Barrantagh

Investment Management

CAPITAL MARKETS REVIEW
SECOND QUARTER 2006

In This Issue:

- **Economic Outlook – Growth Continues but Uncertainty Abounds**
- **Equity Markets – Managing in Volatile Times**
- **Fixed Income Markets – Opportunities Emerging**

- Equity and fixed income markets have succumbed to a bout of volatility as a host of uncertainties, particularly rising interest rates and slowing growth, have captured investor attention.

- The U.S. economy is expected to slow, reflecting the effects of rising interest rates, elevated energy prices and a housing market slowdown. U.S. exports may accelerate to replace weakening consumer spending.

- Paradoxically, many major global economies continue to expand at a solid pace, although U.S. and global monetary tightening will ultimately constrain growth.

- Markets are adjusting to the style of the newly appointed Fed Chairman, Bernanke. His rhetoric is not clear as to just how concerned he is with rising inflation and when his monetary tightening may end. Markets fear he may overreact to inflationary trends.

- Our equity strategy continues to focus on leading companies evidencing visible and predictable operating results. As the full lagged effects of higher interest rates take hold, higher risk premiums in equity markets will be demanded and more volatility can be expected. Our portfolios are beginning to reflect a move to more international names.

- Fixed income markets continue to be characterized by high valuations and narrow credit spreads. While we are maintaining a defensive strategy, we are preparing to add to government bonds as signs become evident that the global tightening campaign led by the Fed is ending.

Economic Outlook – Growth Continues but Uncertainty Abounds

After more than three years of relatively stable conditions, global equity markets and commodities tumbled, some by 10 percent or more, in less than two weeks. Emerging markets and commodities endured the most, although no market sectors have been immune. Historically considered safe havens, banks, pharmaceuticals and bonds have also fared poorly. The resource-concentrated TSX index has been especially erratic after a rise of almost 10 percent to April and gains of about 90% in four years. Volatility has suddenly returned with a vengeance to all markets reflecting a sudden spike in risk aversion. Almost overnight, investor sentiment has begun to reflect a pronounced distrust of risky assets, particularly in emerging markets and a preference for higher quality and defensive securities.

In our view the sell-off is not simply a bout of profit taking. The major underlying concern is the fear that rising global interest rates might upset the delicate scenario of synchronous global growth especially now that America's housing market and consumer sector seems vulnerable. Secondly, the newly installed Fed Chairman, Ben Bernanke, has made a somewhat uncertain start to his tenure. He is dogmatically focused on the recent uptick in U.S. core inflation, but investors fear he will overshoot in raising rates and precipitate a sharp economic slowdown. Certainly monetary tightening policies are in evidence in many key economies. Accordingly the scope for investors to borrow cheaply to make "momentum bets" on rising markets (the so-called "carry trade") has become much less attractive. So far, any talk of hedge funds getting into trouble has been vague although we suspect that hedge funds may be compounding the turmoil through their active derivative trading tactics.

Paradoxically, the recent market jitters are not yet reflected in the global economy. Economists at the international monetary fund recently raised their forecast for global growth in 2006 from 4.3 to 4.9%, and their expectations for 2007 were revised upwards as well. At the same time, inflation in most major countries remains fairly well restrained especially given the sustained strength in oil prices and high capacity utilization levels. Taking a historical perspective, the last three years has been an unusually prosperous period in which global inflation remained very low and monetary policy was extraordinarily accommodative. U.S. consumption, propelled by a multi-year housing boom, led above trend global growth and China reciprocated with an investment boom. During this period the center of global production gravitated towards high savings rate regions, mainly China, and the resultant savings surplus was circulated into U.S. and Euroland bond markets. This framework was a win for all parties. Asia achieved a high rate of economic growth, Japan emerged from years of deflation, the U.S. benefited from cheap goods and cheap money, and Euroland prospered as well. At the same time risk spreads in various capital markets reached historic lows while financial leverage rose to historic highs. Of course, these symbiotic relationships produced imbalances including the U.S. $800 billion current account deficit.

The U.S. economy is definitely slowing but seems to be on track for GDP growth of more than 3% into 2007. While a slowdown from the current 5% pace is occurring, the U.S. economy is proving to be surprisingly resilient in the face of 425 basis points of Fed tightening, record oil prices and the absence of fiscal stimulus. Of course a buoyant housing market (the wealth effect) has played a big part in the consumer-led, strong U.S. growth in recent years and that underpinning has definitely become somewhat shakier. Nevertheless, robust business investment and exports will likely offset some of the possible weakness in the consumer sector. U.S. corporate profits stood at a staggering 15.9% of national income in Q1, the highest since the early 1950's, and corporate balance sheets are very healthy. While corporate profits may be peaking, corporation balance sheets are well positioned for a long period of capital spending.

