Barrantagh
Investment Management

CAPITAL MARKETS REVIEW
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- The U.S. economy shows clear evidence of the anticipated slowdown, reflecting the effects of rising interest rates, and a housing market slowdown. U.S. exports and capital spending remain strong but may not be enough to offset a severe weakening of consumer spending.

- Global economies, particularly Asia continue to expand, but a U.S. slowdown will ultimately constrain global growth reflecting the importance of the U.S. consumer in global trade. China has embarked on a deliberate effort to control its hyper-growth.

- The U.S. market has proven impervious so far to declining economic fundamentals; however, global markets seem vulnerable to correction. The resource dominated TSX has already retreated from highs set earlier in the year.

- Both equity and bond markets remain highly sensitive to every economic nuance. Extreme volatility will obscure underlying market direction.

- Our equity strategy focuses on risk management in this period of elevated concerns over the transition to lower global growth. As the full extent and depth of the global slowdown becomes apparent, higher risk premiums in equity markets will be demanded and corporate performance will come under intense scrutiny. We have taken steps to lower the volatility of portfolios and reduce exposure to economy sensitive equities. As well, our portfolios are beginning to reflect more diversification among sectors and geographic regions.

- Fixed income markets have reacted positively to the pause by the Fed and the Bank of Canada in monetary tightening. Long rates appear rangebound (around the 4.25% level for 10 year treasuries) reflecting a somewhat inverted yield curve. Bonds, especially government, will serve as a safe haven in a period of difficult equity markets but yields are too low to provide the scope for meaningful gains.

Economic Outlook – Growth is Clearly Slowing

The global economy is still expanding but the pace has begun to decelerate under the influence of a consumer-led slowdown in the U.S. economy. U.S. output grew at an annual rate of 2.9% in the second quarter, which represented a sharp decline from the unsustainable 5.6% annualized rate in the first quarter of the year. At the heart of the U.S. slowdown is the cooling of the U.S. housing market which has been the main driver of the current U.S. economic expansion. Over the past five years the value of American homes has increased by more than $9 trillion to an estimated $22 trillion, offsetting to a large extent modest wage growth during the period. The housing boom lifted the economy in three ways: it boosted residential construction (about 4% of GDP), it made people feel wealthier (the wealth effect); but more importantly, it allowed home owners to extract funds from their property by borrowing at cheap rates against their rising home equity. Merrill Lynch estimates that the three factors together accounted for more than half of America's total GDP growth in 2005. Obviously the extent to which house prices level off will have an important spillover effect on U.S. economic performance and indeed the health of the global economy. At least the previous bubble in technology left behind modernized systems and capital improvements that continue to yield productivity gains. In contrast, the investment stimulated by a property boom does little to boost long-term growth. As well, the boom may have diverted resources away from productive sectors causing households to save less and exacerbating America's economic imbalances.

At this stage it is difficult to put the recent deceleration in the U.S. economy in perspective in a larger global context. The rest of the world is still growing at a respectable pace but the sensitivity of the world economy to U.S. growth and the U.S. consumer is critical at this point. The U.S. economy has been responsible for an estimated 25% of the aggregate pace of global growth. The Euro zone in contrast is likely responsible for about 16%, China about 13%, and Japan about 10%. Based on these statistics, it is apparent that contributions from the EU, Japan, and even super-growth China are not capable of offsetting the U.S. as the main marginal contributor to global growth, particularly as global economics have become increasingly interdependent.

A slowdown in the U.S. economy is not the only reason we believe global economic activity will weaken in the quarters ahead. Global monetary tightening has become an influential factor as many central banks, including Japan's, withdrew liquidity from the system. Secondly, data released by the OECD in August showed the leading economic indicator of the industrialized countries edging down in the summer. Chinese growth remains well in excess of expectations with a reported first half GDP gain of almost 11%. However, Chinese authorities have moved more forcefully in recent weeks to reign in growth, raising interest rates and increasing bank reserve requirements. More forceful actions by China to slow its economy combined with a sluggish U.S. consumer, (i.e. less Chinese exports), will dampen the pace of Chinese expansion.

With clear evidence of a U.S. slowdown underway, there will be negative implications for the Canadian economy. A U.S. slowdown will affect Canadian exports, leaving domestic demand as a critical factor in stabilizing Canadian growth. Unlike the U.S., consumption growth in Canada has not been running ahead of income growth and Canada's personal savings rate is positive. With disposable income still growing, we do not anticipate a major decline in Canadian consumer spending. Despite Canada's strong dependency on the U.S. economy, Canada has avoided four of the last six U.S. recessions and we believe the probability of a hard landing in Canada in the face of a significant U.S. downturn is low at present. Canada's resiliency is supported by the continuing development of its energy potential especially with western Canada now accounting for more than one-third of its GDP. On balance, while Canada's export industries and manufacturing will suffer, its economy may well outperform the U.S. over the coming year.

Equity Markets – Elevated Risks Dictate Caution

Capital markets have been characterized, recently, by increased volatility as investors, including hedge funds, grapple with concerns over inflation, interest rate trends and a slowing global economy. Global equity markets have wavered, with the most pronounced swings in riskier assets such as commodities, emerging markets and small capitalization stocks, all market leaders until the latest quarter. The U.S. market has been resilient but may be poised for a decline in synch with the other markets. Evidence is now growing that the Fed tightening is nearing completion. However, investor confidence in equity markets has less to do with Fed policy and more to do with the economic outlook. Strategists wrestle with whether the economy will achieve a soft landing as in 1995-96, or a recession as in 1990-91, or perhaps a protracted and unprecedented phase of sub-par GDP growth.

