Barrantagh

Investment Management

CAPITAL MARKETS REVIEW
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- Global growth of 3% or more looked attainable at the beginning of the year with China and the developing economies maintaining a high growth rate, the U.S. continuing to show signs of improvement and possible solutions to the European debt crisis catching everyone's imagination. Cracks in this outlook developed throughout the second quarter as China's ability to maintain a high growth rate came into question along with renewed concerns about Europe (specifically Spain and Italy) and softening economic numbers in the U.S. Current forecasts for global growth in 2012 remain positive but revisions are definitely to the downside leaving the full potential for the global economy elusive.
- The U.S. is dealing with a softening economy as shown by the most recent manufacturing and employment numbers but little focus has been given to the coming fiscal crisis. It is not a secret that the Democrats and Republicans have not seen eye-to-eye on many issues over the last few years resulting in a postponement of many fiscal actions. Post the U.S. election this fall, the potential for ongoing policy gridlock is high, which many believe may derail an already fragile economy. However, there are historic precedents in which the two parties have compromised to alleviate the country's deficit and stimulate growth.
- With regards to the ongoing European saga, everyone understands what reforms are required to save the Euro and the Eurozone. The question of course, is how these reforms will ever come about. To date, participants have let market forces dictate these reforms over time in the absence of effective policy making. Given the tensions between Germany and the debt-laden countries, crisis management will likely continue to be the order of the day which will condemn Europe to a continuing recession for the foreseeable future.
- China has already begun a round of policy stimulation to try and ensure the current full year growth forecasts of 7.5%. Interest rate reductions, relaxing bank reserve requirements and project spending are all available to stimulate domestic demand and alleviate investors concerns of sub 7% growth, yet external shocks, especially from the Euro area have imposed stresses on China's trade sectors which they cannot control.
- In the first quarter, all news no matter how negative was taken as a positive and stocks advanced higher. In the second quarter, all news, no matter how positive, was taken negatively causing some of the first quarter's gains to be reversed. The similarity to last year's pattern is uncanny including the timing of the talks and dances between governments and their officials. If the fortitude is found to implement the solutions in Europe, investors will focus on the inherent fundamental strength in the equity markets and propel them higher.
- Investors continue to treat the bond market as a safe refuge. Despite the repeated warnings by Canada's Central Bank that rates have bottomed, investors continue to reach for yield at the long end of the curve in an effort to capture some real yield (nominal yield net of inflation). Rather than expose our clients to the inherent risk of long bonds, we have been able to find select corporate bonds that keep our clients' duration low while maintaining a positive real yield. Ultimately, this approach keeps the duration lower than the DEX (the bond universe), which will help to insulate clients to a degree, from possible rising interest rates in the coming year.

Economic Backdrop – Momentum Stifled

At the beginning of the year the global economy seemed poised to sustain a moderate pace of growth, the European debt crisis seemed manageable and the possibility of a new exogenous shock to undermine the recovery seemed remote. However, the latest news flow highlights a significant deterioration in global economic conditions in key regions: the U.S., the Euro area and emerging economies. At a projected 1.4% pace, the second quarter advance in global growth will prove to be the weakest of the entire expansion and continues a stretch of subpar global growth dating back to early 2011. In the U.S., recent data suggests second quarter GDP growth of just 2%, below forecast trend growth of around 2.5%. Economic weakness is broadly based as evidenced by rising unemployment, weak manufacturing, declining exports and a retrenchment in business spending. In manufacturing, which had been a pillar of the U.S. recovery, the latest surveys suggest a sharp contraction. Business spending is being reigned in as the corporate sector, although healthy, has turned more cautious. Based on the above data and other indicators the U.S. economy may be challenged to sustain a 2% growth rate, particularly since a potential fiscal crisis is looming at year end. Post the November U.S. election, the Bush tax cuts will expire, personal tax levels will revert to pre-2003 levels, a host of stimulus measures will runoff and automatic spending cuts will begin, creating fears that fiscal drag will dampen 2013 growth.

Turning to Europe, the sovereign debt and banking crisis has escalated as concerns have risen about the capacity of the region to share burdens, manage austerity programs, and somehow restore growth. The Greek election victory for pro-austerity parties' staves off the immediate threat of a Euro exit by Greece but the country is still falling behind on deficit targets, the recession is deepening and massive withdrawals of funds from its banking system remain unchecked. Meanwhile, attention has shifted to Spain and Italy where the problems are many times larger. Italy's main problems are not excessive government debt, although its debt is high, but rather its lack of growth as the country attempts simultaneous government spending cuts with structural reforms. Spain's plight stems from the collapse of its property boom, and its banks are crippled by an estimated $230 billion in troubled real estate assets (about 20% of Spain's GDP). Spain's sovereign debt is larger than Greece, Portugal and Ireland combined and with bank recapitalization requirements added on, it is too large for Europe's bailout vehicles to handle. For Spain, a full scale bailout may ultimately be necessary.

