Barrantagh

Investment Management

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In This Issue:

- **Economic Backdrop – Recovery Needs Traction**
- **Equity Markets – Discounting Adjusted**
- **Fixed Income Markets – Corporate Spreads Tighten**

- Although global economies continue to contract, the rate of decline (the so-called "second derivative") has slowed and the risk of major shock waves to the economy or the financial system has diminished as governments have stepped into vulnerable areas i.e. (banks, autos, housing).

- Various economic indicators around the globe suggest the worst of the recession is in the past and renewed growth is in the offing.

- In the U.S., housing markets are stabilizing, consumer spending is firming and the rate of job losses is slowing. In many countries inventory de-stocking is paving the way for a rebound in global manufacturing. China's economy is outperforming earlier forecasts.

- Consumers are part way through a wrenching adjustment as their de-leveraging efforts result in increased savings at the expense of current consumption. The U.S. consumer may not necessarily lead the economic recovery as decisively as in the past.

- Businesses are making substantial adjustments to an environment of little pricing power, unutilized capacity, protectionist measures by various countries, i.e. the buy America policy, and still weak final demand for their products and services.

- Equity markets are now properly discounting a global recession rather than a depression but continue to struggle with the timing and magnitude of the economic recovery.

- Corporate bond spreads have tightened, causing a rally in corporate issues, as the credit crisis passes and the economy finds a bottom.

Economic Backdrop – Recovery Needs Traction

Widespread fears of a 1930's style depression have evaporated and the focus now is on the "green shoots" of recovery from a recession, albeit a devastating one. Recent economic data provides mounting evidence that the recession is in retreat. It would be catastrophic of course if there had not been some positive signs of a rebound, given the massive bombardment of stimulus since the fall of 2008. The severe toll exacted by the recession is explicit in the latest worldwide GDP figures. For example, in the first quarter, U.S. GDP fell 6.1% following a 6.2% decline in the previous quarter. Canada's GDP has declined 3.5% for two consecutive quarters reflecting the woes of its manufacturing sector and a steep decline in exports. The latest tally shows that only 2 nations are expected to show growth in 2009; China, 6.5% and India, 5%. Most recently, the World Bank revised its forecast for global growth downward to a contraction of 2.9% this year from a 1.7% decline forecast earlier. The World Bank has also cautioned that economies may be slow to recover due to falling net private capital inflows and protectionist measures by many economies struggling to resurrect domestic growth at the expense of their trading partners.

Examining the downturn in more depth, it is apparent that the consumer has been particularly hard hit as the three supports to spending have been devastated; income growth, credit availability and wealth. Wealth losses suffered by U.S. households total almost $14 trillion since the recession began and efforts to pay down debt have resulted in the savings rate rising to 5.7%, the highest rate in 14 years. The recession has also forced businesses to make wrenching adjustments, amid mounting shareholder pressure, as falling revenues have presaged a steep profit decline in-spite of drastic cost cutting measures. The unemployment rate has risen to 9.6% in the U.S.(it was around 4% in late 2007) and has risen above 9% in the Euro zone. Businesses have pared inventories for five quarters and cut equipment spending throughout the last year. Falling capital outlays accounted for about two thirds of the 6.1% decline in first quarter U.S. GDP while U.S. capacity utilization in manufacturing has fallen to a record low of about 65%, about 14 points below its long term average.

Against the background of these dire numbers it is reassuring that the unprecedented countermeasures taken by Central Banks and governments and even by the private sector, seems to be taking hold. A variety of economic indicators from different parts of the globe have definitely turned positive. First, the American and global banking system is stabilizing. Criticism of the government's emergency care (TARP, TALF, etc.) persists but credit is starting to flow again. A significant milestone was reached when ten financial companies were granted the permission to repay a combined total of $68 billion in loans received under the TARP program. Secondly, conditions have steadily improved in global manufacturing following a 15% decline in output in the year ended March 31st. In America, orders for durable goods rose 1.8% in May and capital goods orders rose 9%. In the Euro area, surveys of purchasing managers indicate a firming trend and industrial production in China appears robust. It seems that order levels in many businesses are rising, following large scale inventory destocking over the last year. As well, industrial production in the U.S. as measured by the ISM Index rose from 40.1% to 42% in May while in the Euro zone, the Purchasing Managers Index rose by almost 4 points to 40.7%. Thirdly, there are fresh signs that housing markets are showing signs of stabilization. The free fall in housing sales has ceased and bloated inventories are shrinking as buyers return to the worst hit markets. Home sales in America rose by 6.7% in May, the fourth increase in five months. In several countries the number of loans approved for house purchases has been rising. Overall, the nascent signs of recovery are encouraging, particularly in the context of the trillions of dollars governments have committed to supporting the economy and the financial system. Of course, government action on the current scale involving a plethora of innovative programs has never been tried before and no one can be absolutely certain what difference these programs will ultimately make. A sustainable recovery depends on government support being supplanted by private sector demand and spending. On that front, we look forward to further evidence that the recovery has traction.

