Barrantagh

Investment Management

CAPITAL MARKETS REVIEW
THIRD QUARTER 2007

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- The U.S. subprime mortgage crisis has infected broader credit markets globally including securitized commercial paper markets. This has led to illiquidity in various debt markets and financing problems for companies dependent on short term revolving credit.

- The U.S. Federal Reserve acted decisively by lowering the Fed fund rate to alleviate concerns that the credit squeeze would spread to the broader economy. It appears that the U.S. economy will avoid recession; although recession risk is high if the housing down turn credit squeeze worsens.

- Global economies are projected to record a solid year of growth overcoming the recent financial market stresses. Europe is less dependent on the U.S. economy than in prior cycles and Asian economies remain in a strong growth mode.

- Inflation pressures are present globally, particularly in China, but Central Banks are more concerned at present with providing liquidity to debt markets than with inflation. Inflation may emerge as the next big worry in financial markets.

- We see no reason to depart from our current equity strategy direction and will continue to invest in leading companies with an overseas presence, strong balance sheets and free cash flow available to benefit shareholders.

- The credit squeeze has resulted in highly unusual and significant price swings in government bonds and corporates in just a few weeks. Higher yield and structured debts will continue to be revalued and all debt will likely experience more conservative pricing. Short term government bonds are likely overbought while corporates are likely oversold. We will be realigning the bond mix in portfolios as markets settle and opportunities arise.

- **Barrantagh has never invested short term cash in asset backed commercial paper (ABCP).**

Economic Backdrop – Credit Crisis Impact

A surprising feature of the current debt market turmoil is how well global economies (excluding U.S. housing-related areas) have withstood the stress in financial markets. This disconnect underscores the fact that the current problem facing investors is not economic fundamentals but rather a crisis of confidence in the financial system. It is estimated that the complex debt instruments precipitating the current market turmoil constitute only 2% of U.S. dollar financial assets, but because of the ingenuity used to package and resell them globally no one knows exactly which products are tainted, where the products are held, and who has ultimate responsibility for any losses. This uncertainty is a critical factor shaping short term investor behavior. The original problem in the U.S. subprime mortgage market has now infected debt markets more broadly, particularly markets for collateralized debt obligations (CDO) and asset-backed commercial paper (ABCP). These instruments depended on the principal of securitization to package a large number of high risk assets into a higher yielding blended security, such as a CDO, which theoretically reduces the exposure to default in the underlying instruments. Unfortunately, transparency of the underlying assets for the buyer of the CDO was opaque at best. Meanwhile the lender had no incentive to worry about credit quality because they were able to sell the package (and its risk) to investors worldwide. A loss of confidence in a broad array of structured debt and commercial paper instruments has occurred which in turn has led to a rejection of all risky assets causing some segments of the short term credit market to become frozen (i.e. no market liquidity). Investors have shifted into safer, more liquid assets with the result that yields on risky assets have soared while yields on safe and liquid assets, like short-term government bonds have fallen. As well, yields in the inter-bank lending market, a critical wholesale market underpinning liquidity offered by the banking system, are rising because of a lack of confidence amongst "fellow" financial institutions. Of course, these effects are symptoms rather than root causes of the problem. When confidence and transparency in the questionable debt products are restored, liquidity should normalize. The problem is that a protracted liquidity crisis can be harmful not only to financial markets, but to the real economy as a whole.

To track whether credit crunch concerns are leaking into the broader economy, we are monitoring several indicators. So far, neither a sagging housing market nor soaring oil prices have dealt U.S. consumers a significant blow. However, the latest readings on consumer confidence indicate a steadily declining trend. Over the past year the contraction in home building has subtracted about 0.9% per quarter on average from the U.S. economy's annual rate of growth and that degree of erosion may well continue into 2008. Nevertheless, under that burden the economy has still managed to grow at a 2% pace over the past year and a recession is not anticipated. The ultimate impact of the credit squeeze on consumers, the cost of capital to business and the global economies overall, is still a large unknown. We take some comfort in the fact that the Fed seems to be aware of the issues, has a potential solution and is determined to ensure that the financial market distress does not undermine the economy even if the solution is contrary to their inflation fighting initiatives.

The rest of the world is experiencing a degree of financial contagion from the United States. Slower growth in Europe, the U.K. and Asia can be expected if the U.S. consumer falters and rising currencies slow exports to the United States. Even if direct financial damage is contained, America's problems could spawn psychological unrest which will translate into financial nervousness and risk aversion. So far the European Central Bank has been somewhat sanguine on the growth outlook, signaling confidence that the Euro zone is robust enough to withstand the turmoil. Meanwhile China and India continue to grow in spite of rising concerns over inflation and output quality.

Equity Markets – What Credit Crisis?

