Barrantagh

Investment Management

CAPITAL MARKETS REVIEW
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- The U.S economy may be at a crossroad following meagre GDP growth of 0.6% in the first quarter (the weakest quarter in four years). While the consensus calls for a sharp rebound over the balance of the year, we see substantial risks of a slow recovery based on protracted housing/mortgage credit issues.

- Meanwhile global economies beyond the U.S. show strong growth momentum, exceeding earlier forecasts, in spite of central bank tightening underway in many countries to contain rising inflation and growth excesses.

- Globally, mergers and acquisitions activity, particularly leveraged buyouts by private equity funds, have become a powerful catalyst in equity markets at a time when corporate profits may be peaking and interest rates are rising. The BCE takeout at $34.2 billion illustrates the clout of buyout firms and the valuation precedents they are setting.

- Our equity mix includes well established international companies generating cash flow in developed markets for redeployment in higher growth emerging market opportunities. The liquidity driven and profit driven phases of the equity market are maturing but we can still find inexpensive equities and see no signs of an economic or financial crisis which would derail equity market confidence.

- A broadly based sell-off has occurred in North American bond markets as investors demand higher yields and reassess the risks of monetary tightening outside the U.S. Mr. Bernanke continues to hold the Fed rate at 5.25% but cautions that inflation concerns dominate his policy thinking. In Canada, Mr. Dodge seems determined to raise rates to bring inflation within his 2% target rate.

- In North American bond markets, government bonds are undergoing a re-pricing (higher yields, lower prices) and corporate spreads are widening as balance sheets become more leveraged to finance share buybacks and make acquisitions. We remain defensive in fixed income pending signs that inflationary pressures are easing and corporate yields fully reflect underlying risk.

Economic Outlook – Divergent Trends

The global economic scene over the past year has been characterized by two diverging trends - strong growth in major economies outside the U.S. on one hand and a sharp deterioration of the U.S. economy on the other. The plight of the U.S. economy was clearly evident in the first quarter as real GDP growth was revised down to a meager 0.6% from 1.3%, reflecting the woes of the housing/construction sector, a downward revision to inventories and lower net exports. This masked solid demand from U.S. consumers and businesses of about 2.5%, outpacing the 1.8% growth in these areas during the previous three quarters.

Economist's views are divided at present as to whether the U.S. economy is poised to rebound or experience further weakness. The bears are concerned that the U.S. economy will be stalled for some time by the housing slump, paltry consumer savings, high gasoline prices, trade imbalances, the fiscal deficit, job losses in manufacturing and foreign competition. The bulls argue that the first quarter was heavily influenced by temporary factors, particularly inventories, and that the stage is set for a rapid recovery (to at least 2.5% growth) pointing to a resilient U.S. consumer, healthy corporate spending, strong exports and a contained housing sector correction. At present, the growth bulls seem to have the stronger case as evidenced by May's surprising strength in retail sales and strong May/June employment, as well as unexpected strength in both the manufacturing and service sectors.

In our opinion, looking at all available data, the arguments that the economy will re-accelerate quickly seem somewhat tenuous. From our perspective, it seems that the U.S. economy is more than likely at a crossroads with the risks of protracted weakness, but not a recession, just as real as the potential for a rapid rebound. Our concerns in part reflect the fact that the housing/sub-prime mortgage debacle may yet become a catalyst for widespread financial market instability with severe consequences for the economy as a whole, including pressure on consumer and corporate spending.

Also of concern is the Fed's monetary policy and its bias to contain inflation. Although the Fed has held bank rates steady for over a year at 5.25% it continues to express deep concerns about inflation, based on its readings of a tight labour market, and high capacity utilization, even though inflation has dropped, for now, to the upper band of its stated comfort zone.

Beyond the U.S., the global economy continues to demonstrate strong growth momentum. The growth from China and India continues to surprise to the upside as one-third of the world's population gradually gains economic importance. China's economy continues to grow at a supercharged 10%+ rate in spite of its authorities efforts to rein in growth and orchestrate its currency upwards. India's economy continues to grow at an above consensus rate of 9% while Japan's recovery points to growth of at least 2%. The U.K. grew at a 2.9% annualized rate in the first quarter and the Euro zone economies advanced 3.1%.

Importantly for Canadians, the Canadian economy continues to outpace its U.S. neighbour by a wide margin. GDP growth accelerated to 3.7% in the first quarter with much of the strength skewed to Western Canada.

Looking at these trends from an investor standpoint, it is apparent that the emphasis on global economic growth has been a major factor in buoyant stock markets in this cycle. However, we have become concerned that investors have not been mindful enough of the overwhelming significance of interest rates as they have risen across the globe over the last year or more. The upside surprises to growth are fuelling inflation worries in many countries and central banks have become more aggressive in boosting policy rates which will eventually drain excess liquidity from financial markets. The risk that monetary authorities may overshoot in their efforts to contain inflation and credit market excesses is a major factor shaping our investment strategies in 2007.

