Barrantagh

Investment Management

CAPITAL MARKETS REVIEW
THIRD QUARTER 2003

Executive Summary

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- The U.S. economy is accelerating and economic conditions in Japan and Europe are improving.

- The U.S. dollar decline against the Canadian dollar and other major currencies is problematic for holders of U.S. securities and further U.S. dollar weakness can be expected.

- U.S. foreign policy in the Middle East and its mounting costs could eventually prove problematic for the economy and for capital markets.

- As we expected, equity markets reacted positively in the third quarter to accelerating global economic recovery and rising corporate profits.

- Corporate earnings and cash flow growth is accelerating in response to positive economic developments.

- In our second quarter review, our investment strategy called for equities to outperform bonds and we still believe equity markets offer the better risk/reward tradeoff. In general, market multiples have not risen materially since the beginning of the year (except technology stocks) because earnings have improved.

- In fixed income portfolios, we have materially reduced our exposure to the government bond market to protect capital in recognition of a possible reversal in Fed policy or the prospect of inflation. Spreads between corporate and government bonds continue to narrow (corporate yields have fallen while long government yields have risen) and we continue to see opportunities in corporate credit markets.

- In the income trust market we have become concerned with overvaluation in oil & gas royalty trusts and some real estate investment trusts. As well, potential tax-related structural problems of some diversified business trusts with U.S. operations give us reason to favour mainly Canadian businesses operating in the income trust structure.

The Economic Backdrop

Accelerating economic growth and rising corporate profits sparked a strong upsurge in global equity markets in the third quarter. Year to date the U.S. benchmark S&P 500 rose 14.7%, the S&P TSX 13.8%, the Nikkei about 40% and major European markets have shown solid increases. Of course, factoring in the 16.4% decline of the U.S. dollar against the Canadian, the S&P 500 is actually down 1.2% in Canadian dollars.

In our second quarter review we concluded that a positive equity cycle had begun and therefore the broadly based demand for stocks this quarter did not come as a great surprise. The primary equity market driver is the recognition that major economies are accelerating after the recession of 2001 and the false start in 2002. The recovery is most clearly apparent in the U.S., but also evident in Asia and Europe. In the U.S., second quarter GDP growth was revised upwards to 3.3%, a marked improvement from the average rate of advance since the end of the 2001 recession.
Several economic indicators support accelerating U.S. economic performance through the remainder of the year and into 2004. For instance, the U.S. consumer has been all-important to the economic recovery so far in the absence of corporate spending. Consumer spending rose 0.8% in August and real consumer spending has now risen close to 3% this year. Moreover, the consumer's staying power seems more assured as household net worth has risen for three quarters (reflecting stock market gains) and disposable income continues to rise.

Business equipment purchases made a major contribution to 2nd quarter U.S. GDP growth, rising 8.2% over the 1st quarter, and we expect this to continue in the 3rd quarter. Technology spending, particularly purchases of information processing equipment, was the main driver, accounting for about 35% of overall capital spending.

For most businesses, telecom and airlines being exceptions, balance sheet repair has been a priority. Corporations now have access to cheaper capital as equity markets have risen and borrowing conditions in the credit markets have eased. High corporate debt is not the obstacle to corporate expansion it posed a year ago. Moreover, companies are increasingly generating free cash as their profitability continues to improve.

The Federal Reserve left the key discount rate unchanged at 1% following its policy meeting in mid-September. The Fed has made it clear that there will be no rate increases until it is certain the recovery is sustainable. We believe the Fed is not likely to raise rates before the U.S. presidential election. Accordingly, interest rates may rise somewhat in anticipation of inflation but not to levels that will induce a housing collapse or trigger debt service problems with consumers. Furthermore, fiscal policy is actively supporting its monetary counterpart.

The yield curve (yields at various maturities) is extraordinarily steep due to historically low short-term rates and much higher long term rates reflecting an inflation bias. A wide spread between long-term and short-term rates is considered a reliable predictor of improving economic activity.

Economic recovery is now also visible in parts of Asia and Europe. In Japan, cyclical developments have spurred a modest economic expansion. Japan's deepening links with China have provided support through exports while falling prices have boosted Japan's international competitiveness. However, the long-run outlook for Japan is uncertain as its longstanding problems, including weak financial institutions and massive fiscal imbalances, will constrain its progress.

