Barrantagh

Investment Management

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- As the economic recovery advances around the globe, observers are beginning to realize that a necessary fundamental shift is starting to occur. A Neo-Keynesian environment is starting to emerge with austerity programs now the priority over the massive government stimuli which underpinned the recovery but produced worrisome deficits.

- In the short run this fundamental rebalancing will constrain economic growth, resulting in weak job creation and low inflation while highlighting the need for world leaders to cooperate on economic policies.

- Not surprisingly, the new reality of low growth and low inflation will involve stresses and strains on many fronts with economic progress erratic and unpredictable. Each country around the globe has different issues to deal with or is at different stages of dealing with the same issues, ensuring that a lot of noisy data will be the norm for some time.

- The U.S. continues to try and reinvigorate its economy with the ever present burden of debt acting like an anchor at every turn. Similarly, Europe's debt crisis has brought a need for change that cannot be ignored. Meanwhile, China has taken on the unenviable task of implementing policies to slow its economy to a reasonable rate without snuffing out its long term growth potential.

- Equity markets are reacting to the recent vision of slower growth and uncertainty in the global economies with a great deal of volatility. Positive returns in the first quarter of the year have been replaced with negative returns as markets worry that the global recovery may not be durable enough to continue once the massive government stimulus is curtailed. We are not making massive changes to portfolios because of the risk that the inherent volatility can cause to clients capital.

- Fixed income markets have been uncharacteristically volatile in reaction to recent economic data releases and geopolitical events. Rather than try to anticipate the volatility, it has proven more prescient to take a longer term view and hold positions in good domestic corporate bonds.

Economic Backdrop – Fundamental Rebalancing Underway

Ever since the global recession hit bottom in the summer of 2009, our investment reviews have tracked the substantial progress global economies have made from the worst recession since the 1930's. In spite of the negative news flow recently, the all important U.S. economy is still expected to grow by 3% in 2010 after shrinking by 2.4% in 2009. As well, in late May the OECD raised its forecast for global economic growth to 4.6% in 2010 and 4.5% in 2011. Of course the economy that is emerging from recession is not the same as the one that entered it. In the pre-recession era a number of forces including a housing bubble, runaway credit practices in a lightly regulated global financial system, and overly accommodating macroeconomic policies, resulted in a world that became unglued. The damage is obvious—high unemployment, millions of foreclosed homes and a huge hole in public finances, all of which need to be addressed.

It is apparent that a fundamental rebalancing of the U.S. economy is underway, from consumption, housing and too much debt, to exports, investment and savings. Certainly America's growth may slow as firms stop rebuilding their inventory and the government's array of stimuli are allowed to expire or taper off. Individuals in America and elsewhere are saving more and borrowing less in the wake of the collapse in asset prices and the desire to control debt. In this transition, with payrolls slack and credit still tight, individuals and investors are faced with a somewhat unpredictable unfolding of a long and overly generous global credit cycle punctuated by a spate of bank and business failures. Against this background it is perhaps not surprising that the U.S. recovery should experience some setbacks as evidenced in the latest economic data. Recent U.S. data suggests that the recovery in the housing market could be on the verge of stalling, that the consumer may lack staying power based on a steep fall in consumer confidence in June and that job creation is weak while industrial output is faltering. America will ultimately have to reduce public spending and raise taxes to avoid a budget crisis, but thanks to its population growth and the dollar's role as a global currency, America still has more fiscal room than any other big deficit country. All of these indicators plus the European sovereign debt crisis adds credence to the fears that the global recovery is not yet self-sustaining.

Hopefully fears about the fragility of the global recovery are exaggerated. Led by the larger emerging economies, the world's output is growing at better than 3% which is remarkable given the depths of the economic and financial crisis just a year ago. China is in obvious need to control excesses which is why its government is trying to constrain loans and property prices without being too heavy handed. China has finally acknowledged the need to accelerate the rebalancing of its economy towards domestic consumption by allowing the Yuan to rise against the dollar which may help to slow growth to more manageable levels. In fact, the Conference Board has recently corrected its leading economic index for China to a 0.3% gain in April versus 1.7%. Of course Europe has a different concern with growth prospects appearing weak. The regions spoiled economies will struggle for some time as necessary austerity measures take hold. Fortunately, Europeans recognize the need for wrenching fiscal adjustment and profound structural reform in labour and private markets for the Euro to remain a credible currency. Eventually, weakening domestic output will be mitigated by the boost that exports will receive from the Euro's plunge. Western Europe and the rest of the rich world have acknowledged the need for austerity but also the need to resolve deficits without triggering a new recessionary environment.

All in all, the present nervousness in capital markets is justifiable; however, current fundamentals for continued economic recovery seem to outweigh the risks of a new round of recessionary conditions. As was the case going into the recession, the recovery is highly dependent on the judgment of politicians. In that regard, global cooperation is essential and post the G20 meeting, there are signs that world leaders are more inclined to look for ways to work together than promote their own interests.

Equity Markets – Growth Pendulum Swings

What a difference a quarter makes! Driven by the macro factors mentioned in the Economic Backdrop, equity markets around the globe have staged what appears to be a 180 degree turn on just about every issue, economic or otherwise, that was present in the first quarter of this year. Talk of inflation has now turned to deflation, global GDP growth is wrestling with double dip concerns, government spending to support the economy has been replaced by competition to see which country will be judged to have implemented the best austerity package and even China's anxieties with-respect-to currency, interest rates, fiscal stimulus and worker unrest are looking more westernized. As a reflection of these concerns the equity markets have turned what were positive returns for the first quarter to negative returns year-to-date. The S&P/TSX is down 5.1% to the end of June while the MSCI global equity index is off 8.1% in Canadian dollar terms.