Equity Markets - Managing in Volatile Times

Equity markets generally performed well in the first four months of the year and then suddenly hit the wall. The primary drivers of earlier gains were solid Q1 corporate earnings, expectations for continuing revenue and earnings strength and investor expectations that the Fed would complete its tightening phase without materially threatening economic growth. We are now witnessing a process by which macro risks are being re-priced and the framework marked by elevated asset prices and very low interest rates is now coming under serious question. While the world is not likely headed for a major downturn, capital markets are not as low risk as the narrowing of credit spreads and booming emerging markets were telegraphing. Increased equity market volatility is a natural by-product of rising uncertainty about the future. In our previous quarterly letter, we mentioned these threats and suggested that "we anticipate modest returns accompanied by an increase in volatility". Our present strategy continues to incorporate these concerns and we feel our longer term view, beyond the current market volatility, will ultimately position our clients to achieve the returns they desire in a more prudent manner.

Setting aside the macro risks, we believe that during this period of equity market turbulence it will be individual corporations which can execute and deliver earnings which will provide equity strength over the balance of the year. In general, economic fundamentals point to moderating earnings growth. North American corporate profit margins stand at a multi-decade high and revenues are likely to moderate as economic growth slows. Profitability levels are probably at greater risk now than a year ago; particularly since rising costs usually lag the top line. The powerful earnings recovery that has been in place since 2002 in the U.S. and Canada will be harder to sustain from this point forward. Accordingly, modest equity market returns are likely to be delivered, and those returns will not be shared as widely as in prior periods.

Our strategy will be to focus on dominant companies offering relative earnings stability, strong cash flow growth, and reasonable valuation compared to downside risks. As the Fed and other central bankers complete their monetary tightening efforts, companies providing a secure and competitive dividend yield should outperform. With representation in our portfolios by financial services such as the TD Bank and communications, such as Corus Entertainment and Shaw Communications, we believe our portfolios are relatively well positioned to cope with the current environment. In commodity related areas, we remain under weight oil and gas although we continue to hold our favorite natural gas producers. We have not added to our holdings in metals and materials. In the near term, we do not see a significant rebound occurring as markets may well be inclined to adjust further to the realities discussed above.

Looking over the next few quarters, our current research suggests clients will witness a larger international component in their portfolios. Companies such as Cintra Concesiones de Infraestructuras de Transporte, a Spanish based corporation which builds and maintains toll highways (including the 407) and parking garages in Spain, Portugal, Ireland, Canada, Chile and the U.S. Our meetings with management suggest that they are focused on steady cash flow growth through operational volume and price increases as well as continuing their successful acquisition strategy. In fact, looking at Cintra's current stable of assets, should the company not complete any further acquisitions, their internal rate of cash flow growth would be well in excess of 10%. It is these types of companies that we believe will perform well during the current market environment and beyond.

Fixed Income Markets - Opportunities Emerging

For several quarters we highlighted the fact that valuations for North American government bonds were stretched and that corporate spreads had narrowed to the point where opportunities in the corporate market were slim. Accordingly, we have been recommending a conservative approach to fixed income with defensive positions in relatively shorter duration securities. As we head into the second half of 2006, bond investors face a somewhat more aggressive Fed tightening stance and sufficiently strong economic numbers to cause the yield curve to rise and bond prices to fall. U.S. treasury yields have gravitated higher by about 30 to 40 basis points over the past quarter. The correction to bond prices has restored valuations to more reasonable levels and we are now vigilantly watching for an entry point to position for what we expect will be a strong rally in bond prices. Specifically, we will be seeking opportunities over the coming months to add to our allocation of government bonds. We should point out we are still cautious on fixed income markets at this juncture for several reasons. First, economic data suggests that upside risks to inflation have not diminished to the point where the Fed would consider inflation a non-threat. Our expectation that the U.S. dollar may weaken further adds to the likelihood of still rising inflation and the recent strength in capacity utilization rates suggests the same trend. Overhanging the bond market is the risk that Asian economies which have heretofore demonstrated an insatiable appetite for U.S. treasuries will become less interested in U.S. treasuries. As Asian economies grow less dependent on U.S. consumption, they will have less interest in holding U.S. treasuries. A peaking of capacity utilization rates and diminishing inflationary pressures or an apparent end to Fed tightening are all factors that would encourage us to position more aggressively in the government bond sector.

Corporate bond credit spreads have recently widened in many industries, and will continue to do so. With global monetary authorities continuing to tighten while earnings growth is expected to slow, credit spreads have generally bottomed, and the ratio of credit agency rating downgrades to upgrades is changing. There is a rising risk of credit events from the growing M&A environment and from restructurings. In the meantime, we continue to reduce exposure in the corporate sector and will redeploy the cash over time, initially in government bonds and then allocating to other sectors as opportunities arise.

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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