

Barrantagh Investment Management Inc. provides disciplined portfolio management to institutional and individual investors. The firm is committed to a high level of client service provided directly by its experienced partners.

We are dedicated to preserving our clients' capital while generating growth through consistent application of our value-based fundamental investment philosophy.

We manage portfolios on a segregated basis to meet our clients' investment objectives. Because the firm is owned by our professional staff we maintain a completely independent and objective perspective.

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