Barrantagh

Investment Management

CAPITAL MARKETS REVIEW
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- We have been forecasting low growth with low inflation for some time and see no reason to change as most market soothsayers, including Bernanke, have moved towards our view. The possibility of greater growth globally at this point is low. The fiscal predicament for both governments and individuals alike, the banking system and several other factors have undermined the foundations for more normalized growth.

- The fear of a double-dip recession has heightened volatility in the markets but will not likely materialize. Signs of economic recovery continue to mount while government leaders seem determined to avoid negative economic growth through whatever means possible including another round of quantitative easing (QE).

- Globally, Europe, Japan, China, Brazil, and many other nations have shown surprising economic strength. However, a slow down, although not unusual when economies are recovering, is occurring in many nations. Not unexpectedly, China is an outlier. It actually needs to orchestrate a slow down to subdue soaring growth and ease a real estate boom. This is a nice problem to have but also brings uncertainties.

- Equity markets have been volatile but seem resigned to a slow economic backdrop which can be positive for markets. Balance sheets are stronger than they have been in 30 years which increases the flexibility to deal with excess cash flow. Increasing dividends, share buybacks and M&A (merger and acquisition) activity will be the result, helping to create a supportive stage for longer term returns.

- Should the economy continue to improve and inflation remains low, valuation multiples on company earnings and cash flow may expand. Not only will investor confidence return but companies will be rewarded for their ability to grow earnings in a "real" environment.

- Several countries including Canada, the U.S., Japan, Australia, and the Eurozone entities seem to be on hold with-respect-to interest rate increases. This, along with the recent economic slowdown and talk of disinflation, has propelled the fixed income markets.

- Although corporate spreads have tightened, we believe the improving economy, the health of corporate balance sheets and a scarcity factor continue to make corporate bonds attractive on a relative basis.

Economic Backdrop – Low Growth, Low Inflation

In our Q1 Capital Markets Review, we noted the considerable progress made by global economies in recovering from the recession, but we have been forecasting that growth, longer term, would likely be sporadic and lower than in previous economic cycles. Certainly, for the U.S., the longest and deepest recession since the Second World War appears destined to be followed by one of the slowest recoveries. Just a few weeks ago, consensus U.S. GDP growth for 2010 was 2.8% but has now been revised downward, closer to 2.3% as the reality of lingering problems from the recession hit home. These problems include the job drought, personal debt hangover, banking industry retrenchment, weak real estate markets and the ballooning federal deficit. Interestingly, these problems also characterized the 1990–1991 recession but it was quickly followed by the extraordinarily buoyant years of the Clinton administration. While one can never underestimate America's capacity for self-renewal, in reality the foundations for growth that were in place in 1992, or in the later downturn of 2001, are now missing. The consumer and the banking system were in a much healthier state than today. As well, the government was fiscally strong, posting its first budget surplus in l998. It wasn't until 2002 that wars, tax cuts, recession and a faltering stock market conspired to spawn the deficit. Today, a combination of falling tax revenues and soaring government spending produced a $1.45 trillion deficit in 2009 which remains an intractable problem, just as the baby boomers move into retirement, placing additional strain on government finances.

Nevertheless, signs of economic recovery in the U.S. continue to accumulate, even though some data points are coming in below expectations. Although unemployment remains high at 9.6%, the labor market has improved and companies added more jobs in August than many projected. As well, retail sales climbed 0.4% in August which exceeded expectations for a second straight month. Factory output increased in August, although orders for durable goods rose just 0.3% compared with the 3% gain economists originally predicted. Although new home sales declined in July and housing prices continue to weaken, pending home sales unexpectedly rose in August. As well, the value of business inventories rose 1% in July, the biggest gain in two years pointing towards increasing economic activity. U.S. growth will remain muted for some time and the road to recovery will not be smooth but it is our view that the feared "double dip" recession will not likely materialize. Our confidence is in part based on the resolve of government leaders to head off that outcome.

With the U.S. economy facing headwinds, the sustainability of the global recovery depends critically on the Eurozone and Asia. Of course, Europe's sovereign debt upheaval which took centre stage earlier in the year has focused attention on the impact that proposed austerity plans would have on economic growth in Europe. A large component of these plans involves curtailments to govenment wage bills and entitlement reductions, over longer periods, which may not be very damaging to economic recovery. In fact, economic data indicates the Eurozone economy continues to recover as GDP expanded at 3.9% in the second quarter spurred by stronger export markets in face of the declining Euro currency.

Meanwhile, the Chinese and Japanese economies are evidencing signs of weakness in some areas. Although Chinese growth came in at a very healthy 10.3 % in the second quarter vs. 11.9% in the first quarter, the Chinese government seems serious about tightening credit to rein in the real estate boom and it is approving fewer infrastructure projects to avoid a capacity glut. At the same time Chinese policy makers will likely be careful not to spoil the dynamism that has elevated China to an economic leader.

Looking at the global economy from an overall perspective, slow growth in the advanced economies seems inevitable at this stage, partially offset by relatively strong performance in the emerging economies. The net result will be a protracted period of uneven progress in the global recovery and with it, tame inflation and low interest rates can be anticipated. This scenario is not necessarily negative for capital markets.

