Barrantagh

Investment Management

CAPITAL MARKETS REVIEW
SECOND QUARTER 2005

In This Issue:

- **Economic Update – Growth Continues, Imbalances Build**
- **Equity Markets – Pockets of Opportunity**
- **Fixed Income Strategy – Remaining Defensive**

- Global economic growth surprises on the upside, but reflects a widening imbalance between resilient U.S. and Chinese economies and weakness in Europe and Japan.

- The U.S. consumer and Asia (particularly China) are the primary engines of global economic growth. U.S. personal spending has so far held up in spite of higher interest rates and record high oil prices. Asset appreciation (housing) supports ongoing consumer confidence. The Chinese economy is not slowing as much as originally anticipated.

- President Bush's foreign and domestic agenda has become more and more bogged down in controversy. His apparent fiscal recklessness worries markets.

- The conundrum of rising short term rates but falling long rates (yield curve flattening) has caused fixed income investors to become defensive. Long bonds are vulnerable to unexpected inflationary shocks.

- Equity markets (Ex/energy) have traded sideways to down this year in response to full valuations and a maturing cycle. Our stock selection strategy is based on specific value creation attributes of particular companies including free cash flow deployment.

- Corporate earnings growth is peaking overall, but pockets of above consensus out performance can be distinguished. Corporate free cash flow generation is at a record high with benefits to investors from reinvestment or increased dividends. We continue to favor equities over bonds and to invest in companies with proven business models, superior execution skills, and the capacity to deploy free cash flow prudently.

- Selected income trusts afford opportunity to diversify income accounts in an environment where long-term bond yields remain low.

- Long bond prices have responded little to rising short-term interest rates, a trend which has little precedent in previous monetary tightening cycles. Corporate credit spreads initially widened in the wake of rating downgrades (General Motors and Ford), but have since tightened again. As balance sheets continue to improve, selected corporate bonds offer greater return potential than government issues.

Economic Update – Growth Continues, Imbalances Build

In spite of troublesome economic headwinds (tightening monetary policy, record high oil prices, volatile currencies) the rate of global growth, led by the U.S. and China, continues to surprise on the upside, albeit global growth is clearly slowing. U.S. real domestic product grew at an annual rate of 3.8% in the first quarter, on a par with fourth quarter 2004 growth, largely reflecting strength in consumer spending and exports. Recent data (household investment, consumer confidence, productivity) suggest U.S. growth could continue, although the foundations for long-term sustained growth appear more and more suspect. Troubling signs, are present, however, as often discussed in previous letters, ranging from an extended housing boom, high oil prices, soaring consumer indebtedness, to an ever-widening U.S. current account deficit and anemic job creation. The last time the world economy faced such a confluence of imbalances was in the late 1960's. The boom of the 60's led to soaring inflation in the 70's and the debt crisis of the 80's. Most economists don't believe history will repeat itself in part because the world economy is more deregulated and globalized, inflationary forces are weaker and central banks are more vigilant.

The textbook solution to economic "excesses" is higher interest rates, but higher interest rates in today's environment could exacerbate some of the imbalances. The challenge is to address the sources of potential "over exuberance" without inducing a marked slowdown in world growth. The longer the status quo persists, the greater the risk that a more disruptive market driven adjustment will occur down the road. It is a tricky time for central banks which have a narrow mandate with broad issues. In this cycle central banks have in a sense been a contributing force to the imbalances, allowing an unprecedented degree of liquidity to exist in the system for a protracted period of time. Curtailing liquidity may be virtually impossible without possible serious and economic repercussions.

A continuing major imbalance is strong growth in the U.S. and China compared with weak growth in Japan and the Euro area. Another is the enormous U.S. current account deficit, measuring approximately 6% of gross domestic product (compared with a surplus of 0.4% in the Euro area and 3.7% in Japan). Such deficit levels are unprecedented for a country issuing a major reserve currency and could lead to a disorderly decline in the dollar, turmoil in financial markets, trade protectionism and even a recession. It is obvious that at some point the U.S. needs to raise savings rates and reduce budget deficits. On the other hand, Europe and Japan should boost demand by making their economies more flexible. In this cycle, China is a special case. China's low cost labor allows it to be a global source for manufactured goods, a deflationary story, while rapid growth in China's domestic economy leads to ever increasing demand for global raw materials, an inflationary story. China and other Asian countries may eventually need to allow their currencies to fluctuate more against the dollar to offset their export advantage and assist in rebalancing the U.S. trade deficit. Fed Chairman Greenspan has openly criticized the growing U.S. lobby for U.S. tariffs on Chinese imports to pressure a revaluation of the Yuan. Certainly there are risks to upsetting the symbiotic relationship between growing U.S. debt and the ability of Asian nations to finance it.

