Barrantagh
Investment Management

CAPITAL MARKETS REVIEW
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- The state of the global economy has continued to deteriorate in the third quarter as the drag on U.S. and European growth from declining business confidence, policy indecision and the fallout from the escalating Eurozone debt crisis takes its toll.

- The European debt crisis has escalated as the reality sets in of possible contagion to the European banks and the global economy as a whole. European banks will need recapitalization and that recognition has led to punitive interbank interest rate levels and tightened credit conditions. These spillover effects threaten to push Europe into a recession. Hopefully depositors and lenders will not withdraw funds en masse exacerbating stress on the bank sector.

- The U.S. economy is close to "faltering" to quote Federal Chairman Ben Bernanke. The policy response from President Obama is a $447 billion fiscal stimulus plan (the Jobs Act) which is likely to get bogged down in yet another wrangle between the Democrats and Republicans. Mr. Bernanke has deferred a third round of quantitative easing for now but has committed to keeping interest rates low until 2013 and is trying to induce lower borrowing costs through Operation Twist (i.e. swapping short term for long dated fixed income securities). Unfortunately the Fed has little ammunition left to influence the real economy.

- In emerging markets particularly China, India and Brazil, growth has held up as it did in the 2008 recession, but it is not enough to offset the weak outlook in the developed world and worries abound that China may not orchestrate a soft landing. Even if China is successful in its soft landing efforts, its economic growth delta will be slowing at the same time that the U.S. and Europe are slowing.

- Delays by governments in Europe and the U.S., to act on their respective debt problems, has created uncertainty in the equity markets as to what the solutions are to these problems and what are the consequences. As the stability in the market has eroded, fundamental analysis seems to be taking a back seat to the macro news putting investors on a buying strike until there is clear visibility on the macroeconomic and political fronts.

- The fixed income market has been a beneficiary of the global flight to safety triggered by the lack of economic growth and the debt crisis. Also helping to drive fixed income markets are the government instituted policies to alleviate debt and economic stresses around the globe together with the easing of inflationary concerns as commodity prices decline.

Economic Backdrop – Recent Deterioration Concerning

In our previous capital markets review, we commented on the elusiveness of a self supporting economic expansion pointing out that weakening trends in global economic activity have led to a ratcheting down of growth projections. Now, three months later the sobering reality is that the global economy is more fragile than previously thought and government stimulus programs remain critical. Recently, the International Monetary Fund (IMF) warned that the global economy was entering "a dangerous new phase" with mounting threats to the economy from rising government credit risk, fiscal tightening in developed nations, and policy indecision. The Fed Chairman, Mr. Bernanke, echoed this refrain citing the recovery is "close to faltering".

At this juncture, concerns centre on three fronts: 1) The escalating European debt crisis and collateral damage, 2) Deteriorating economic conditions in Europe and the U.S., (representing about 60% of global GDP), 3) The struggles of policymakers to balance the conflicting goals of further stimulus and high levels of debt requiring strict austerity programs and additional tax revenues.

The most immediate concern is the deepening European debt crisis, the stress of which has been exacerbated by the ineffective efforts to date to design and approve debt restructuring programs. While the crisis centers on Greece, it has spread to Italy and Spain, nations that are plainly too large for the IMF or European government agencies to rescue. Those countries, as well as Portugal and Ireland, likely do not have the capacity to expand fast enough to service their debts. Consequently, global pension funds, insurers and banks are selling off the bonds of these countries driving interest rates to punitive levels. Eventually massive write downs of sovereign debt held by the banking system may be necessary, eroding bank capital and raising fears of a liquidity crunch that could morph into solvency problems for some banks. European leaders appear at long last to understand the gravity of market conditions and appear determined to take bold action. A plan is underway to increase the maximum lending volume of the European Financial Stability Facility (EFSF), originally established to deal with Greece, while the European Central Bank will continue to intervene in sovereign debt markets to provide liquidity support on an interim basis. Of course, clarity is lacking as to how the crisis will be resolved. What is certain at the moment is that growth in Europe, already faltering, will probably slow further. Over the longer term, the debt ridden nations will need to close their large budget deficits and their economies will need to recover to the point they can service, and ultimately reduce their restructured debt obligations. These challenges will require a wrenching drawn out campaign to modernize their economies implying slow growth in Europe over an extended time frame.