Equity Markets – Year of Expectations

Although this year is not over, it seems inevitable that the equity market performance in 2010 will be defined as the year of expectations… more importantly, economic expectations. The overly bullish and the persistently bearish seem to be gyrating towards a middle ground for the economy which is low growth with low inflation as mentioned in the economic section. In this arena, both sides can claim some victory with the bulls pontificating that the economy is continuing to heal and better growth is just around the corner, while the bearish camps dwell on the concern that low growth is very close to no growth and does not give much of a margin for error, allowing them to continue to wave the economic double-dip concern. Equity markets have reflected these seesawing expectations with positive performance in the first quarter, negative performance in the second quarter and finally, positive performance in the third quarter. All of this volatility has resulted in positive year-to-date performance for Canada and the world, with the S&P/TSX up 7.5% and the MSCI up 0.4% in Canadian dollar terms.

Although the economic recovery may not be as resilient as some historic recoveries, the equity market seems to be reacting very much as one would expect for a slow economic recovery. Recoveries, no matter what the amplitude, initially create a positive move but this is always followed by a soft period or correction which is pursued by continued recovery and growth. It would appear that the set back has or is occurring, causing the Federal Reserve Chairman (Bernanke) to talk about further quantitative easing (QE – basically creates cheaper capital) as a stimulus. At this point consumers may welcome QE but corporations in general do not need it. In looking at debt to equity ratios of corporations today, their balance sheets are the strongest they have been in over 30 years. The recent increase in merger and acquisition activity and the steady increase in dividends from corporations support this thesis.

Increasing dividends is an important landmark. As the fixed income market has rallied, causing yields on fixed income vehicles to decline, dividend paying corporations become very enticing investments when looking at relative valuations and long term returns. In a low growth, low inflation environment, dividends are sought-after by investors as a safer portion of their long-term equity investment opportunity and this is only enhanced if dividend increases are expected. Meanwhile, the valuation backdrop on equities suggests that cash flow and earnings multiples are low. The multiples at which companies trade are usually higher in a low inflation environment versus a high inflation environment. If a company can grow revenue and therefore earnings in a low inflation environment, this is usually a truer or more pure indication of a high quality company. We therefore expect a low inflation environment to help expand multiples along with the normal multiple expansion that occurs as the economy improves. Coupling this with the previously mentioned solid balance sheets, dividend increases, merger and acquisition activity and share buybacks, investors seem comfortable that the environment for equities is supportive. Looking beyond the potential multiple expansion, if the economy continues to heal, earnings will grow, which again supports a constructive view of the equity markets at this time.

One of the names we have analyzed for our clients that captures many of the aforementioned equity traits is Hewlett-Packard (HP). The company is involved in PC's, printers, software and IT services. HP has consistently shown returns-on-equity of +20%, has been active on the acquisition trail to vertically integrate their offerings and only trades at six times cash flow per share which is less than ten times earnings per share. The company has recently appointed a new CEO and estimates that it can grow revenue between 5% and 7%. The company has historically been conservative with its estimates and continues to generate huge free cash flow with the flexibility to buy back shares, increase the dividend or continue on the M&A trail. Cloud computing, software, security and mobility are just some of the areas that HP will focus its efforts to take advantage of large market opportunities and generate growth in excess of what is expected for the economy.

Fixed Income Markets – Rate Hikes Pause

Many of the issues we discussed as we entered the third quarter remain. The day-to-day movement in bond markets continues to be driven by short term global movements between risky assets (corporate debt and equities) and low risk assets (government bonds) based on the latest rumour or headline. For instance, the most recent news that China has been a buyer of Greek debt (Euro denominated) buoyed the market substantially and indeed China has made it clear that they are prepared to make further purchases of Greek and other Euro denominated government debt.

In the U.S., the Federal Reserve is feeling pressure to act on a faltering economy but is divided on the effectiveness of the various options they have been urged to consider. The first step they took in September was to stem the runoff in Federal Reserve assets. Quantitative Easing (QE) in 2009 and 2010 caused the total assets held by the Fed to inflate, largely in the form of mortgage backed bonds. The low interest rate environment engineered by the Fed this year has accelerated the repayment of the assets, causing the runoff. The Fed has committed to buying U.S. government treasury issues to replace the principal portion of the runoff. While not really QE as it was designed, this action sent the same effective positive economic stimulus message out to the market.

In Canada, on September 8th, the Bank of Canada raised the overnight rate to one percent, the third increase in administered rates this year. This latest tightening of monetary policy was widely anticipated and fully discounted by the marketplace. However, since that move, public statements by Mark Carney, Governor of the Bank of Canada, suggest that the risks to the downside in the Canadian economy are growing and this may prove to be the last rate hike for some time to come. This caused Canadian government bonds to rally with long bond yields making new lows in September. September also brought the long awaited Basel III proposals on bank capital. The announcements that accompanied this caused significant consternation in the markets worldwide as each country's banks, bond markets and regulators tried to establish what country specific implications would result.

Since the end of the second quarter, the G20 inspired cries for tightened fiscal policy have faded. Governments are much more focused on sustaining economic growth in a decidedly soft environment than on the niceties of targeting debt reduction. If they can keep their economies growing, then the deficits will take care of themselves. That is the theory in any case!

Cash has continued to seek fixed income investments and the new corporate issue market has not kept pace. Consequently, credit spreads have tightened and corporate treasurers are slowly coming to the realization that, regardless of new issue spreads, the all-in cost of funding implicit in today's yield curve is very attractive. This has not led to new supply but rather has led to existing issues being called and replaced with new lower cost debt, ultimately leaving buyers to invest in a market place that is supply starved relative to demand. We continue to see opportunities in the Canadian corporate credit market and will make investments as the opportunity arises, but we are wary of issuers who feel it is a seller's market and as such, issue debt with yields or features that are less than attractive for buyers.

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