

# Barrantagh

## Investment Management

### CAPITAL MARKETS REVIEW SECOND QUARTER 2011

#### *In This Issue:*

- ◆ **Economic Backdrop – Self Sustaining Expansion Elusive**
- ◆ **Equity Markets – Déjà vu 2010**
- ◆ **Fixed Income Markets – Inflation Transitory?**

- The economic recovery, now two years in duration, continues to be supported by stimulus designed by the central policy makers around the globe. Low interest rates, quantitative easing and spending have all been part of the tools used to induce the recovery. The goal for all was common – ensure the recovery endures. Now, similar to last year, recent economic numbers and non-aligned priorities have caused many to question whether or not the recovery can become self sustaining.

- Economic indicators vary in strength around the globe but in the U.S., recent releases from manufacturing to consumer spending and consumer confidence have come in lower than expected. This has lead economists to reduce the forecasted U.S. GDP growth rate to approximately 3% for 2011 which is down from around 3.5%. This, along with the budget debates as the U.S. hits its self imposed debt limits, has caused prognosticators to focus on spending cuts, leading to the possibility that some economic stimulus may be removed. Ultimately this creates concern for the amplitude and longevity of economic growth.
- Along with other deliberate measures, China is increasing interest rates to cool its economy, deflate a housing bubble and stem inflationary pressures, causing many to worry that one of the main drivers of global growth will slow. However, with GDP growing at 9.6% (higher than expected), China has room to implement policies and target a more sustainable long term growth rate.
- Despite the negatives that draw attention, many believe that the second half of the year will see a rebound in global economic strength driven by the Japanese rebuild after the quake, continuing growth in the developing markets, pent up demand for durables and lower energy prices helping to stimulate consumer spending and relieve further energy induced inflationary fears.
- Equity markets have been finely tuned to the oscillating economic numbers, causing investors to fluctuate between more economically sensitive names in the first quarter of the year to defensive securities in the second quarter. We continue to incorporate our proven, bottom up, fundamental investment philosophy to find companies that should do well over the longer term, rather than try and catch each change in the economic climate or what is more commonly known as momentum investing.
- Demand for bonds is being driven by the flight to quality as investors seek safety from uncertain economic numbers and the ongoing European debt situation. However, bond market participants are divided on whether or not current inflationary signs are transient or do rates need to rise to stanch inflation before it becomes endemic.

## **Economic Backdrop – Self Sustaining Expansion Elusive**

It has now been two years since the recovery began, following the worst slump since the Great Depression and, broadly speaking, the global rebound has proven to be more durable than expected. Undoubtedly, much of the credit must be given to the decisions made by policy makers in the U.S. headed by Federal Reserve Chairman, Ben Bernanke and leaders around the world as they implemented actions designed to build confidence and restore growth. Near zero overnight interest rates, a host of stimulus measures including quantitative easing and an agreement between president Obama and the Republicans to extend the Bush era tax cuts and enact new ones, led to forecasts of 3% to 4% growth for this year in the U.S. Unfortunately, in the last quarter several disappointing economic reports suggest these forecasts were overly optimistic and the recent weaknesses in economic performance has caused some economists to even question the extent to which the stimulus measures have in fact succeeded. In the first quarter, U.S. GDP expanded at a rate of 1.8%, a pace of expansion well below expectations. One element of the slowdown in growth was housing prices which fell in March to their lowest level since 2003. Manufacturing output has evidently weakened according to the latest data released and consumer confidence fell to 60.8 in May from 66 in April (it was more than 100 before the recession). While consumer spending, which makes up about two-thirds of overall spending has generally held up, the pace of growth slowed to 0.5% in April as consumers were squeezed by rising prices for food and gas as well as ongoing attempts to reduce debt. Beyond specific near term data points an overriding concern is the looming withdrawal of the stimulus programs such as quantitative easing. Since the fall of 2008 policy makers at the Fed, the White House and on Capitol Hill, have had one dedicated goal; heading off an economic crisis and insuring a recovery. Now other concerns are starting to become economic priorities including the Federal budget deficit, national and state debt levels and inflation. The debate in congress is shifting from passing stimulus programs to finding ways to cut spending.

