Barrantagh
Investment Management

CAPITAL MARKETS REVIEW
THIRD QUARTER 2009

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- Positive economic data recently points toward an end to the recession. A return to growth in the third quarter is widely expected but not without risks.
- Growth in China and other Asian economies is accelerating and more important to a global recovery than in previous cycles. The current global economic environment presents a dichotomy between the strength in China and other Asian nations (ex-Japan) and the fragile, subdued recovery underway in the U.S. and much of the G7 world.
- So far temporary factors such as inventory re-stocking and the cash-for-clunkers program have fuelled much of the turnaround. Final demand driven by business and consumer spending is firming but remains weak. The U.S. consumer is not in a position to underpin the recovery as in past cycles; consumers are credit and wage constrained.
- The U.S. Fed has been unwavering in its commitment to maintain a highly accommodative monetary stance (i.e. no rate increases) for an extended period, perhaps another year. Its stance is supported technically by low inflation indications.
- The Fed and other Central Bankers seem to be united in their resolve to maintain their massive liquidity programmes until the economic recovery becomes self-supporting.
- The powerful rally in equity markets is a result of increased confidence, recovering from a low level, supported by a healing economy and drastically improving company fundamentals.
- Despite the Central Bankers rhetoric, Government bonds show signs of worries that administered rates may soon rise. Meanwhile, the rally continues in the corporate fixed income world albeit at a slower pace.
- We continue to emphasize corporate bonds over Government bonds and equities over fixed income where client mandates allow.

Economic Backdrop – Recovery Gaining Ground

Over the summer a consensus has rapidly taken shape that the global recession has ended or is about to end. A litany of improving economic data, albeit some of it inconclusive suggests the all important U.S. economy is in a bottoming out process. July U.S. housing data (new home sales and the Case-Shiller index) came in better than expected and the most recent manufacturing data and consumer confidence surveys also surpassed consensus. Furthermore, personal consumer spending was up 0.2% in July and the rate of job losses is abating. Overall, U.S. GDP still contracted in the second quarter but at only a 0.7% annual rate after plunging 5.5% and 6.3% in the previous two quarters. The Euro area economy may also have reached bottom. GDP in the 16-nation currency zone fell by just 0.1% in the three months to the end of June after a 2.5% drop in the first quarter. France and Germany in fact are showing signs of modest GDP growth although other European economies are still struggling including Britain.

Meanwhile, led by China, Asia's emerging economies have revived faster than the G7 countries with several expanding at annualized rates of more than 10% in the second quarter. In past global recoveries the U.S. has always been the locomotive of growth as the American consumer rebounded and fuelled overseas demand. This time leadership is coming from the East, especially China, which avoided the financial crisis and has shown accelerated growth of 7.9% in the second quarter. To a large degree the global recovery is a traditional industrial rebound, driven by the need to restock inventories. This impetus is especially powerful in Asia as manufacturing accounts for nearly 30% of GDP and industrial production across the region grew at a 25%+ annualized rate in the second quarter.

Regardless of the mounting evidence of a return to growth, the question remains just how durable is the recovery and what pace of growth can be expected on an ongoing basis. There are strong arguments that this downturn's origins favor a weak recovery and a period of subpar growth for several years. In the near term our concern is that much of the improvement in U.S. economic output reflects temporary stimuli. Businesses slashed output and liquidated inventories so drastically throughout the recession that increased production is now necessary just to replenish depleted stock piles. Inventory rebuilding and the cash-for-clunkers auto program, are responsible for much of the economic improvement in the U.S and these are not long term supports to the economy.

A more sustainable recovery depends on a rebound in consumer and business spending (i.e. final demand). Historically, in the first year of recoveries since 1972 consumer spending has contributed at least half of overall growth. However, in this cycle U.S. consumers are not in a position to offer their traditional support. Debt fuelled consumption during the housing bubble has been replaced by deleveraging, a high rate of savings and job insecurity. As well, the effects of government support to household incomes (tax cuts and federal subsidiaries) are fading. Furthermore, the flow of credit to business and consumers is still severely restricted as banks are reluctant to offer credit while households are less inclined to borrow.

Looking further ahead the recovery remains highly dependent on fiscal and monetary life support and Central Bankers all agree it is too early to implement an "exit strategy" on any meaningful scale. The $800 billion U.S. stimulus package and last autumn's massive injection of public capital loans and loan guarantees into the financial system remain critical underpinnings to the recovery. Fortunately, Mr. Bernanke, supported by President Obama, is committed to maintaining those programs for as long as it takes to get the economy on track. For example, the Federal Rescue extended its $1.25 trillion program of buying mortgage-backed securities into early 2010. As importantly, Fed Chairman Bernanke has succeeded in persuading the Open Market Committee that record low interest rates (zero to 0.25%) pose no immediate risk of inflation and are essential to ensuring the U.S. economy stays on a recovery path. Mr. Bernanke's resolve together with strengthening trends in key segments of the economy lead us to believe that the upturn is sustainable, although growth over the longer term may be more muted than in previous cycles.

Equity Markets – Fundamental Support

The combination of low interest rates (i.e. meager money market returns) and a more positive economic outlook has continued to fuel a powerful rally in most financial markets since the March lows. The resolve of Central Bankers to maintain low interest rates until the economic recovery is firmly established has been a huge impetus to equity investors. As well, quantitative easing, using Central Bank balance sheets to ensure liquidity in the banking system and mortgage markets and to suppress long term bond yields, has also had a positive effect.

