Barrantagh

Investment Management

CAPITAL MARKETS REVIEW
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- The odds of the U.S. economy averting a broadly based recession have improved. Excluding the housing and auto sectors, the U.S. economy is still growing at about its expected long term growth rate.

- The housing downturn and tightening lending standards have yet to take a significant toll on consumer spending. Nevertheless, consumer confidence has fallen to recessionary levels, usually a precursor to consumer weakness.

- Globally, growth in developed economies is showing some stresses. Euro zone growth is slowing and the Japanese economy is fragile. China and India continue to shrug off the slowdown elsewhere but Chinese inflation levels are worrisome and the infrastructure boom leading into the Olympics is probably unsustainable at its current pace.

- In the aftermath of the all-out assault by central banks on the credit crisis, banks and investment dealers continue to report losses and are engaged in a lengthy process of balance sheet repair. Credit contraction is underway and poses a risk to both consumers and business spending.

- As global stock markets struggle to find a firm footing, we remain somewhat overweight equities reflecting our confidence in our portfolio companies which evidence strong balance sheets, skilled management, superior business models and the ability to maintain or increase dividends.

- Amidst the many current uncertainties, new investment opportunities are emerging, such as companies which will benefit from the huge petrodollar surpluses to be invested around the world.

- In fixed income, we remain overweight government bonds as a safe haven in a lingering credit crises environment. We believe it is still premature to invest in corporate issues.

Economic Backdrop - U.S. Recession Less Likely

Fallout from the lingering credit crunch and worsening housing slump is weighing heavily on the U.S. and developed economies. The credit crisis continues to manifest itself in ongoing write-downs by leading global banks and investment dealers, but the ready availability of capital to shore up bank balance sheets is a positive sign. Meanwhile, the housing slump in the U.S. worsens as housing starts decline, home prices are still falling, and mortgage foreclosures rise. Versions of the U.S. housing slump are showing up in Britain and other countries as well. At the same time, the world's monetary authorities have changed direction, moving away from an all-out assault on the credit crisis to a sidelined posture aimed at striking a balance between inflation and weakening economic growth.

The latest data indicates the U.S. economy grew at modest annualized rates of 0.6% and 0.9% in the fourth and first quarters. With assistance from tax rebates, strong foreign demand for U.S. goods and lean inventories, the chances of the U.S. economy avoiding recession have improved. Recent U.S. economic weakness is sharply skewed toward housing and autos. Excluding these two categories, accounting for 7% of GDP and only 3% of employment, the economy is growing at about a 2% rate. This pattern was clearly absent in the early stages of the 2001 recession.

A key source of underlying strength is the service sector which accounts for nearly 60% of GDP. Service sector GDP rose 3.0 – 3.5% in the last two quarters. The resilience in service sector employment compared to past recessions explains why overall job losses, have been much less severe than in previous recessions. A source of strength is exports and overall industrial production, although slowing, is benefiting from foreign demand. Over the last two quarters foreign trade has likely offset about half of the drag on economic growth related to housing and autos. For now, it appears the weakness in the U.S. economy has not spread widely enough to generate a deep and broadly based recession. Meanwhile the Canadian economy is in better shape than its neighbour but will likely show excess capacity by late summer. Foreign trade remains the weakest component of growth and the commodity boom masks problems in other areas of the economy.

Beyond North America economic performance is holding up surprisingly well, although consumers around the world are grappling with higher food and fuel prices. Also, strong currencies relative to the U.S. dollar are hampering exports into the U.S. In Europe, British house prices are in decline and economic growth has slowed markedly. Many of Europe's economies seem to be deteriorating based on measures of business and consumer confidence. In Asia, the Japanese economy appears fragile, reflecting declines in industrial production and weaker exports. The all important Chinese economy is still growing at a rapid pace of about 10% but inflation has risen to an unsustainable 8.5% rate and the countrywide infrastructure boom leading up to the Olympics may dissipate.

An overriding economic risk for investors is the return of stagflation i.e. a period of sub par economic growth and rising inflation. Global inflation has hit a nine-year high of 4% and it may rise further as higher oil prices work through world economies. The issue is how to foster economic growth but contain rising prices of critical commodities such as energy, food and water. The Fed and other monetary authorities are signaling that controlling inflation is a priority, implying an extended period of weak economic growth. In summary, if the credit crunch and the housing slump don't continue to dampen the economy, the Fed, in reversing monetary policy, may induce the same result. Either way, a strong recovery seems unlikely this year.

