Barrantagh
Investment Management

CAPITAL MARKETS REVIEW
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- Economic growth in the United States appears to be picking up. While still not supplying the jobs needed for a full consumer recovery, the rate of job creation is improving. The real estate industry, consumer confidence and proxy measures for capital equipment orders are all gaining ground.
- The real drama for the first half of the year came from the U.S. Federal Reserve. Financial market participants went into the June Federal Open Market Committee (FOMC) meeting expecting to be told by Mr. Bernanke that there was no change anticipated in policy. Instead investors were told that tapering (the slow reduction of the amount of stimulus provided by the Quantitative Easing (QE) program) might be started in the autumn and QE would be terminated by mid 2014.
- Bernanke's early tapering announcement may allow recognition that economic growth is picking up, which will be positive for the equity markets and credit spreads, thereby allowing a shift in the approach to tapering with minimal market disruption.
- In Europe, the anxiety continues to reflect general global concerns – slow growth for some time with any signs of stability remaining fragile due to the ever present possibility of a crisis. As an example, while showing some signs of stability, the EU remains vulnerable to unexpected news regarding any of the member countries' bailout terms or recovery. Portugal, Spain and Italy in particular remain volatile.
- The initial concern that China might suffer a hard landing has passed and China's policy makers seem to be focused on achieving long term growth while increasing domestic consumption. To achieve this goal, growth may slow more in the short term than initially expected (7% GDP versus the already adjusted 7.5% consensus), which has spooked market participants. Nonetheless, China has shown that it is cognizant of dealing with market excesses as it steers its economic direction.
- Japan has taken a dramatic step and committed to push US$1.4 trillion of liquidity into its economy through bond purchases while allowing the yen to decline in an effort to drive a major part of its economy, exports.
- If the U.S. economy is able to accelerate as tapering occurs, rates will be allowed to rise. For equity markets to become comfortable with this outlook, investors will first have to reconcile equity markets moving higher as rates move higher under the new regime. Ultimately this means a decoupling of the bond and equity markets which has merit on several fronts. One can only envision a positive climate for equities should this scenario unfold because of the prerequisite for underlying strength in the economy.
- While we continue to find value in the corporate bond market, it is becoming a more challenging environment, and volatility has risen steadily. We expect the curve to steepen beyond 10 years, at least until sometime next year when the Bank of Canada makes its first baby steps towards tightening. As we move closer to that time, we will become more conservative in order to protect capital.

Economic Backdrop – Spotlight on Tapering

As we move from the first half of the year to the second half, many of the same concerns persist, but a number of concerns that have long dogged the world economies and markets appear to be on the way to resolution. For instance, across Europe, indicators suggest that things are not getting worse and as one would expect with most inflection points come conflicting signs. EU unemployment has reached 12.2%, particularly affecting the younger generation, but there is evidence of new job creation in France and Germany. Economic growth indicators remain negative but they seem to have bottomed, well above the levels reached during the 2008-2009 recession. Going forth, the anxiety in Europe continues to reflect general global concerns – slow growth for some time with any signs of stability remaining fragile due to the ever present possibility of a crisis. As an example, while showing some signs of stability, the EU remains vulnerable to unexpected news regarding any of the member countries bailout terms or recovery. Portugal, Spain and Italy in particular remain volatile.

In Asia, China has lately been the source of rumour and concern. The apparent efforts by the Peoples Bank of China (PBoC), the Central Bank, to promote a lessening of risky lending practices in the domestic market, particularly in real estate, led to a sudden spike in the overnight interbank lending rate. This was exacerbated by the rumour that one key bank had defaulted on its overnight borrowing, causing overnight interbank lending rates to rise sharply to over 12% from the more normal 2% to 2.5% range. The PBoC took action by injecting liquidity to stabilize the market. The initial concern that China might suffer a hard landing has passed and China's policy makers seem to be focused on achieving long term growth while increasing domestic consumption. To achieve this goal, growth may slow more in the short term than initially expected (7% GDP versus the already adjusted 7.5% consensus), which has spooked market participants. Nonetheless, China has shown that it is cognizant of dealing with market excesses as it steers its economic direction. Meanwhile, Japan is also trying to steer its economic direction by implementing a very aggressive re-inflation program of the Japanese economy. To do this, Japan has taken a dramatic step and committed to push US$1.4 trillion of liquidity into the economy through bond purchases while allowing the yen to decline in an effort to drive a major part of its economy, exports. Many would suggest that they are finally doing what should have been done 20 years ago. So far the results have not been as dramatic or successful as expected but more time is required to judge the ultimate outcome.