Looking back at the problems in Greece, Spain, Portugal and Ireland, it is apparent that the piecemeal steps taken by European leaders so far to build a firewall around these countries (partial bailouts and ad hoc monetary injections), lack credibility in capital markets and are seen, quite correctly, as steps to merely "paper over the cracks". In economic circles there isn't much disagreement on the shape of a master plan to save the Euro. Europe needs to supplement existing currency union with tighter fiscal union, i.e. centralized enforceable controls over members' government spending and a common borrowing authority accessible to the weaker states. As well, banking union is required, involving a common system of bank regulation, common deposit insurance, and centralized monitoring of the capital adequacy of banks. Europe has made progress towards fiscal cooperation and banking union in recent weeks as it faces a deepening crisis. For example, progress was made at the June 28-29 Summit of European leaders towards a more unified banking system. The European Central Bank (ECB) will become the overall supervisor of banks in the Eurozone, and once that control mechanism is in place, the various bailout funds will be allowed to engage in recapitalizations directly without channeling funds through the affected national governments.

Given the slowdown in the U.S. and recessionary conditions in Europe, it should come as no surprise that the Chinese economy continues its softening trend driven by both domestic and external factors. On the domestic front, the government's efforts to push economic restructuring, especially tightening in the housing market and industrial sectors with overcapacity, has constrained growth. The economy lacks new sources of growth in the near term in part because macro policy has been behind the curve. Accordingly, growth concerns have risen to the top of the policy maker's priority list. Unlike the U.S., China has ample scope for monetary easing and a series of pro-growth measures have recently been implemented. These include a 50 basis point RRR cut in May, a 50 basis point cut in the benchmark lending rate, and a reduction in the floor lending rate for business to 70% of the benchmark (from 80%). Current forecasts of full year growth still hover around 7.5% but if U.S. growth remains weak and the crisis in Europe intensifies, China's expected economic recovery in the second half of the year could be jeopardized.

In summary, with three of the world's largest economic regions dealing with their unique, yet intertwined macro issues, crisis management will likely continue to be the order of the day and ultimately limit the full potential for global economic growth.

Equity Markets – Crisis Fatigue

After a very strong start the equity markets have given back some of the gains from the first quarter of the year. It would appear that the constant wear and tear of the European debt crisis and the unavoidable knock on effects are driving concerns that the global economy is slowing. These concerns seem to be culminating in a general fatigue for equities which is the polar opposite to the first quarter. This development has shown an eerily similar pattern to 2011 but one big difference is the focus of all stakeholders. Last year Greece was the focus, but this year, as mentioned in the previous section, Spain and Italy whose economies are much more meaningful on the European and therefore global stage have been added to the spotlight. The effect in the equity markets has been decidedly negative for the second quarter as the S&P/TSX was down 5.7%, resulting in a year-to-date number of negative 1.5%. In Canadian dollar terms, the MSCI (global markets) is down 3.0% for the quarter but still up 6.5% for the year-to-date.

In previous commentaries we have remarked how well companies have been doing despite the political and macroeconomic background. Valuations are reasonable versus historic multiples, balance sheets are in great shape, free cash flow is strong, merger and acquisition activity is healthy and operating margins are being maintained. Despite a general bias upwards, markets continue to repeat patterns which have resulted in one of the most volatile periods of time in the history of the capital markets. The three largest concerns coincide with the worlds three largest economic regions; Europe, China and the U.S. as mentioned in the economic section.

The largest worry in the equity market continues to be the European debt crisis. European leaders need to address several issues to give equity markets some solace. First, the Euro currency needs to continue its decline to help generate ongoing demand for European products. Secondly, interest rate reductions to alleviate the cost of debt and stimulate consumer spending need to continue. Thirdly, capital injections need to continue along the lines of the LTRO (Long Term Refinancing Operation). Rather than loans, a method needs to be created whereby equity can be injected directly into ailing banks, similar to TARP (Troubled Asset Relief Program), which the U.S. used with great success post the housing bubble. To some degree the first three steps have been initiated. However the equity markets continue to agonize over the lack of detail, timing and size of capital required with regard to any relief programs. The markets would also like to see some form of fiscal integration or a mutualization of the debt such as the use of Eurobonds. This would drop the interest rate on the debtor nations dramatically. Lastly, it seems inevitable that any austerity program timelines will have to be extended to allow economic growth to continue.

The equity markets' concern with China has a simpler solution. After many years of double digit economic growth, China has stated its desire to reduce its GDP growth rate to around 7%. As China's economy slows, the equity markets continue to be concerned that it will overshoot on the downside. This is most notable in the underperformance of commodity-exposed players where our clients remain underweight. Lowering interest rates and easing domestic banking requirements would help to stimulate the consumer and China has recently started to move on both of these fronts.

