Barrantagh

Investment Management

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- Rising interest rates, elevated energy prices and decelerating house prices may conspire to slow the U.S. consumer and therefore U.S. growth. U.S. capital goods spending is strong and U.S. exports may accelerate to replace weakening consumer spending.

- Global economic growth could face headwinds in 2006 if the U.S. economy slows.

- Fed Chairman, Greenspan has made it clear that he is targeting the U.S. housing boom as well as rising inflation.

- A key dynamic in the global economy going forward will be the extent to which G7 economies recover (Europe) or continue growing (Asia) as the U.S. economy slows.

- Longer term the U.S. will need to move from a consumer driven economy to an export driven economy.

- Our equity strategy continues to focus on companies with specific value creation characteristics. We see increased risks in equity markets as a whole, but believe that the best management teams, with sound strategies and free cash flow generation will outperform.

- Despite recent negative media attention to Finance Minister Goodale's comments regarding income trusts, we continue to identify sound income vehicles for our clients.

- Fixed Income markets are characterized by high valuations and narrow credit spreads. Our strategy is to stay patient and adopt a higher than usual cash holding until opportunities present themselves.

Economic Update – Slower Growth Ahead

In previous reviews we have commented upon the above-trend rate of global economic growth led by the U.S. and Asia. Unlike prior cycles, where crises have often developed, growth in this cycle has been marked by contained inflation, unusually accommodative central bank policy, a resilient U.S. consumer, and an industrial boom in China. Economic activity is holding up well. U.S. GDP growth is hovering at the 3.5% level, Canadian activity is not too far behind and Chinese growth has remained strong at around 9%. We have commented previously on the significant economic and financial imbalances that characterize the current state of economic affairs, namely:

1) America's current account deficit is forecast to widen to over 6% of GDP, while Germany, Japan and China will likely run record surpluses.
2) Inflation is being constrained by cheap goods from China and other low-wage economies. As well, inflationary expectations have been held in check, in part because of Central Bank credibility.
3) Compared to previous cycles America's real bond yields have responded only slightly to tightening monetary conditions. America's real bond yields are lower than Japan's and about the same as in the Euro area.
4) In previous cycles, large budget deficit countries generally were penalized by higher real long-term interest rates. Today, there is little correlation between borrowing and real interest rates. In a sense, financial markets are not effective as economic watchdogs. America's exuberant spending has so far been subsidized rather than punished.
5) Soaring oil prices and hurricane disasters are also unusual features of the current economy.

Regardless of these concerns, the International Monetary Fund recently forecast that global output will grow well above long-term trend rates next year. We are more cautious because global economies are about to face a number of severe tests.

First, the foundations underpinning American spending, especially record high housing prices, are becoming more shaky. These foundations have been rocked not only by hurricanes and sharply higher fuel costs, but by a shift in America's economic mix towards higher inflation, higher interest rates, and looser fiscal policy (i.e. increasing debt). According to the University of Michigan's survey, inflation rates are expected to jump above 3% over the next few years, rates not seen for several years.

Secondly, the factors that have helped insulate the U.S. economy from elevated energy costs are now fading. Until now, U.S. consumers have been eager to reduce savings in favor of consumption supported by the positive wealth effect of the housing boom. However, the U.S. personal savings rate recently dropped to zero and further declines seem unsustainable. Chairman Greenspan expressed a considerable degree of concern about the "apparent froth in the housing market" in his summer testimony to congress and reiterated these views at a recent central bank Symposium. For the first time, U.S. monetary authorities have admitted to targeting asset price inflation. Chairman Greenspan's resolve introduces new risks to the economic landscape, which are magnified by the bond markets reluctance to cooperate with his intended policy path. Abnormally low and immovable long bond yields continue to fuel the housing froth. Attempts to wrestle long bond yields higher could result in a policy extreme, whereby the Fed unintentionally inverts the yield curve. Every time a yield curve inversion has occurred in the past four decades, the U.S. economy has found itself in a recession.

More broadly, the U.S. economy seems to be in transition from slowing consumer spending to heavier reliance on capital spending and exports. However, even if this transition is successful, we doubt that capital goods outlays and exports will sufficiently offset slower consumer spending. On balance, we expect deceleration in North American economic growth from the 3.5 – 4% forecast towards 3% going into 2006.

The above issues will also test an increasingly U.S. driven and interdependent global economy. Non-Japan Asia is extremely energy inefficient at the same time that it is highly dependent on U.S. consumption. While China shows few signs of slowdown at this stage, about one-third of Chinese GDP is exported and a high proportion of that heads to the U.S.

Canada's small, open economy is unlikely to escape a U.S.-led slowdown. We expect respectable GDP growth in Canada over the next year (3%+) but are cognizant of the downside risk. Decelerating global demand, coupled with the impact of recent currency strength, will weigh on Canada's exports. Furthermore, the Bank of Canada appears to be set to continue a tightening campaign this fall.

A key dynamic in the global economy going forward is the extent to which G7 economies and Asia pick up the pace of global growth as the U.S. economy slows from above-trend levels.