Based on first quarter growth the U.S. economy has not yet bowed to high oil prices, its rising debt burden or rising interest rates. As well inflation seems to be under control as measured by the personal consumption expenditure index which grew at a 2% annual rate instead of the 2.2% estimated a month ago.

Regardless of the positives, the lack of direction in equity markets is telegraphing that there are significant risks to the ongoing health of the global economy. Of course there are only two leaders on the world scene with the power to make much difference, Mr. Greenspan and Mr. Bush. Mr. Greenspan is continuing on course with his hiking of interest rates at a measured pace, and has no mandate for broader action. Unfortunately, Mr. Bush's second term is not going well. The most visible problem remains Iraq, but the president's domestic agenda is not going well either and the President's approval ratings continue to dip. Obviously capital markets are concerned with an American president consumed by domestic strife and a Chairman of the Federal Reserve poised to retire in January 2006.

Equity Markets – Pockets of Opportunity

The global S&P 1200 Index return for the year has been slightly negative and Canadian stocks are largely flat to down over the year to date (except for the energy and financial services sectors). The sideways trading pattern of equity markets is not simply a psychological phenomenon; it reflects opposing forces which have left investors in a quandary. On the negative side, equities confront a tightening liquidity environment, a slowing global economy, a peaking profit cycle, and fair to stretched evaluations. On the positive side a number of economic indicators are stabilizing or turning up. The U.S. economy is far from a recession type slowdown while China's economic performance continues to be strong. Accordingly, well positioned companies can continue to prosper bolstered by balance sheets that are the best they have been in years and abundant free cash flow.

Given the weight of negative influences on capital markets and relatively high current valuation levels, we believe the rate of stock market appreciation going forward will be a function of operating out performance, particularly earnings and cash flow growth, rather than a price/earnings expansion.

On the earnings front, markets are turning their attention to second quarter corporate profits. Thompson First Call pegs the estimated year over year growth rate for S&P 500 stocks at 7.3%, down from 13.8% in the first quarter and 19.7% in the fourth quarter of 2004. These results would translate into the slowest year over year growth in U.S. profits since the third quarter of 2002. Nevertheless, 7% plus is approximately in line with average growth rates over the past fifty years. Energy has been by far the largest contributor to earnings growth. If energy sector earnings are eliminated, the rest of the market's growth looks considerably weaker at about 5%. For example the consumer discretionary sector is actually expected to show a 4% drop in year over year profits. First Call's numbers suggest U.S. earnings growth will rebound in the second half. However, we regard these forward projections with skepticism.

In Canada, earnings growth should be about double the U.S. pace thanks to the S&P/TSX composites heavy weighting towards resources, although the expected 13-14% year over year growth will be down 5 or 6 points from the first quarter. Compared to the U.S., profit growth in the second half of the year in Canada will likely fall into single digits definitely a slowing trend.

Turning to strategy in this mid-cycle environment, equity gains will likely be derived from revenue driven earnings and cash flow delivery favoring companies with pricing power, market share gains, restructuring plans taking effect and superior service or operational excellence. In our research, we are still able to find well-positioned companies with strong execution skills that are able to generate free cash flow while trading on a reasonable, albeit higher, valuation basis. These companies transcend a broad range of sectors and hence our portfolios do not overweight any particular sector or theme. Communications restructuring should favor strong cable and communications companies such as Shaw Communications and Corus Entertainment. In the area of corporate recovery we have exposure to selected industrials including transportation (CP Railways). We maintain a strong position in financials (Bank of Nova Scotia, Power Financial) based on their ability to deploy excess capital for the benefit of shareholders including increasing dividends.