With regards to the U.S., focusing on job creation, supporting the housing recovery and keeping rates low remain paramount to stabilizing the recovery and keeping the consumer engaged. However, looking towards year end the aforementioned post-election fiscal crisis looms large. Unfortunately many of the pending decisions on taxes, spending and other programs have been delayed until after the November election. What many may not realize is that $500 billion in decisions may require compromise depending on the outcome of the election. This is approximately 3% of U.S. GDP and with the economy growing around 2% it is easy to see why the equity market would be concerned.

All of the above mentioned issues take time which leaves investors wondering how long companies can continue to inspire confidence. The quality and/or growth in earnings may come into question as these macro issues continue to chip away over time. For instance, more recently companies such as McDonalds, Caterpillar, Procter & Gamble and Nike (which we recently sold for clients) have all expressed concern that the slowing growth in China and other areas is adversely affecting inventory and the outlook for sales. As a firm we have recognized these concerns and also recognize the long term opportunity in the equity market versus other asset classes. Therefore, we have tried to remain exposed to equities in a manner that removes some of the volatility in the market while we wait for the macro issues to be resolved. We are mindful that equities can have a very positive response as compromise is reached and the above mentioned solutions are implemented. We cannot emphasize enough that diversification, preference for dividends where possible and seeking self sustaining growth in best of breed companies will continue to be the best position for our clients in the current environment.

Fixed Income Markets – Positioned for Tightening

There are a number of familiar themes still at play in the bond market as we enter the third quarter. The markets survived a victory by the "pro-bailout" forces in the Greek election, Europe is seen to be entering into a mild recession and Germany remains steadfastly opposed to the issuance of common bonds in the Eurozone. The changes are hard to detect. In France, Hollande was elected to the Elysee Palace and all connections with the policies and intents of his predecessor, M. Sarkozy, are being severed. The close relationship between France and Germany has been replaced with a close relationship between France and Italy. France is moving figuratively from a northern European country to a southern European country, and Germany is becoming more isolated, even as their economy exhibits signs of slowing. Spain has sought €100 billion to bail out its banks following the failure of Bankia, and Italy is trying desperately to avoid being pushed to restructuring. Member governments and their Central Banks are still trying to decide what structure to use, and which vehicle. The EU summit at the end of June brought more detail and more questions. The movement towards a single EU wide bank regulator (the ECB) is picking up momentum, but will only come with treaty changes, so it will be a number of months or longer before implementation. As a direct regulator, the ECB will be able to lend directly to the banks, and provide rescue packages. In the meantime, the European bond markets are reacting favourably to the proposed changes and the apparent softening of the German position.

In the U.S., the Federal Reserve has extended Operation Twist and is slowly being pushed to initiate a fresh round of Quantitative Easing (QEIII). Should this occur, it would ensure that long government yields stay low, and keep rates from rising too quickly when economic growth starts to catch hold.

These events have generated powerful swings in the major world bond markets including Canada. We have seen regular news driven gyrations, characterized as "risk-on" and "risk-off". Risk-on days bring a rally in equities and risk-off days bring a flight to safety provoking a rally in government bond markets. These days often alternate one day after the other! The Canadian bond yield curve flattened as expected. With bond yields below the rate of inflation for the first 15 years, investment inflows are particularly focused on the longer end of the curve to try to pick up real yield. Driven by the massive volume of coupon payments and bond maturities in early June (approximately $60 billion), the issuance of new corporate debt has been strong after a reduced volume in the first quarter.

A recent development we are watching in major bond markets is the proposed shift in pension liability measurement methodology. In the past it has been considered prudent to use current market rates to discount back the pension liability. The steady and steep decline in interest rates has, of course, led to a sharp rise in the present value of the pension obligation. Companies have had to make large contributions to make up the difference. Legislation passed in Sweden and Denmark and proposed in the U.S. use various formulae such as the 25 year average of the corporate bond yield. Given the sharp and steady decline in bond interest rates over the last few years, this calculation would generate a significantly higher discount rate and sharply reduce the required reserve. This may lead to a reduction in the purchases of long bonds by pension funds and others, as these bond investments will not be required in the same volume or role as before.

We remain significantly overweight corporate debt, but select our holdings very carefully. While minimizing exposure to the short end of the curve, we have shortened duration in anticipation of action by the Bank of Canada in the coming months to slow consumer credit growth. Recent rule changes for mortgages and home purchase related debt will be watched and evaluated to see if they have the desired effect. If not, the next move will be monetary policy tightening by the Central Bank. In the meantime, the lure of the possibility of borrowing term money at or close to the rate of inflation and using those funds to buy real assets remains powerful. It will take a significant rise in the cost of borrowing to deter buyers and this may have a negative impact on the short end of the bond spectrum.

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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