While Europe overall has been stagnating, some countries appear to be emerging from recession. Receding inflation, European Central Bank easing of interest rates and the potential for fiscal relaxation should act to lift Euroland domestic demand. In sharp contrast to the United States, fiscal policy in Euroland has been largely neutral. Overall, Europe will continue to lag the U.S. growth path in 2004 in spite of a rebound in Germany and the U.K.

The Canadian economy stalled temporarily during the second quarter of 2003 (0.3% growth rate). The Bank of Canada has revised downward its inflation expectations to about 2% for 2004. Accelerating growth in the U.S. will stimulate the Canadian economy. However, if a good part of U.S. growth comes from business investment and less from consumer spending, then the impact on Canada will not be as large as expected. We believe it is likely that the Bank of Canada will adopt a more accommodative rate policy.

U.S. Foreign Policy – Its Mounting Costs

The euphoria of a swift and relatively bloodless ousting of Saddam Hussein has now been replaced by deep concerns internationally and among Americans themselves over what is being accomplished in the war on terrorism. What are realistic Middle East objectives and what will be the financial burden on the United States?

The U.S. government's budget deficit will likely be in the $475 billion range next year or nearly 5% of GDP, compared to a $236 billion surplus in 2000. Just two years ago the U.S. government was projecting surpluses building to $5.6 trillion through 2010. Underscoring the new reality, President Bush requested an unexpectedly high $87 billion from Congress. That amounts to an 11% hike in discretionary spending which implies federal spending next year would be over 20% of U.S. gross domestic product - the highest in a decade - while tax revenues are falling.

The new reality has raised concerns but not caused serious problems yet. Over the long term, an orderly decline in the U.S. dollar and a medium term rise in U.S. yields against a backdrop of expanding global demand would be a reasonable adjustment mechanism to get the current account deficit rebalanced.

Mr. Bush's re-election campaign in 2004 could well be crimped by the foreign policy and budget problems now coming to light. For most of their tenure, the Republicans have been good for Wall Street, so the recent decline in his rating may well give stock markets some concern for 2004.

Equity Markets Outlook

As pointed out in our second quarter review, equity investors have had to "climb a wall of worry" ever since the 2001 recession and the terrorist attacks of September 11th, 2001. In early 2003, the buildup to the war in Iraq, the war itself, and the global threat of terrorism dominated investor thinking. Since May, stock markets have rallied dramatically as investors put emphasis more on the fundamentals related to the state of the economy and corporate profits.

Investors have come to accept that the conditions for a period of healthy economic growth are in place and that the heavy doses of fiscal and monetary stimulus are working. Investors also took comfort from the Fed's statement that it will keep rates close to current levels for a "considerable period". Admittedly, mounting government and personal debt will have to be dealt with in the future. Nevertheless, for the foreseeable future, the liquidity environment will continue to provide powerful support to the equity market.

Supporting our thesis that the bull market has scope to expand is the significant progress made by corporations in generating earnings and cash flow. The ongoing strength of consumer spending combined with tight control over costs has sparked a sharp upturn in corporate earnings. For many corporations, earnings improvement so far has primarily reflected corporate cost-cutting initiatives and productivity gains. Profit margin improvement is now starting to combine with stronger demand (i.e. revenue growth). Investors may well be underestimating the sizeable leverage in the corporate sector especially if deflationary pricing pressures ease.

Over the last year earnings and corporate cash flows have risen, keeping market valuations basically unchanged even with the current market movement. Since the quality of earnings is now better (fewer turnaround adjustments) valuations are more reliable. However, we are being diligent in our analysis to avoid companies where stock appreciation has moved ahead of earnings growth potential.

While generally cautious about overvaluation in the technology sector we identified ATI Technologies as an investment opportunity. ATI Technologies is a maker of graphics chips that have become the “chips of choice” for many applications, including the Microsoft X-Box game system. The company has taken substantial business away from its main competitor, Nvidia. Having obtained ATI at an attractive cash flow multiple, we are now watching its margins diligently as research and development costs are rising, and production costs may also rise as ATI increases production to meet the new market share it has gained.

We have also invested in Fairmont Hotels and Resorts, a name with which most readers will be familiar. In Fairmont we have found a very high quality management team running very good hotel and resort properties. The company’s stock price was depressed by 9/11, SARS and the general lack of consumer travel. These seem to be one-time issues – recent data shows consumer discretionary spending on holidays is increasing. We were able to obtain Fairmont at a cash flow multiple well below its U.S. and Canadian comparators.