In the energy sector, much of the upward move in share prices has occurred in big cap oil oriented names which investors, including hedge funds, use as a vehicle for playing the commodity. As stated many times, our oil and gas investment approach is not a commodity play but a means to participate in the growth oriented juniors whose stock market performance is less related to commodity moves and more to execution of production growth plans (acquisitions and drilling). We remain committed to a narrow group of small and mid cap producers (such as Rider Resources and Celtic Energy), which have lagged oil indexes to date this year, but over time create significant value for their shareholders through rapid additions to reserves and production.

Fixed Income Strategy – Remaining Defensive

Following negative signals in March, recent positive economic indicators suggest that U.S. growth momentum is firmer than initially thought. Signals of economic strength are usually negative for the bond market, yet interest rates for all maturities beyond two years have remained flat to down since our last letter.

On July 6th for example, the ten year treasury closed at 4.08%, down 13 basis points from late April. Fears of a decline in U.S. economic prospects have given way to fears of the impact of GM and Ford debt downgrades on the corporate bond market and on hedge funds.

Until the recent evidence of economic strength, a debate had begun as to whether the Federal Reserve had largely completed its tightening of monetary conditions. That debate faded when the Fed raised its benchmark interest rate on June 30th to 3.25% from 3% representing a 225 basis point upward move from a year ago. The accompanying statement from the FOMC was more hawkish than many expected, and intimated that further rate increases would follow. Over the past few weeks the U.S. dollar has firmed up and corporate bond yields have adjusted upward, movements consistent with tightening financial conditions. On the whole however, rising inflation has kept real rates unusually low considering the stage of the economic cycle.

With core inflation at 2.2% (1.1% in January 2004) real short term rates are about 1%, well below consensus estimates of the natural rate of interest consistent with non-inflationary growth. As discussed, the impact of higher short term rates has been partially neutralized by a fall in longer dated bond yields leaving overall monetary conditions very loose. In fact, money appears to be unusually easy worldwide. Although inflation appears under control compared to previous cycles, inflation in services (versus goods) is high and increasing with unit labor costs accelerating. The Fed suggests that the inflation impact of oil and import prices is likely to wane in the coming months, but even if core inflation remains near 2.2% a return to (neutral) financial conditions would require further Fed rate rises. The question then arises as to the response of the bond market. Do bond prices finally move upward as is typical of a tightening phase or do they remain flat as has occurred so far. The risk is that the longer bond prices remain flat, the greater the probability of a sharp rise in yields in response to some unforeseen event.

In Canada, economic indicators on the whole have recently been encouraging. The capacity utilization of 86% reached in December is the highest since 1988. Overall, domestic demand is strong and sufficient to offset the drag from international trade. Under these conditions with Canadian productivity lagging and unit labor costs increasing and fiscal policy taking an expansionary turn, the Bank of Canada will likely have to adjust rates upward.

It is becoming more likely that the Bank of Canada will act in the coming months to tighten monetary conditions through a 25 bp increase in the bank rate. Until last week this was not priced into the yield curve, but the latest clues telegraphed by the Bank caused a violent reaction over the holiday long weekend, flattening the curve through increases in short term interest rates, which was felt generally throughout the curve. Roughly 17 bp of a rate increase is now discounted in the yield curve. In all likelihood there will be a further flattening of the curve in the weeks to come.

Given these considerations, our fixed income strategy has become more defensive. We continue to “high grade” the corporate holdings, taking gains where possible and replacing those holdings with ones of higher credit quality. The corporate bond market has been generally starved of new issues, as most corporates are experiencing growing cash flow, and have little need for financing. Real return government bonds continue to have a significant role in the management of fixed income portfolios, with those securities responding well to the rising trend of inflationary measures. In the mainstream government bond markets we are avoiding the short end of the yield curve where rates are moving up, and hold selected longer dated issues in the belief that Fed policy will help keep inflation under control, and long rates will stay in their current range or even fall somewhat. We are cognizant of the risks of an unexpected shock, which would cause long yields to bounce up but rate the probability of such an occurrence low for now. Finally, we are avoiding U.S. denominated issues because of the strength of the Canadian dollar.

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.

For more information contact:
Barrantagh Investment Management Inc.
(416) 868-6295

Copyright 2005 Barrantagh Investment Management Inc. All rights reserved. Reproduction of portions of this Commentary is permitted provided the source is noted. Please notify us at info@barrantagh.com of any reproductions.