Equity Markets - Discounting Adjusted

Stock markets around the world have staged a significant "relief rally" since March based on the perception that a repeat of the Great Depression will not occur and what turned out to be a very severe recession is now showing signs of recovery. What began as a combination of "bottom-fishing" and short-covering has now attracted investors who are very willing to emphasize the positives while assuming the negatives are already priced into current valuations and earnings estimates. While investors seem to have forgotten that the global financial system was perhaps on the brink of collapse just eight months ago they remain extremely sensitive to the risks of an economic recovery, shifts in monetary and fiscal policy, the state of the financial sector, and the outlook for corporate profits. These concerns are, of course, justified and the current mood of investor optimism may be premature.

The reality is that the so called "green shoots" of economic recovery are just that and global economies are still contracting albeit at a slower pace. We expect the economic recovery will probably take longer and be less vigorous than current expectations seem to indicate for many reasons. The deleveraging process around the world is far from complete, unemployment is still rising, wages are stagnant, consumers have become more frugal, businesses are struggling to regain sales, protectionism is on the rise, government deficits are ballooning and the threat of higher taxes has become a worry. Fortunately, policy makers are fully engaged in efforts to mitigate the damage from the recession but their efforts are not likely to be strong enough to return the world to the high growth, low inflation era that characterized 2002 – 2007. In all likelihood excessive regulation and government intervention will also be factors that will constrain growth. An important factor in global growth is the role played by major emerging countries, particularly Brazil, China, and India. Analysts expect a strong contribution from these countries driven by a significant pickup in the spending capacity of an expanding middle class. However, in the near term, the flow of capital to these countries may be constrained in the aftermath of the credit crisis, limiting investment and therefore, job growth. As well, the banking system will be a lesser force than in the last growth cycle. With extensive regulation soon to become law, the sector will be de-risked and de-levered but innovation in extending credit will be limited and the cost of credit will probably be higher.

Farther down the road governments will need to manage the process of draining the system of emergency liquidity, a task complicated by the possibility that the U.S. and the U.K. will face slow growth at a time of increased pressure to create jobs. Governments are notoriously reluctant to impose short term pain for long term gain.

In the final analysis, global growth will likely be lower and unemployment higher notwithstanding the continued rotation of the engines of economic activity away from industrial countries and towards emerging ones. The heavier hand of government in economic life has usually not been conducive to maximizing private sector ingenuity. The upshot of the above scenario is that corporations will have to be much more efficient and adept at executing their business plans and generating profits than in the era, now ended, of lax credit standards and free reigning market forces. The implications for our investment approach are that we will have to be even more diligent in the selection of companies for investment which will prosper in the world that emerges post recession.

One of the industry sectors that we have been increasing in our clients portfolios is banks, more specifically Canadian banks. Prior to the credit crisis, Canadian banks were well overcapitalized which gave them a large cushion to absorb the credit shock. The banks were forced to take large write-downs over the last two years but never came close to breaching any regulatory covenants. Meanwhile they have all been able to re-capitalize bringing their balanced sheets to coverage ratios that are better than pre-crisis. Today, bank valuations are cheap, the dividend yields are high and we believe can be maintained while growth prospects both domestically and internationally are abundant. Canadian banks have become the model for the industry globally and should be a solid investment in a low growth, low inflation environment.

Fixed Income Markets - Corporate Spreads Tighten

The second quarter brought the much anticipated tightening of corporate credit spreads and a host of new issues to go with it. The market response to what were essentially the first new corporate issues since the start of the credit crisis was overwhelming. Liquidity was tight as no one wanted to sell bonds, rather buying the new issues with cash. So demand came from all sides: the regular buyers of corporate credit, equity participants seeking to capture the high coupons, and of course, retail institutions. The new issues met with staggering demand, with issues increased in size and buyers receiving as little as a ten percent fill on their orders.

Initially, issues were priced with a large concession to the expected secondary trading level (i.e. additional yield over and above comparable secondary issues), and the bonds would rally significantly to capture the concession. More recently the concession has been smaller and the range of credit quality of the issuers has broadened, necessitating more rigorous credit analysis.

Spreads have narrowed significantly through the quarter, and continue to do so, although at a slowing pace. The addition of BBB corporate credit new issues to the market has also added a greater degree of diversification. Familiar names such as Bell Canada and Rogers Communications (launched respectively as $600 million and $700 million issues and each increased to $1 billion, both BBB issuers) have joined a market previously dominated by bank and life insurance company issuers (typically A to AA rated issuers).

Government yield curves have been battered up and down through the quarter as market participants worried about the depth of the recession, the risks of inflation or deflation and the government need for new debt issuance. In the U.S., bondholders are worrying about the timing and shape of "exit strategies" for the government supplied stimulus. While most forecasters remain convinced that the Federal Reserve's monetary policy is on hold well into 2010, this does not stop concern about the many ways in which liquidity might be withdrawn. In Canada, the principal concern is the massive amount of government funding that will be required to finance Federal and Provincial deficits. Old theories of "crowding out" are being pulled out of the drawers and dusted off. This theory suggests that there will be competition between government and corporate funding efforts ultimately raising the cost of capital. However the evidence to date suggests that there is sufficient liquidity available in our markets to support the new bond issuance required.

A large part of the widening in corporate credit spreads experienced through 2007 and 2008 has been recovered. There is still more yield to be captured and our intention is to continue to add exposure to the corporate market. We remain cautious in our approach to credit analysis. We are not prepared to buy every new issue in the hope that ongoing demand will support every issue. Instead we seek to identify the issuers that will offer good returns on a risk adjusted basis to our clients' portfolios over the long term.

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