In the financial services area the TD Bank meets our criteria. The TD Bank is committed to building its retail operations (integrating Canada Trust, etc.) under a new senior management team skilled in that segment. Over time, TD Bank is concentrating on the Canadian retail market which should result in more stable earnings and a higher return on equity. The period of maximum opportunity for the banks to take advantage of interest rate declines and loan growth has likely passed, but TD Bank offers scope to benefit from a streamlining of operations.

Finally we continue to hold well-positioned natural gas producers that have visible volume growth potential, good cost control, and strong balance sheets such as Progress Energy Inc. We are conscious of the fact that cash flows of many oil & gas producers have come under pressure as oil and gas prices have moderated and operating and finding costs have ratcheted up. We hold companies that can offset these issues through low cost volume growth. We remain bullish on the longer term outlook for natural gas prices, although the near term fundamentals have deteriorated somewhat as high prices have caused demand erosion and natural gas was injected into storage at a record pace throughout the summer.

Fixed Income Markets

Taking a long-term perspective, it may be that the investment world is experiencing an inflection point. The 20 year downtrend in both bond yields and inflation may have bottomed. At the very least inflation and bond yields are both more likely to trend up rather than down over the longer term.

In the short run investors have just gone through a period of highly unusual turbulence in the bond markets. In just a few weeks U.S. ten-year rates saw increases that historically took months to occur. During the month of May, comments from the Fed Chairman induced bond investors to believe deflation was a real threat and led the bond market to speculate that the central bank would move to lower long term rates through direct intervention causing bond prices to move sharply higher

Since then, the economy has shown every sign of a significant acceleration in growth. The bond market began to echo concerns that rapid growth would fuel inflation leading to a reversal of Fed policy. As a result, the markets quickly reversed course and U.S. ten-year yields jumped from 3.10% to 4.5% in the space of just a few weeks. By the close of the quarter, yields had retraced some of the rebound to the 3.95% level.

Recent Fed statements suggest that a tightening in policy is some way off in the future. However, with rates far below the level of nominal GDP growth, it seems likely that by the end of the year the markets will have raised their expectations of the speed and extent of a Fed tightening. We have, therefore, recently added some Real Return Bonds to the fixed income portfolios to help offset this risk.

As with our equity strategy, our fixed income strategy is an extension of that put in place earlier in the year. With U.S. interest rates at historically low levels and little scope remaining for monetary ease in the U.S., the U.S. treasury market does not offer much scope for reasonable returns. An added risk for accounts managed in Canadian dollars has been the strengthening trend of the Canadian dollar against the U.S. dollar. With the Canadian economy feeling the pressure of the high dollar and slower growth than the U.S., there may be more scope for monetary ease in Canada. Accordingly, Canadian bonds in some maturity ranges are more attractive than their U.S. counterparts.

In corporate bond markets, the spread between corporate yields and government yields narrowed materially in the third quarter and we earned solid returns on our corporate bond holdings. With corporate earnings and balance sheets continuing to improve, there is likely to be further narrowing of corporate bond spreads over time. Our focus on uncovering value opportunities among corporate bonds means that our fixed income portfolios should continue to benefit from this trend.

Income Trust Update

Our own analysis confirms that the return on a portfolio of diversified business trusts, real estate investment trusts and oil & gas royalty trusts is highly correlated with and very sensitive to Canadian bond yields compared to the performance of the overall market. During the period in which many income trusts have been launched, interest rates have been declining and therefore supportive of the appreciation of those trusts. At some point in the future the interest rate trend may reverse and trusts will have difficulty offsetting the negative impact of rising interest rates. We have reduced our weighting in income trusts to recognize this risk and also to reduce exposure to the oil & gas and real estate sectors.

A new issue has arisen for those trusts structured around U.S. businesses or businesses with substantial profits in the United States. A concern has been raised by some large accounting firms as to whether the structures of certain trusts are effective in eliminating income tax at the operating company level. Apparently, the risk of the U.S. tax authorities taking action is low but we are avoiding trusts with exposure to this issue for the time being.

We continue to believe selected income trusts are sensible vehicles for individuals seeking income and certain pension funds and will continue to invest in them to augment and diversify income investment returns as opportunities arise that meet our investment criteria.

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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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