On the global front the possibility of a greater than expected slowdown in China, the primary locomotive of global growth, is a concern and there are a host of other worries including the possibility of the European debt crisis spiraling out of control. In the euro zone, growth has slowed although Germany continues to expand at a near pre-recession pace. Major countries in Europe are attempting to implement austerity programs at a time when consumer spending is fragile, unemployment remains stubbornly high and inflation is creeping up. In Asia the Chinese government is attempting to engineer a cooling off of the housing bubble while at the same time not undermining growth. Meanwhile, Japan's economy is projected to have a "V" shaped recovery in the aftermath of the earthquake. As policymakers attempt to manage these issues, tensions between leaders and main street are building as fears mount that economies get stuck in a cycle of low growth in which companies won't hire because their customers won't spend, while consumers won't spend because companies won't hire.

Notwithstanding these concerns, we remain confident, as do key forecasters such as the International Monetary Fund, that the global economy can withstand the current soft patch and the second half of the year will see a more vigorous rebound. The downturn in the U.S. economy in May and June reflects, temporary factors such as high oil prices which are easing, extreme weather in various parts of the country and supply disruptions related to Japan's disaster. Looking beyond the summer months the fundamental drivers of growth remain in place including accommodative fiscal and monetary policy, pent up demand for consumer durables and investment (corporations are cash rich) and continuing strong growth in emerging and developing economies. In emerging countries growth is expected to exceed 6.5% according to the IMF, little changed from April forecast. China is expected to lead the way with growth of 9.6%. As well, stronger than previously expected growth in Germany, France, Italy and Japan will partially offset weakness in the U.S. In Canada, growth has stalled at present but is expected to average 2.9% for the year. Challenges to securing the transition from recovery to a durable expansion are daunting but not insurmountable. Meanwhile, Chairman Ben Bernanke and other economic decision makers continue to defend easy money as necessary for an eventual self sustaining economic expansion. In his April press conference, the first by a Fed chairman, Bernanke said that in his view the main risk is not doing too much, it is doing too little. In the economy it seems that both consumers and businesses are waiting for signals of better times ahead, while in politics the debate centres on whether or not the economy needs more help from government. In the meantime investors will be looking to see how various issues become resolved in a way that will ensure that the U.S. and other countries move from induced recovery to self sustaining expansion. Investors will undoubtedly remain on edge and markets will remain volatile until the path ahead becomes more certain.

## Equity Markets – Déjà vu 2010

When reviewing the equity markets year-to-date, if you feel like Bill Murray in the movie “Groundhog Day” you are not alone. The markets around the globe not only seem to be reliving calendar year 2010 to an eerily similar pattern; the events that drove the pattern also appear to be the same. The European debt crisis, or what is referred to as “the second in as many years Greek bailout package”, was cause for concern as it was in the second quarter of 2010. Requiring the rest of Europe to help finance its shortfall while passing austerity measures through the Greek parliament created great anxiety as onlookers worried about the contagion affects that might occur throughout the Euro, and most likely the rest of the world, had Greece defaulted. Meanwhile, economic numbers slowed quite dramatically in the second quarter, as mentioned in the economics section, in the same way they did in the second and third quarters of 2010, having a decidedly negative impact on equity markets. Even though the markets rallied strongly near the end of the quarter as the Greek parliament passed the austerity measures qualifying them for further aid, it was not enough to negate the earlier sentiment. For the quarter, the S&P/TSX (Canada) was down 5.15% resulting in a year-to-date return of 0.16%. Meanwhile, the MSCI (Global markets) fared slightly better with a return of 0.06% for the quarter bringing a positive return of 2.39% for the first half of the year.

The divergence between Canada and the rest of the world seems to reflect the risk-on, risk-off emotions that are apparent in the equity markets, ultimately causing valuation swings between industry groups. In the first quarter investors were willing to buy more volatile industry groups such as industrials, energy and technology as economic numbers looked strong and even the Middle East uprisings along with the Japanese earthquake could be overlooked. In the second quarter, more defensive industry groups such as health care, telecom and utilities led the way as the European debt situation and slower economic numbers were relived. The slowing economic numbers created a tug of war between the risk-on and risk-off sectors as investors struggle to understand whether or not this is a “normal” inventory slow down in the continuing economic expansion or is it a prelude to a recession. This debate is commonly referred to as a soft versus a hard landing and as mentioned we believe the soft landing scenario will unfold.