The question now arises as to whether equities reflect too much optimism or whether the stage is set for a long term bull market. Of course much of the recent surge merely reflects a retracing of the steep decline that began in 2008 as the equity markets nervously forecasted an economic calamity that did not arrive. In that regard, there is still a high degree of uncertainty with regard to the strength, magnitude, and timing of the economic recovery process. As noted, both consumption and output levels remain depressed. As well, deleveraging and the sharp rise in U.S. household savings will clearly prolong the recession's recovery. At this juncture virtually every G7 nation faces a large output gap, low inflation, historically low interest rates and an unprecedented level of fiscal stimulus. Accordingly policymakers are squarely focused on promoting growth and stimulating their economies with little regard for future inflation. Their efforts will likely be positive for the stock market. Of course, it is unsettling that the outlook depends so much on government decisions at this juncture rather than self sustaining private sector strength. Given the magnitude of government interventions there is much more scope for policy makers to go wrong than in previous cycles. This risk may well be underestimated by equity markets.

Regardless of these complexities at the macro level, there are positive developments in the business sector which, in the final analysis, will be very important to equity market performance. Many corporations have adjusted rapidly and decisively to the recession and are emerging in a lean, financially fit, and focused state and will perform well in a low inflation, low growth economic environment. In fact, the rapid response by many corporations to the recession is beginning to show up in profit margins and corporate profits. Profit margins have been growing in response to corporate cost cutting and productivity gains, and profits have been rising in the past few months especially relative to previous expectations. However, company revenues have yet to grow. Companies have focused on maintaining strong balance sheets leading to unexpected merger and acquisition activity as buyers take advantage of weaker competitors or realign themselves for future growth.

In our equity analysis we have been focusing on those companies that have adapted well to evolving business conditions, have a degree of pricing power and are self financing at a time when final demand remains weak and competitive forces are intense. Companies such as Adidas AG which is a familiar global brand to most readers, is leveraged to consumer discretionary spending and has exposure to developing economies. Trading at a multiple of eight times cash flow while displaying returns on equity in the upper teens, its valuation seems modest in both relative and absolute terms. Catalysts beyond valuation improvement exist for Adidas. For instance, since purchasing Reebok, it has been a drag on margins and therefore profitability. Currently, Reebok is in a turnaround phase such that any improvement will fall directly to Adidas bottom line. As well, Adidas generates cash flow in excess of its capital needs so it is not reliant on credit and can use this money for expansion plans. Meanwhile, with about 50% of Adidas revenue generated by footwear, the 2010 World Cup may also be a catalyst as it has been in the past.

We have sold a couple of names that we have held for some time. McDonald's, which has been a great holding for our clients, continues to be a solid company with good growth prospects and lots of management depth. However, from a valuation perspective it had reached our targets and therefore similar to Pepsi Bottling Group which was purchased by the parent, PepsiCo Inc., at a great price, McDonald's was sold. We currently see many opportunities in the market and will use this cash to position our clients for the long term.

Fixed Income Markets – Issuer Focus Is Key

Historically, as the economy lifts from a recession, Central Banks look to increase interest rates and this time is no different. While the market generally does not expect to see administered rates rise until later in 2010, there is a growing consensus that the longer term rally in government bond yields has stalled. While we expect to earn the yield on government bonds, we do not expect much performance beyond. Therefore, when consistent with client investment objectives, we are using government holdings in portfolios as a source of cash to take advantage of corporate fixed income opportunities or to re-balance into the equity market.

The opportunity in the corporate fixed income market continues to be supported by the further tightening of credit spreads throughout the third quarter. Average five year "A" rated credit spreads (the premium the issuer must pay over a comparable government yield to reflect the relative riskiness of the bond) moved from 175 basis points at the end of June to 145 basis points at the end of September. This is a significant tightening in bond pricing terms, and continues the trend set in the first half of the year, albeit at a more calculating pace.

The new issue market welcomed several new bond issues for "A" and "BBB" rated companies. The success of most of these issues serves to emphasize how much the new issue and secondary markets have opened to both new and seasoned issuers at the right price. However new issue volumes, particularly in August and September, have not returned to previous years' levels, and have not sustained the pace of the second quarter. The onslaught of new issues expected in September following a quiet August never materialized. This can be partly attributed to the substantial liquidity in corporate balance sheets, reducing the need for funding and partly to continued nervousness in the market as participants waited for the "inevitable" correction, which has not materialized. Corporate credit spreads have generally demonstrated a positive correlation to the equity markets, rising and falling with the stock markets. We expect this to continue, especially now that the overall level of spreads has returned to more normalized long term ranges.

While most new corporate issues have been well received, the market did not welcome all. Some issuers attempted to push the perimeters of pricing tolerance and found fewer buyers. On the other hand, the U.S. and Canadian government bond issues have continued to receive a warm reception, with the odd exception, amply demonstrating the sheer liquidity available in our market.

In the Real Return Bond ("RRB") market, breakevens have crept modestly richer, indicating a future inflation expectation of 2% in Canada. This remains consistent with the Bank of Canada's inflation target, and even the Governor of the Bank of Canada sees more downside risk to the inflation forecast from the relentless rise in the value of the Canadian dollar.

For many investors in fixed income markets, the easy money has been made. Now the application of a sound credit analysis discipline is the key to good performance. Investors cannot rely on a broad rally in the corporate market to generate solid returns. Each issuer and issue must be carefully examined to ensure that we are buying and holding issues that offer long term value on a risk adjusted basis.

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