The real drama for the first half of the year came from the U.S. Federal Reserve. Financial market participants went into the June Federal Open Market Committee (FOMC) meeting expecting to be told that there was no change anticipated in policy. Instead, investors were told by Mr. Bernanke that tapering (the slow reduction of the amount of stimulus provided by the Quantitative Easing (QE) program) might be started in the autumn and QE could be terminated by mid 2014 with the first actual tightening of policy possibly coming in late 2014 or early 2015. Having previously said that unemployment in the range of 6.5% and inflation greater than 2% is required to initiate tightening (i.e. an increase interest rates), the Fed is now telling the market that inflation well below 2% is acceptable and an unemployment rate "in the vicinity" of 7% is enough to warrant a slowing of the amount of liquidity being supplied by the Fed.

What would happen when the time came to start withdrawing liquidity from an economy that is as addicted to this liquidity injection as the U.S.?

It did not take much effort for the market analysts to realize that 7% unemployment might come early in the fourth quarter of the current year. Predictably this reversal triggered a sell-off in all asset classes, with equity and bond prices dropping sharply. The dramatic nature of the sell-off sent policy makers out to try and convince the market that they had misunderstood the Fed's message and should still view the policy level as one of easing and not a tightening mode. If the suggestion of the onset of tapering caused the U.S. treasury and equity markets to sell off, then what would happen when the time came to start withdrawing liquidity from an economy that is as addicted to this liquidity injection as the U.S.? The answer seems to be that economic growth in the United States appears to be picking up. While still not supplying the jobs needed for a full consumer recovery, the rate of job creation is picking up. The real estate industry, whether measured by new home construction or by re-sales, is picking up steadily. The impact on consumer confidence of rising home prices, as measured by the jump in the Conference Board Index, is noticeable and the knock on effects in related industries are palpable. Profitability is continuing to pick up, and proxy measures for capital equipment orders are also gaining ground. Bernanke's early announcement may allow recognition that economic growth is picking up, which will be positive for the equity markets and credit spreads, thereby allowing a shift in the approach to tapering with minimal market disruption.

Equity Markets – Rate Regime Change

The second quarter for equity markets started where the first quarter left off – up. However, as the quarter progressed, the widespread expectations for a pullback were realized due mainly to the worry over QE3 deceleration (less stimulus), China's slowing growth, rising interest rate fears and the big rally that has occurred in equity markets since last November, causing a pause as investors digest concerns and reflect on the future. With a retreat of 4.1% in the second quarter, the S&P/TSX is now in negative territory for the year at –0.87%, however global markets remain positive for the year-to-date at 15.1% in Canadian dollar terms, even after a slight pull back late in the quarter. The global equity rally in the first half of 2013 was driven more by expanding multiples than by rising earnings as the perceived risks in the market faded. We believe the most probable outcome for the second half of the year is that equities will continue the rally and there may be a leadership change with-respect-to industry performance.

For the markets to become comfortable with this outlook, investors will first have to reconcile equity markets moving higher as rates increase under the new regime.

Ultimately investor's views are forced back to the merits of each investment based on fundamentals.

This means a decoupling of the bond and equity markets which has merit on several fronts. First, equity markets relative to other asset classes remain undervalued causing a mean reversion trade to play out. Supporting this move is the normalization of risk versus reward in the various asset classes due to the marginalization of European debt concerns and a focus on the European recession – something with which the markets are far more comfortable. Secondly, during the years where investors perceived high risk scenarios, many non-traditional fixed income investors defaulted to the security of lower risk, yield oriented investments, driving a valuation wedge between the asset classes. Today the opposite seems to be true as non-traditional equity investors, worried about interest rates increasing, buy into the stock market in the search for higher yields and more capital gains. Thirdly, global growth along with inflation, remain below desired levels suggesting that any increase in rates will be very gradual and well telegraphed. Combining a reversion to the mean for risk, with an economy that has the potential to grow with fewer stimuli, presupposes that there may be a leadership change with-respect-to industry performance, as previously mentioned. Our studies suggest that broad statements such as this may be true in general but lacking in specifics. For instance, more defensive industries such as utilities which support strong dividend yields have done well in the last few years relative to the market while mining stocks have struggled. Many strategists predict that cyclical stocks should lead the way as previously occurred in similar economic inflection points. However, when we look at the fundamentals of each industry, a different conclusion may be reached. Ultimately investor's views are forced back to the merits of each investment based on fundamentals. These include, supply/demand, revenue growth, costs, margin improvements, balance sheet concerns and many other factors that affect share price.