Our faith in the soft landing, as it relates to equity markets, lies in the tailwinds that we believe are developing which will give support to equity positions. For instance, as the Middle East and Libya situations play out, generally with positive conclusions, fuel prices have been easing. Meanwhile the IEA (International Energy Agency) announced that it will release 60 million barrels of oil into the market over the next few months helping to cap or suppress oil and gas prices. Higher energy prices have been a drag on consumer confidence and increased costs for companies in general. Therefore, any relief in this area is a positive for equity markets as risks of an oil shock and/or further energy induced inflation (read “interest rate shock”) have diminished. Also helping the soft landing scenario is the stimulus from the rebuilding of Japan, post the earthquake, and the knock on affects as manufacturing facilities such as automotive lines, starved of parts from supply line disruptions, can now operate at full capacity. Meanwhile, order back logs have been stable to increasing suggesting that demand remains firm, creating a supportive environment as the markets switch from the April to August “worry season” to the earnings reporting season. Finally, as the stimulus from QE2 (quantitative easing) ends, and its ultimate affect debated, there is talk of a tax repatriation holiday in the U.S. similar to what occurred in 2004. This would allow companies to repatriate cash from foreign operations at a 5% tax rate rather than the current 35% rate. Given the size of foreign earnings (at least \$1.4 trillion) it is easy to assume that this event could have a larger positive impact for the U.S. and the markets compared to QE1 or QE2.

Assuming that economic growth does continue, even though it may be at a slower rate than expected, investors can choose to take a shorter term view and try to time the swings and sentiment in the market from industry to industry or they can choose to buy high quality companies, with excellent balance sheets that will do well for the next several years. We have chosen the later which is also the more prudent and proven course of action; find high quality companies which may perform well or poorly during any one quarter, but ultimately perform well over the long term. Although the Canadian market may lag during the risk-off periods, there are many names that fit this strategy. For instance, CN Railway with its continuing efficiency improvements, strong balance sheet and industry leadership is a perfect example of a quality company which can be held for the long term. As well, Painted Pony Petroleum, an energy company delineating a large resource opportunity in the Montney area of British Columbia, has a high quality asset base which we believe positions the company for solid future growth.

## Fixed Income Markets – Inflation Transitory?

Assailed from all sides the bond market still managed a further positive return in the second quarter. Participants bought duration in the first part of the quarter, believing the central bank would start tightening at some point in or immediately following the end of the quarter. Instead a minor avalanche of bearish North American economic statistics pushed the prospect of a reduction of liquidity into the later part of the year or possibly even beyond. This has in turn steepened the Canadian yield curve, with investors shortening duration and longer term rates shifting upwards in response. In addition the tepid market response to the three latest U.S. Treasury auctions has spilled over into Canada.

As we have stated in previous commentaries, there exists a serious risk of the Bank of Canada being caught off guard by growth in inflationary forces while they focus on providing stimulus to the economy. As the headline and core inflationary measures in Canada have crept up, the monetary authorities have preferred to characterize the impact as transitory and have not responded. When the statistics for May were released in June, the headline inflation rate (CPI) had jumped to 3.7% year on year and the core (excluding the more volatile food and energy categories) increased to 1.8% year on year, both values being significantly greater than forecasters anticipated. These values finally encouraged the Bank to acknowledge the pressure and emphasize a firm commitment to inflation fighting. However, there has been no further action taken.

The subsequent sell off in the government bond market, accompanied by widespread buying of stronger corporate credit, still placed real yields out to beyond five years at negative levels. Negative real rates of return are not sustainable and could lead to massive misallocation of capital, and we therefore expect government yields to rise further. Corporate credit spreads will tighten in response to rising government yields, thus preserving the value of corporate holdings through the early stages of the cycle. As a taste of things to come, in the last month we saw a steady gain in value in floating rate notes (FRN) and higher quality corporate debt. Real Return Bonds (RRB) witnessed a widening of breakevens as the long end of the curve sold off, but hold the potential for a much stronger response.

The Bank of Canada must still formulate a response to an uncomfortable environment. Economic growth has slowed, the consumer is reluctant to spend, and measures of inflation are inching upwards. Added to this is a poor international atmosphere, with Canada in particular on the receiving end of a general flight to safety in world financial markets. With the end of quantitative easing in the U.S. and the continuing pressure from the Greek debt crisis, the buying interest in Canadian bonds is unlikely to end. This, coupled with ongoing concerns about the debt ceiling in the U.S., should prevent sharp upward adjustments to the Canadian yield curve. The current mood of the market, and the trading pattern of the financial futures, suggests that the Bank of Canada will raise the bank rate at the October meeting, more as an initial adjustment to appease the market but may become the first step in a drawn out campaign of tightening monetary policy.

We are maintaining an overweight position in corporate debt, supplemented with holdings of floating rate notes and real return bonds, in the accounts where the investment policy statement permits such holdings and weights. The FRN's tend to soften volatility and protect the capital in a period of rising interest rates. RRBs provide a line of defense against unexpected upward movements in interest rates in response to inflationary trends.

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