Barrantagh

Investment Management

CAPITAL MARKETS REVIEW
THIRD QUARTER 2004

- As the global economic cycle matures, slower growth (but still above trend) can be expected into 2005. Weakening consumer spending will contribute to decelerating growth in the U.S. economy. The state of the Chinese economy is critical to growth outside North America.

- The well telegraphed "measured" pace of increasing U.S. interest rates is on schedule with 0.75% Fed funds increases implemented to date. It is apparent the Fed is creating room for monetary ease in the future, if needed, and pre-empting future inflation (benign at the present).

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- The current lack of direction in equity markets has more to do with earnings disappointments, geopolitical uncertainties and a growing wariness of the "lone ranger" tactics of President Bush than concern with rising interest rates.

- The key drivers of equity gains earlier in the year (above-trend global growth, above consensus earnings reports and monetary ease) are less powerful today. Negatives such as, rising interest rates, high energy prices, twin U.S. deficits, Mid-East turmoil and the U.S. presidential race have moved to the forefront.

- Equity markets have adopted a more confident posture recently but a closer look suggests that it is driven by two sectors. We are adding quality companies to the portfolios, including selected income trusts, which are positioned to benefit from an enduring economic recovery.

- Bond prices have recovered recently since their sell off proceeding the June 30th Fed funds hike but the longer term trend is bearish. While we have taken profits in certain bond holdings, we are continuing to emphasize the corporate market where opportunities for credit improvement and therefore capital appreciation are still prevalent.

Economic Backdrop – Global Growth Healthy But Decelerating

The news media is full of negative stories including fears of a global slowdown, higher oil prices, lack of progress in Iraq and uncertainties surrounding the U.S. presidential election. These issues have acted to dampen consumer and investor confidence. Equity markets have eked out modest gains this year but many individual stocks have stumbled. A central question is to what extent are worries about deterioration in the global economic backdrop justified. A chief concern is the extent of the slowdown in China as restrictive credit policies take effect. So far, a slowing Chinese economy has had little negative impact globally. For example, U.S. exports to China and other Southeast Asian countries are still rising faster than in 2003. Signs of a slowdown are evident in parts of Europe although the economic expansion in Euroland continues at a trend-like pace.

With regards to the U.S. economy, a fair assessment is that economic growth appears to be on a recovery path once again after faltering in the second quarter. In the spring, the sharp run-up in consumer prices early this year (record gas prices and weak job growth) took their toll on consumer spending while triggering speculation of an aggressive timetable for Fed tightening. But three months of benign inflation readings have eased pressures for rapid rate increases, reinforcing chances that the U.S. expansion will continue.

An important sign of a firming U.S. economy is the apparent rebound in consumer spending. U.S. Consumer spending increased 1.1% in July and 0.1% in August following a decline of 0.5% in June. Other signs of consumer strength include continued increases in personal income, additions to non-farm payrolls and continuing robust levels of existing home sales. Real consumer spending will probably grow at an annual rate of about 3.5% in the third quarter or about twice the 1.6% second quarter advance.

Another fundamental underpinning to the U.S. expansion is the recovery in the industrial sector. After falling 0.5% in June, industrial output rebounded 0.4% in July and rose again (albeit moderately) by 0.1% in August. The August gain was depressed by a drop in utility output, reflecting cool weather, and auto plant shutdowns for new-model changeovers. Manufacturers are benefiting from the efforts of companies to restock inventories to levels more in line with demand trends. So far this year, manufacturing output is growing at a 5.6% annual rate more than double the 2.5% rate for 2003.

With consumers and businesses working in tandem to generate growth, U.S. GDP growth will likely recover significantly in the third quarter (close to a 4% annual rate of growth). As well, GDP growth for the second quarter was refigured upwards to 3.3% from 2.8%.

Canada's economy, in contrast to that of its main trading partner, accelerated strongly in the second quarter to a growth rate of about 5%. Canada is a net beneficiary of the recent rise in commodities and the ongoing strength of global economic activity. The western provinces are likely to outperform the central region because of their resource-oriented economic structure. Canada's economy will likely perform well this year reflecting Canada's strong trade position and improving domestic fundamentals. Generally, this favours a strengthening of the Canadian dollar, which supports domestic investment.

Looking at the industrial world overall, global economic growth is likely to stay above trend well into 2005. Higher oil prices will dampen industrial activity over the next year. However, oil shocks are less disruptive today than in the 1970's because low inflation reduces the need for monetary policy restraint, energy efficiency has improved and the inflation-adjusted price of oil is lower.

In summary, conditions remain favourable for continued expansion of global economies into 2005 providing a constructive backdrop for equity markets.

Equity Strategy – The Haves and Have-not

In our second quarter report we pointed out that the most important catalyst to further stock market appreciation would be improving corporate operating results, particularly cash flow generation. To date in 2004, North American corporate reports provide evidence of strengthening balance sheets and growing cash flow, yet the broad indexes have managed at best, only marginal gains. In fact, some market segments like the NASDAQ are down by 15% or more from their 2004 peak. This illogical phenomenon can be explained by the "haves and have-not" and the fact that equity markets are always trying to anticipate future conditions.