In July, investors recognized the U.S. housing subprime mortgage crisis and consequently eliminated all of the market gains for the year. From the August lows, many sectors of the equity market have recovered indicating that they seem impervious to the crisis in structured debt markets. In fact, in a perverse way the financial crisis may prove to be a boost for equity markets and there is evidence that the current market rebound is more than a temporary reprieve. It is apparent that Central Banks are not going to allow the reassessment of financially engineered products to derail economic growth. Central Banks are providing overnight and term liquidity to instill confidence and ensure that debt markets function while the situation is assessed. As well, on September 18th, the Federal Reserve lowered the Fed funds rate by a more than expected 50 basis points, signaling a clear determination by the Fed to provide support to the economy and deal with the risk of fuelling further inflation later.

Apart from monetary ease, there are other factors pointing to a favorable overall outlook for equities. While U.S. and global growth are likely to soften over the next couple of quarters, many companies are continuing to grow earnings and cash flow aided by expansion in markets unaffected by the credit squeeze and strong demand in global markets. Companies such as Pepsi Bottling Group have strived to reduce costs in the face of escalating commodity prices while increasing prices to get profit margins back in line. This has resulted in an impressive revenue growth of 7% per case in the most recent quarter. Even after the recent positive stock performance, Pepsi Bottling Group remains one of the best relative valuations in the group. In addition, during uncertain market conditions the investment community views this industry as a defensive play.

The supply/demand equation for equities remains positive as corporations, institutions and individuals hold plenty of cash which must be deployed. Through share buybacks and leveraged buyouts the universe of stocks is shrinking, particularly in Canada, and insider trading in many equities reflects net buying to be the overriding trend. In this environment, we believe we must remain disciplined. Recently we sold Corus Entertainment Inc. and Le Chateau Inc. Both of these securities represent well managed companies with each displaying competitive advantages in their particular industries. We have held these securities for some time and received large capital gains. However, even great companies should be sold once the market has recognized the opportunity and driven the valuation beyond levels that can justify further substantial long term returns for our clients.

As explained in our last quarterly letter, our focus within the equity market has been on international companies that benefit from global demand and meet our stringent valuation criteria. We see no reason to depart from this direction as events have unfolded throughout the summer. In our stock selections, we have emphasized European based stocks over U.S., which are less affected by the decline in the U.S. dollar. Our emphasis has also been on large capitalization companies which are less economically sensitive because of their diversification across business lines and geographies. These characteristics are particularly appropriate when equity price volatility is pronounced. We also favour companies that have shown an ability to organically grow their business over time based on market share leadership and proven management. Within these criteria we experienced strong dividend growth.

We remain most concerned about the performance of U.S. consumer discretionary and financial companies. With this in mind, we have examined the Canadian banks in detail and are satisfied that they have well defined, low exposure to structured credit market problems and at the same time offer reasonable value. The recent slate of multi billion dollar international acquisitions by Toronto Dominion, Royal Bank and Bank of Nova Scotia support this view.

Fixed Income Markets – No ABCP for Our Clients

As revelations on the depth of the credit crisis unfolded, activity in fixed income markets during the past couple of months could best be described as perplexing. The pragmatic approach adopted by the Fed and ECB in response to the market dislocation has been calming. Nevertheless, even with Central Banks deploying all available options to stabilize money markets and restore liquidity, the solutions to the problem ultimately rests with the participants in the markets. Investors must become satisfied with the transparency of their holdings and the valuations at which they trade. Marking securities to market, particularly structured vehicles, is difficult when markets are thin or virtually non-existent. Furthermore, banks are reluctant to disclose information or start intermediating again while competitors are sitting on the sidelines. For many reasons the process of repricing risk will take time and true liquidity will only be restored as investors complete their reassessment of risk versus return relative to the underlying fundamentals.

In our client's portfolios, liquidity has not been an issue through the credit crunch. **We have never invested in asset backed commercial paper.** We have limited our near cash holdings to government issued treasury bills on the basis that the additional returns on ABCP were difficult to analyze; especially the securitization, which is now being realized by all market participants.

Turning to the markets in general, dramatic shifts have occurred in the pricing and yield on debt securities across the yield curve as investors strive to re-position. At the front end of the yield curve, government yields have been driven sharply lower by a massive flight to quality. The yield on two year treasuries has declined 60 basis points since August 1st. Even the mid term area of the bond market has shifted dramatically with yields on 10 year treasuries falling by about 70 basis points. Corporate credit spreads have widened even more dramatically for similar reasons.

These dramatic swings in yields may well be overdone as investors may have overreacted to the credit squeeze. It is likely that with the flight to safety the government bond market is overbought while some areas of the corporate credit market are oversold. Notwithstanding these intuitive conclusions, there are too many shifting variables at this time and too much risk of further dislocation before fundamental value can be assessed. Accordingly, we remain underweight bonds in a balanced portfolio preferring cash equivalents which offer a reasonable yield without term risk. We still favour government bonds over corporate bonds and we will look to take advantage of mispricing situations as they arise.

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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