The reversal of fortune from one quarter to the next is ultimately distilled into one factor, the outlook for economic growth, which affects the prosperity of companies around the globe. It is this pendulum which has swung in a direction that may not have been envisioned by the equity markets. Expectations of healing and ultimately "normalized" economic growth were discounted in many stock valuations, creating an illusion that all was stable and well. However, the euphoria of averting economic chaos is meeting reality and making investors nervous. Recent economic numbers and geopolitical rhetoric have shown that this recovery is fragile. Investors are realizing that global deleveraging is required by all economies, not just the PIIGS (Portugal, Ireland, Italy, Greece and Spain) which will result in an extended period of low or muted growth. As mentioned, we continue to believe it will be a period of low growth with low inflation and therefore, to gauge the continued health of corporate earnings, our vigilance on indications of consumer strength or weakness is heightened at this point.

The current pull back in the market is not only due to debt levels around the globe focusing investors on a slower growth environment, but is also a function of investor response to the strong performance of global stock markets since the most recent bottom in March 2009. After large market moves it is not unusual to witness pullbacks of at least 15% as the market pauses to reflect on what the future holds. The "Asian Contagion" in 1997 to 1999 created a similar situation. Markets around the globe were very concerned about South East Asia's debt levels, Russia and Argentina defaulted on their respective sovereign debt and Brazil was left to try to reinvigorate its economy. The markets reacted quickly and a steep sell-off ensued in 1998. This was followed by a sharp recovery within six months to the levels at the start of the crisis. As current fears of a return to recessionary conditions abate, a repeat of 1998 is a distinct possibility. Either way, volatility continues to be with us for some time.

In this environment, reviewing company releases relative to expectations becomes paramount. For instance, Grupo Televisa's latest financial information undermined our confidence in the company's ability to execute and enhance value for shareholders so we sold. We also sold Research In Motion (RIM) and Apple Inc. for different reasons. We initially invested in RIM to gain exposure to solid growth in the corporate smartphone market and we invested in Apple to gain exposure to the retail smartphone market. Competitive pressures on RIM have changed the risk/return opportunity so we exited this position. Meanwhile Apple has continued to grow market share through innovative technology improvements and the stock price surpassed our expectations. Should our analysis of the iPad opportunity change our view on valuation we may get an opportunity to revisit this investment. Although our recent actions for clients have been biased towards selling positions rather than buying, we have a long list of names, many of which are proven dividend paying companies, we wish to purchase at the right prices. As always, we will continue to incorporate our fundamental research to indicate both buy and sell opportunities as market valuations try to find equilibrium with the economic growth pendulum.

Fixed Income Markets – Holding Steady

Similar to the equity markets, the key theme for the last three months in the fixed income market has been the sudden and volatile off and on attitude to risk. This has been driven variously by the threat of default by Greece, weakened Spanish banks, slowing world economies, and the end of inflationary worries particularly through declining commodity prices.

In Canada the economy has noticeably slowed from the strong level of the first quarter, with the latest data showing that economic growth took a holiday in April, and more recent indicators suggest that this pause may have persisted. Market activity in Canada was further complicated or distorted by the removal of the Olympics and the addition of the G8 and G20 summit influence. Throughout May in particular, volatility was key. As each piece of economic data was released or as each rumour was examined, the bond market either found a voracious appetite for risk, and sold government bonds in vast size, replacing those holdings with corporate debt or equity, or took part in a sharp flight to quality, buying back those government bonds in place of corporate debt and equity. The beginning of June brought us the first rate hike in the Group of Seven industrialized economies, courtesy of the Bank of Canada. The Bank Rate was increased by 25 basis points to 50 basis points on the first of June, meeting expectations. However, in the accompanying statement the Bank also appeared to be lowering the probability of a July rate increase, to some extent robbing the first stage of monetary tightening of much of its impact. Subsequent to that event, the Governor of the Bank has stated that no particular course of action is preordained leaving the bond market to debate the potential next step.

Throughout the quarter it has been difficult to find a strategy that consistently worked. One week there would be a flight to quality, the next brought a buying surge to long provincial bonds. This might in turn be followed by a rush to short government bonds. Ironically, volatility proved to be greatest in the government bond market rather than the normally expected sources. Therefore, it has proven more appropriate to hold steady to one strategy and thereby avoid the risks to capital that changing strategies may have caused.

Inflation remains sidelined in Canada and in the U.S., with the key markers showing a slowing rate of price increase. This has been reflected in the under performance of the Real Return Bond market. While this has rekindled discussion about the risks of deflation, it is not a position we support. We continue to see signs of growth at the corporate level, and this will maintain demand for goods and services.

The Canadian government yield curve remains stubbornly steep, despite having responded initially to the Bank of Canada rate hike with a mild flattening. While new issue volumes have been lower than normal, those that have come to market, both provincial and corporate, have been generally at longer maturities. The vast liquidity in the bond market has ensured successful launches for most issues, despite fairly narrow concessions.

We remain committed to our strategy of seeking value in the Canadian corporate bond market, and see stability returning as we transition into the third quarter. In general, corporate balance sheets are notionally in better shape than the governments, and little refinancing is left to be done, reducing the danger of government financing crowding out companies in the fixed income markets. This should in turn lead to a general tightening in credit spreads in the Canadian marketplace.

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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