Equity Markets – Selectivity Is the Key

Canadian equities have achieved mid, double digit returns year-to-date largely in response to a sharp revaluation of energy stocks, which represent 25% of the TSX. The Canadian index is up a modest 5%, excluding the impact of energy stocks. Interestingly, the Canadian market ex-energy has outperformed the S&P 500 including energy. The S&P 500 started the year just over 1200 and has not made much progress since. Overall, the bulk of North American equities have been struggling to show gains this year.

Barrantagh portfolios have performed extremely well this year despite less than market exposure to energy stocks. We have achieved this by sticking to our principles of investing in management teams whose track records we can objectively measure, with defensible corporate strategies that produce free cash flow.

Our investments in TD Bank and Bank of Montreal continue to fare well as both corporations direct surplus capital to share buy backs and increased dividends. Telus and Shaw Cable are experiencing the free cash flow generation that follows years of network investments. Le Chateau's focus on operational control is generating very healthy margins, and a growing cash balance.

Within the energy sector, our strategy continues to focus on smaller, entrepreneurial natural gas producers like Galleon Energy, who benefit from a combination of exploration and development success, and tightening North American gas supply. This same natural gas supply problem is directly benefiting our energy service investments, like Calfrac and Western Lakota. Their expertise in completing and maintaining production for gas producers is more and more critical, as companies increasingly develop the technically challenging reservoirs that remain in Western Canada.

Our confidence in our equity investments does not mean that we are ignoring some of the greater economic risks in today's market. Concerns relating to a U.S. housing bubble continue to keep us out of real estate and building products companies. Lack of confidence in the U.S. consumer finds us avoiding consumer durables, and the domestic steel producers that supply them. With a tightening Fed, we do not like companies with debt, or those that rely on capital markets to execute an acquisition or arbitrage strategy.

The Income Trust market has been turned into a degree of turmoil by Finance Minister Goodale's announcements that he is reviewing the income trust investment structure because of concerns over tax leakage and a perception that income trusts have a negative impact on economic productivity. We do not believe either to be true, however, it's unlikely a minority Liberal government will take action before an election on an issue which affects many Canadians and cannot be easily explained.

Fixed Income Markets – Patience Required

The past quarter saw the continuation of the Federal Reserve's policy of raising administered rates at "a measured pace". The Fed Funds target rate was raised by 25 basis points at each meeting of the FOMC in the quarter. This process will continue, with a target rate of 4.5% or higher likely to be achieved by early next year. The past quarter also witnessed the resumption of the Bank of Canada's program of monetary policy tightening, with the Bank Rate increased by 25 basis points. Canada's central bank is expected to increase the Bank Rate again following its next meeting on October 18.

These actions have been taken ostensibly to prevent an uncontrolled inflation acceleration in both economies. In the U.S. the Fed has made it clear that it is also targeting the housing bubble, the source of significant funding for consumer expenditure. In the past, Mr. Greenspan has maintained that it is better to allow a bubble to run its course and let market forces dictate the outcome (even if it leads to a burst). The central bank would then clean up in the aftermath, rather than trying to control or prevent the bubble in the first place. Part of the rationale for this hands-off approach was that it is not always possible to tell if it really is a bubble, and the process of deflating (or bursting) the bubble may do more harm than good to the broader economy. This time around, the Fed clearly appears to be adopting an interventionist approach by targeting asset values, and trying to slow or reverse the growth in the housing market.

The Fed is clearly concerned about the persistency of inflation. A recent Fed study pegged the sacrifice ratio at 4 to 1. This means that the Fed estimates it would take a 4 percent increase in the unemployment rate to reduce the rate of inflation by 1 percent (starting from full employment). Clearly this is a further incentive for the Fed to remain pre-emptive in the fight against inflation.

The bond markets in the U.S. and Canada have watched with some satisfaction as the central banks have acted, and allowed the yield curves in both countries to flatten significantly. The lack of concern about the future prospects of runaway inflation has kept the longer end of the curve quiet. Yields remain unchanged in the 20 to 30 year maturity range.

Foreign investment flows have continued to push into the North American debt markets, confounding skeptics that expected this flow to falter. The continuing strength of the Canadian dollar has further encouraged foreign bond investors. This process has no doubt been helped by the persistently high price of oil, generating large dollar revenues to be recycled.

Corporate spreads have remained tight, as observed in last quarter's letter. This has been partly a function of improving credit quality and cash flows, and partly a function of reduced supply. In the quarter, new issuance has declined, as companies have either repaid outstanding debt, or funded their activities from cash flow, not requiring the issuance of new debt. The same improvement in financial condition at many issuers that has allowed us to achieve strong returns on existing positions has also slowed the supply of new bonds. The shortage of new issue and secondary debt has kept spreads tight (higher prices). In addition, the September coupon cash payment flooded into the market competing for new paper.

While corporate spreads remain historically tight, we continue to identify investment opportunities. The slight widening of spreads in September has provided an improved compensation for credit risk. We continue to high grade bonds, taking gains and positioning conservatively in both credit quality and maturity range.

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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