Equity Markets – Fuelled by Private Equity

Until the shakiness seen in the first quarter of 2007, global equity markets have been overwhelmingly positive with the only interruption occurring briefly about one year ago. Concerns, then and now, centre on inflation, slower economic growth, declining asset quality and the peaking of corporate profits. Recently investors worldwide are pondering the potential for troubles in the U.S. subprime mortgage market to spread to credit availability generally and drag both consumer and corporate spending downward. Certainly with interest rates rising around the world, we at Barrantagh are paying heed to the potential for a widespread credit contraction to be the catalyst for a correction in equity markets. Global liquidity — including petrol dollars, corporate cash, private equity, household net worth, pension fund reserves, and central banks reserves has been abundant, if not excessive, encouraging investors, whether individuals or sophisticated funds and institutions, to pursue increasingly risky avenues for investment in equity and commodity markets.

Massive amounts of cash supplies to the capital markets have contributed to record global merger and acquisition activity, and the rise of private equity funds as a force in capital markets through their leveraged buyout activities. According to Thomson Financial, the value of mergers globally has exceeded $2 trillion so far this year and may finish 2007 at a record dollar value of $4.5 trillion. Much of this is financed by debt borrowed from banks, pension funds and even government coffers. Many of these deals are led by private equity firms which now number over 170 with assets averaging over $1 billion.

Within this environment, the clients of Barrantagh are positioned to perform well while avoiding unreasonable levels of risk. Barrantagh has adhered to its approach of identifying companies trading at reasonable values in relation to their ability to generate earnings and cash flow which is, as it happens, closely aligned with the philosophy of many private equity funds. Reflecting our basic buy and hold philosophy, Barrantagh's patient approach has experienced steady returns and its stock selection has resulted in benefits to clients, directly and indirectly, from takeover bids for such companies as Alcan, as well as the revision in valuations stemming from takeovers of comparable companies (i.e. FNX Mining). Financial stocks of course have marked time reflecting their tendency to under perform in periods of rising interest rates. Nevertheless, Barrantagh remains committed to its holdings in diversified financials as well as companies in other sectors which dominate their businesses and are generating free cash flow to invest in growth or increase dividends.

Our search for value extends to international companies which have proven themselves in a global business environment and are widely recognized by investors for their competitive advantages. Currently, approximately 50 percent of the equity weighting in Barrantagh accounts is comprised of international companies several of which are European based and have the capacity to deploy free cash flow generated in developed markets to opportunities in faster growing emerging markets. ING Groep NV, Grupo Televisa SA and Telefonica SA are examples of such companies.

Fixed Income Markets – Re-pricing Underway

Following a long stretch of steady and predictable increases in the Fed funds rate from 1% in June of 2004 to 5.25% in June of 2006, the U.S. Federal Reserve has adopted a neutral stance over the past year, seeing no reason to adjust rates. On June 28th, the Fed once again decided to stand pat. As discussed last quarter, the Fed Chairman, Mr. Bernanke, in office now for seventeen months, has had to balance concerns about the housing/mortgage-led U.S. slowdown against inflation increases which exceed his comfort zone. Recent data indicates that inflation has eased somewhat towards the upper range of its 1% to 2% comfort zone. For now the data suggests there is no inflation motive to shift policy. Furthermore, the Fed seems confident that the U.S. economy will rebound decisively later this year. Accordingly, rate cuts to support housing and the consumer (considered necessary by many pundits early in the year) do not seem likely now. Nonetheless risks to the economic recovery abound, and at the same time, Mr. Bernanke's "predominant policy concern" remains – i.e. that inflation may fail to moderate as expected.

While the Fed remains on hold to consider its options, fixed income investors have not been so disciplined. From mid May to mid June ten-year treasuries surged more than 60 basis points to nearly 5.3% before subsequently retreating to about the 5.0% yield level on renewed subprime mortgage concerns and weak housing reports. Looking at movements in yields more broadly, the clear trend in this quarter has been a shifting upward of yields across the entire spectrum of the yield curve. Ten year treasury yields have risen about 30 basis points since May 1, while the yields on similarly dated Government of Canada bonds have risen over 40 basis points since early March. The resultant downward re-pricing of bonds, a difficult period for investors, can be linked to central bank policy shifts, economic growth and risk.

Investors finally realized that the Fed would not cut rates and re-priced the bond curve accordingly. A portion of the bond re-pricing relates to an up-tick in the imbedded risk premium related to re-leveraging of balance sheets in the wake of mergers and acquisitions activity and concerns that China and Kuwait may diversify away from U.S. dollar holdings. All in all, the path of least resistance for U.S. government bond yields seems to be higher in the near term and the same can be said for Canadian bonds.

At present, the Bank of Canada Governor, David Dodge, is weighing a more aggressive tightening stance than his U.S. counterpart. In a May 29th announcement, Mr. Dodge gave a firm signal that monetary tightening was likely in the near term. The latest economic indicators only confirm the Bank of Canada's intention.

Turning to corporate bond markets, we continue to believe that investors are not being adequately compensated for intrinsic risk, even though corporate spreads over government bonds have widened significantly over the past two months. The recent widening in corporate spreads mainly reflects the risk of re-leveraging of balance sheets in response to threatened leveraged buyouts. Over the next few months we believe a number of factors contributing to heretofore narrow spreads will turn somewhat less positive (corporate profits, strong balance sheets and excess liquidity). For instance we believe banks and institutions are beginning to tighten lending standards not just for mortgages, but also to corporations. As these trends play out corporate spreads will widen further in our view. Accordingly, we continue to prefer government bonds over corporates and have diversified our government holdings across the most attractive segments of the yield curve to mitigate risk and maintain a conservative duration of less than 6 years.

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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