When we dissect the Toronto Stock Exchanges (TSX) year-to-date performance, the momentum behind two industries, oil and gas and the financial sector has been strong. The energy sector has been propelled by skyrocketing energy prices and the financial sector has been buoyed by the consumer's ability to keep spending. These two sectors are responsible for more than 50% of the over-all TSX weighting, so when they do well, they help to give a positive look to over-all market performance. However, the broader market including other sectors such as health care, utilities and industrials has shown negative performance year-to-date as worries about future economic polices (read US election), tax hikes, slowing world wide growth and a general rise in interest rates depress investor confidence in the long term outlook for corporate performance.

Along with the wide divergence in performance of various sectors, the markets are proving to be a narrowly based "market of stocks". This year the TSX is up over 400 points. Three companies, Research In Motion (a tech company), Manulife Financial (a financial company) and Canadian Natural Resources (an energy company) contributed about 200 points to the total gain in the TSX, again displaying the dichotomy in the growing markets between the "haves and the have-not".

We have been positive with respect to equity markets and remain positive relative to bonds but we are wary of the "have and have-not" scenario that has unfolded. An assessment of the earnings and interest rate backdrop suggest that a more challenging phase of the stock market cycle lies ahead regardless of what happens to the price of oil, the US election or terrorism. A primary influence on investor confidence has been a series of earnings disappointments and downward estimate revisions which often indicate that consensus forward earnings estimates are too high. For instance, Coca-Cola reported a disappointing outlook and the company's stock price fell over 20%. In short, there is growing skepticism over the earnings outlook and concern that negative earnings surprises will become more widespread.

From our review of corporate trends it would appear that revenue and cash flow growth in general are still in a solid growth phase. However, as we look to the future, we believe that benefits from cost cutting have reached a limit for many companies; top line growth is likely to moderate in response to decelerating economic activity and global competition together with higher costs are pressuring profit margins. This potential slowdown in revenues and cash flow growth is now being complicated by somewhat tighter monetary conditions.

While slowing cash flow growth in conjunction with valuation compression limits the return potential for equities, we believe the risk/return tradeoff still favours equities relative to bonds for two primary reasons. We believe interest rate increases will be modest compared to other cycles and will not precipitate a major economic retrenchment. Secondly, we are able to find companies which are achieving capital efficiencies in their operations and generating cash flow in excess of current capital requirements. In discerning these companies, our value-based equity strategy is particularly effective when rising risk aversion is contributing to downward pressure on market multiples. In addition, we look for out performance from high quality stocks at a time when macro level uncertainty is mounting. Investors have shown little patience over time to pay premium valuations or purchase volatile earnings streams in periods of growing economic and financial market uncertainty. We will commit to companies with solid evidence of growing cash flow, predictability of operating results and potentially higher dividend payments.

We favour securities such as Bank of Montreal due to its valuation and excellent balance sheet which is carrying excess capital. This will allow it to grow. Credit risks seem to be low and all divisions are firing on all

cylinders. Going forth we will continue to monitor consumer spending and how the bank invests its excess capital to ensure the long term quality of this investment.

As mentioned, the energy sector has done well, and although we have concerns with respect to oil prices, we continue to favour gas names such as Compton Petroleum for the long term. Cheap, large gas reserves have become more and more difficult to find supporting a higher average natural gas price then has been historically experienced.

Fixed Income Strategy – The Challenge Continues

Amid a sustained economic recovery and low core inflation, the Fed will likely continue tightening U.S. short term rates at a "measured" pace, which is in line with market expectations. Since the June 30th increase of 0.25%, the Fed followed up with a 0.25% increase in August and another 0.25% in September, commenting lately that the recovery had "gained some traction". Clearly the Fed is pre-empting inflationary trends and creating room to maneuver (i.e. reduce rates if current trends become derailed) as the Fed funds rate heads higher in 2005, as we expect.

Interestingly, interest rates (yields) at the long end of the Treasury market have moved down over the year which seems to be at odds with a growing economy and rising rates in general. The yield to maturity on 10-year Treasuries has declined from a mid-June high of 4.87% to the 4% level at the time of writing. Recall that the 10 year yield was running above 4% for the better part of the period between July 2003 and March 2004. Today's economic picture is clearly vastly different than in late 2003. The U.S. economy has "traction" now and inflation has come off its floor. In our view a 4%, 10-year treasury yield cannot be justified at present and conclude that the long end of the Treasury market is vulnerable to a downward correction (lower bond prices, higher yields).

In Canada, GDP growth is in an accelerating phase (in contrast to the U.S.), the economy is operating near full capacity and consumer price inflation is rising. Since monetary policy has always been tighter in Canada than in the U.S. the Bank of Canada may not raise rates as aggressively as the Fed, but rates are forecast to rise nonetheless.

In terms of strategy, we recognize that North American government bonds have been performing better than we expected but valuations remain stretched and we continue to adjust our holdings of government bonds to a narrower range of opportunities. Consistent with our approach throughout 2004 we continually weigh opportunities in corporate bond markets where credit enhancement provides potential for capital gain as well as yield. Business balance sheets are continually improving as evidenced by the steady rise in the interest coverage ratio of the non-financial business sector. A steady recovery in profits and cash flow is at the root of this trend towards higher credit ratings for corporate issuers.

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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