As an example, we had an opportunity to purchase Bed Bath & Beyond (BBBY), a leading home furnishing company that many readers will know and may have experienced. After growing the revenue line materially for many years, the shareholder base continued to expect significant top line growth. However, if you know management, they clearly talk about the focus on the bottom line. Management wants earnings and cash flow to grow. BBBY's shares pulled back as a result of slightly missing estimates due primarily to the consolidation of an acquisition and top line growth disappointing investor's expectations. We were able to purchase the shares below 10 times forward earnings per share, a material discount to the historical average of 15 times and the peer group at 14.5 times. BBBY has had industry leading same store sales (average of 3.3% vs. 1.4% for peers), strong bottom line growth (over 15%) and solid store growth (above 3%) during the last several years. The management team has been in place for over a decade giving us great confidence that they will be able to continue the trend in bottom line growth. The company generates material free cash flow which it uses to reduce its share count (reduced share count by 7% in 2012). Going forward we expect earnings growth to reaccelerate as a result of continued growth in same store sales (2-4%), store growth (over 3%) and share buybacks of greater than 3%. Combined, this should result in the bottom line growing more than 10% and if the share valuation simply returns to the peer average, the result is a return in excess of 40%. Interestingly, many consumer discretionary stocks have excessive valuations and can be vulnerable in a possible rising rate environment. Strategists may state that this is a group to avoid but reviewing the fundamentals and using valuation as a safety tool to protect the downside, allows us to find great upside opportunities for investors in areas others may shun.

Fixed Income Markets – Volatility Watch

In previous commentaries we have insisted that interest rates are simply too low. With interest rates held as low as they are, there is a massive risk of distortion in the allocation of capital. In just over a month the U.S. Fed changed everything. First, Mr. Bernanke suggested in his Joint Economic Council address in May that tapering might begin in 2013. Then in the press conference following the June FOMC meeting, Mr. Bernanke accelerated the process by suggesting that tapering of QE would in all likelihood begin in the autumn. The impact on the bond market of these announcements in Canada was the equivalent of two 25 basis point Bank Rate hikes causing a negative move for bond prices in the order of 3 standard deviations over the norm!

Canadian rates will take their cue from movement in U.S. rates, regardless of the discrepancy in economic condition.

The reaction may have been overdone but the message was clear and the effect on the yield curve was immediate. With the short end of the curve firmly anchored by a 1% Bank Rate, the curve steepened with 10 year yields at levels that have not been seen since 2011.

While our neighbour to the south appears on the slow road to recovery, Canada is slowing. The latest official data release has Canada growing a mere 0.1% (month of April 2013 data) or 1.4% year over year. This places the Canadian bond market in the squeeze between the proverbial rock and a hard place. As has been amply demonstrated by the price activity in June, Canadian rates will take their cue from movement in U.S. rates, regardless of the discrepancy in economic condition. This view was supported when Canada heard the first public statement from the new Governor of the Bank of Canada, Stephen Poloz. Despite some participants' expectations or wishful thinking there was no change made to the mildly tight policy put in place by his predecessor, Mr. Carney. Meanwhile, it looks like the U.S. will soon have a change as well. President Obama took the opportunity in a press conference to suggest that Mr. Bernanke's time as Chairman of the Fed would come to an end in January, helping to promote fears of an accelerated end to QE.

One clear indicator of the trend in rates has been the surge in new corporate debt issuance. We have been anticipating the day when corporate treasurers would decide that despite the wider (and widening) credit spreads, the all-in cost of financing remains exceptionally low. This would lead to a strong wave of new issue financing, accompanied by redemption of outstanding issues. All through the last month of the quarter there was a rush to get new issues priced and launched, particularly in the real estate investment trust (REIT) space. This came to an abrupt close following the selloff triggered by the post FOMC Fed comments. However, new issues (government, corporate, asset backed etc.) still managed to be significantly higher in Q2 2013 than Q2 2012. On top of that, bond issuance year-to-date is over 60% of total 2012 new issue sales.

We do not purchase bonds that are below investment grade, but following this area of the bond market can confirm ones thinking. For instance, a few new issues for high yield borrowers were cancelled, together with the planned call for redemption of higher cost outstanding issues. One can only conclude that the buyer's appetite for risk in the bond market has declined markedly since the Bernanke announcements.

The Government of Canada yield curve generally steepened through the month of June as mentioned, but also followed a volatile pattern through the quarter, with rates rising in the 5 to 10 year area and flattening somewhat beyond that period. Corporate credit spreads were also more volatile as they scraped tighter through early June, and then pushed wider as market participants became less comfortable with risk.

While we continue to find value in the corporate bond market, it is becoming a more challenging environment, and volatility has risen steadily. We expect the curve to steepen beyond 10 years, at least until sometime next year when the Bank of Canada makes its first baby steps towards tightening. As we move closer to that time, we will become more conservative in order to protect capital. We have such tools as floating rate notes (FRN) and Real Return bonds (RRB) to employ, and can always increase cash.

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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