Equity Markets - Values Outside Canada

Investors' confidence around the world has been severely shaken by a confluence of headwinds including the weak U.S. economy, the erosion of home values, financial system de-leveraging, energy and food price shock, and the prospect of inflation potentially requiring tighter monetary conditions.

Equity markets around the world have sold off dramatically in the last few months. The S&P500 has fallen 10% this year, the London FTSE 13%, the Tokyo NIKKEI 10%, and the Hong Kong market nearly 20%. Overall, the MSCI World Index has fallen 11% in 2008, and the Morgan Stanley EAFE (an index reflecting non-North American market performance), has fallen about 20%. The remarkable exception is the Canadian S&P/TSX which has achieved gains for the year as it continues to ride the commodity bull market. In fact, since the beginning of the credit crunch last August, the Canadian benchmark has outperformed every other index in the world. During the tech boom in the late 1990's, performance of the S&P/TSX was dominated by Nortel with a 35% weight at one point, and the technology sector with a 40% weight. In this cycle, the Canadian market is highly dependent on the right call for commodity prices. The S&P/TSX correlates more strongly than any other benchmark with the CRB Futures Index. It could be argued that the diversity of companies in the Canadian resource sector provides the opportunity for spreading risk this time around. However, all of these companies comprising over 40% of the Toronto exchange, depend on the same macro theme. Is global growth strong enough to sustain the commodities boom? Investors are well aware that oil prices have doubled over the past year and other commodity prices have sustained near record levels. Buoyed by the commodity boom, the Canadian stock market is priced as though the positive factors driving performance will continue unabated e.g. contained inflation, low interest rates, strong earnings growth. At this stage we believe the Canadian market is overly vulnerable to the cyclical nature of commodities. There is a worrisome degree of speculation in oil and agricultural prices. Meanwhile, we are cognizant that global stock markets are likely to recover over time from recent depressed levels, particularly as the U.S. economy stages a recovery.

An overall caution we have held for some time is that earnings outside of commodity-based companies have been a challenge. Obviously financials have been a massive drag on overall earnings performance but other sectors have seen a decline as well. End market demand is sluggish in some areas while margins in other sectors are under pressure from rising capital and input costs. Accordingly, we have been very careful to focus on companies with clear competitive advantages in their markets, strong earnings and cash flow generation in the current environment and leadership capable of managing through more difficult business conditions.

Against the above negatives and a narrow highly cyclical Canadian market, we have structured portfolios which have outperformed global indices by a wide margin. We have exposure to energy and materials, and the bulk of our equity holdings are companies with strong balance sheets and sound operating performance in the current environment, complemented by strong management skills. For sometime we have seen reasonable valuations and plenty of sidelined cash outside of Canada which prompts us to continue to favor a strong non-Canadian component in our investment portfolios.

A recent addition to the portfolio is British America Tobacco, a company in a recession-resistant business, with a strong balance sheet and a dividend rate well above the return on short term government bonds. Other international holdings, which we have discussed in previous letters, such as Telefonica, Diageo and McDonalds also have defensive characteristics. Finally, we are underweight financials but believe the Canadian banks are sound value and offer safe yields in spite of recent stock price weakness.

Fixed Income Markets - Defensive Stance Remains

Over the last two to three months fixed income markets have swung between euphoria (at the prospect of further administered rate reductions) and gloom coming from a growing focus by central bankers on inflation. In the latest action from the US Fed FOMC (holding rates unchanged) a balance was struck between the upside risk of the inflationary impact of commodity prices, chiefly oil, and the downside risk to economic growth. We do not expect sharp moves in government bond markets in either direction. However, since last quarter the yield curve has alternately steepened and flattened as traders try to find the best strategy to deal with the current environment.

The impact of the credit crisis continues to linger. Corporate credit spreads are creeping outwards, and the volume of non-financial new issues remains low. The Maple market which has been a regular source of new issues also remains largely on hold. The new issue market in Canada has therefore been dominated (principally) by banks, as they either raise new capital to repair balance sheets or replace maturing deposit notes. New issues have required concessions to the market to ensure successful launches. While that has been effective, it has also caused spreads on outstanding issues to move wider, accepting the concessionary spread as the new determinant of market value.

We remain on the sidelines with regard to buying corporate debt, waiting for the market to find new stability. We have been pleased to see the re-pricing of corporate debt, and most particularly structured debt of all types, and expect this to continue for some time still. In the meantime we will continue to focus on maintaining liquid government bond holdings.

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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