So far the market is betting on a soft landing which implies that the U.S. economy will shrug off the housing sector downturn. We believe the fundamentals that have so far underpinned the strength of the consumer are largely moving in the wrong direction. We take some comfort from the fact that corporate performance is still strong. Our analysis indicates that equity markets may generate attractive returns for sometime as long as valuations are not stretched. There are risks to this conclusion with U.S. profits now 11.5% of GDP vs 6.0% four years ago and profit margins at a 5-decade high. Margins are increasingly threatened by cost/push from wage increases, high commodity prices, and rising import prices. Current market multiples do not appear expensive but that low valuation is a result of historically high margins. In our view, investing aggressively in a period of peaking earnings does not appear to be a recipe for good returns.

We remain cautious in our approach to equity markets which has lowered the volatility and downside risk in our clients portfolio's immensely. We have built our clients portfolios with their long-term objectives in mind but cognizant of the need to withstand perceived greater risk in the short term. Our worst fear is that the economic slowdown will be more severe than consensus forecasts.

Accordingly, we have rebalanced the portfolios to eliminate equity positions which are extremely sensitive to economic activity, i.e. CP Rail and First Quantum. Although these securities have more than doubled since our first purchase, they are very sensitive to economic slowdowns which may cause both top and bottom line erosion.

We have also remained underweight in the resource sector in our core equity and balanced accounts, not because of a negative view of the long term outlook for this sector but to attempt to manage through a cyclical downturn as excess inventories are eliminated over time.

As mentioned in our previous review, our current research implies that client portfolios will take on more of an international look as we head into 2007. As this shift occurs it will help to manage risk on an ongoing basis in view of shifts we see in global equity opportunities. This will result in further geographic and asset class diversification.

In the domestic market, we will maintain or perhaps increase our weighting in financials and dividend paying stocks as these equities should respond well to a more favorable interest rate environment. The recent purchase of Bell Aliant, a high yielding telephony play, is a good example of this strategy. As we execute our rebalancing ideas, the asset mix of the portfolios will be skewed near term towards a greater than usual holding of cash and short term income investments.

In summary, we are focused on risk management in the current volatile environment of elevated risk and are not inclined to push aggressively for near term returns.

Fixed Income Markets – Low Yields but a Safe Haven

The most important development in fixed income markets over the past three months was the decision by the Federal Reserve to pause in its tightening cycle. The bond market rebounded, sending treasury prices higher. It is apparent Mr. Bernanke and his colleagues are faced with an awkward dilemma posed by the combination of strengthening inflation and faltering economic growth. The Fed is waiting for evidence that inflation is decelerating as growth slows. Accordingly, it is too soon to suggest that its tightening campaign has ended but obviously the Fed fears over-shooting and thereby precipitating a severe economic slowdown. The Fed's latest projections foresee U.S. growth of 3.25 – 3.50 % this year and 3.00 – 3.25 % next, slow enough, it apparently believes, to prevent core inflation from rising much further. Therefore, despite pausing since July, the Federal Reserve continues to have a tightening bias. The bank of Canada seems to have adopted a similar policy to its U.S. counterpart. For now, neither central bank is likely to move from their current stance, perhaps maintaining the present freeze on rate increases through the winter. Lower energy prices and housing boom reversal supports this view.

U.S. treasury yields declined along the curve during September and the inversion of the yield curve increased with two-year yields at 4.71% and 10-year yields slightly lower at 4.64%. Although volatility in bond prices can certainly be expected, it is our view that we have seen the high for bond yields this cycle. By the turn of the year the risk of a sharp U.S. slowdown will be more apparent and inflation may well be peaking. If these trends unfold, as we expect, it is possible that the Fed could actually cut rates. Regardless, based on the reaction of bond prices to Fed policy over the last year, it does not appear that the longer end of the yield curve will change significantly over the next few months. Accordingly, the opportunity for significant capital appreciation in the bond market to enhance returns beyond the running yield appears remote.

Canadian bonds will probably keep pace with their U.S. counterparts through year end with 10-year Canada/U.S. yield spreads staying around 65 basis points. The Bank of Canada may well be less inclined to match U.S. rate cuts, if they occur, reflecting stronger underlying domestic demand in Canada compared to the U.S. The decision to invest in U.S. treasuries versus Canadian government issues must, of course, take into account exchange rate movements. If the Canadian dollar were to fall under the influence of slower M&A activity and lower commodity prices, then Canada bonds would clearly under perform treasuries. Since this scenario cannot be ruled out, we are looking for investment opportunities to shift some funds to U.S. treasuries during the coming quarter.

Turning to corporate credit markets, it is still true that spreads over government bonds remain too narrow to justify further investment. Furthermore, the risks may well rise as the economy slows which usually leads to some deterioration in corporate balance sheets. Accordingly, we continue to realize profits on corporate bond holdings and redeploy the funds in government issues.

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.

For more information contact:
Barrantagh Investment Management Inc.
(416) 868-6295

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