On the economic front in the U.S., economic indicators suggest that the economy is close to stagnating following revised GDP growth in the second quarter of 1.3%, and first quarter growth of just 0.9%. Most recently, continued weakness in auto and home sales (even though gasoline prices and mortgage rates are falling) translated into flat retail sales in August although September numbers were more promising. Further signs of weakness include a meager 0.2% rise in consumer spending in August while personal income fell 0.1%. Meanwhile, the U.S. unemployment rate remains stubbornly above 9%. Obviously Bernanke and the Obama administration are struggling to find ways to create jobs and avert a second recession in three years. To that end Bernanke introduced a monetary tool dubbed "Operation Twist" replacing $400 billion in short term treasuries in the Fed's portfolio with longer term treasuries in a move to induce lower borrowing costs. In addition, president Obama has introduced a fiscal stimulus plan only part of which is likely to pass. Meanwhile a bipartisan super committee charged with designing a plan to reduce the deficit by at least $1.5 trillion, is already hostage to the 2012 election agenda and budget process. On balance none of these measures are likely to be effective and the U.S. economy is likely to fluctuate around a low growth rate for some time. In spite of the stagnation apparently underway in Europe and North America, Asia remains an important growth area. Even with restrictive monetary and fiscal efforts, Chinese growth remains high at over 9% but investors worry about who will continue buying Chinese exports as other economies slow.

Equity Markets – Macro is Driving

The procrastination by European governments in dealing with their sovereign debt situation has consumed all market participants and is driving concerns of contagion risk including bank failures, a Japanese style stagnation and/or global recession. These concerns have undermined any confidence in the equity markets and highlighted fundamental problems with the Euro and the European Union that need to be fixed. These are large, complex issues that will take time to resolve, which has focused all eyes on the macro environment with a decidedly negative tone, resulting in some dramatic downward movements for equity markets in the third quarter as fear continues to dominate the markets. The S&P/TSX was down 12% while the global markets were down 10.8% resulting in year-to-date returns of negative 11.9% and 10% respectively.

For fundamental investors this environment has been tough. Despite the macro concerns companies have been performing well. Eighty percent of companies have beat earnings estimates over the last two years, but because of the political consternation and its potential impact on the economy, analysts have been lowering estimates with-respect-to companies earnings and cash flow. The same is true for companies' operating margins. Margins are above any levels seen for the last 30 years as companies remained lean after the 2008 global recession and sales grew. Balance sheets are strong as companies have been loath to increase debt while hoarding cash. The valuation backdrop, both absolute and relative, suggests that companies are cheap and are already discounting a recessionary scenario. However, for the markets to stabilize and fundamentals to move to the forefront several events need to occur. First, the EFSF needs to be established and funded. This should occur by early November. Second, European nations need to inject capital into weaker banks to give the market confidence that a financial crises will not occur. Third, lower interest rates to help the consumer while incorporating a longer term view with-respect-to any austerity measures. Lastly, fiscal unionization is required. It seems untenable to have a common currency, common monetary policy (through the European Central Bank) and 17 individual fiscal policies.

Unfortunately it does not seem that the politicians have the appetite or resolve to implement these measures in an expedited manner which suggests that no matter how good the fundamentals look, investors must adjust. We have chosen to transition client's portfolios to try and manage the monthly volatility. The first measure is to diversify portfolios further. Normally, fundamental analysis may skew the portfolio towards one area of the market. However, with diversification we have chosen to find value in all areas of the market. The ultimate result has been a reduction in the sensitivity to economic volatility. As well with companies performing well, as their balance sheets and margins attest, dividends should be safe. In a low growth environment dividends may be a good portion of the return and will also help to dampen volatility. We are also looking to steer clear of any companies which rely on economic growth to move the top and bottom line. Generally this tilts our research to preferring companies that can generate growth through research, mergers and acquisitions or have a product that is required by others no matter what the economic background. Best of breed companies become a focus while smaller capitalization names may be avoided. Finally, we have lowered our valuation tolerance which means that we have adopted more conservative price targets on companies.

During this transition we have sold companies such as Alcoa and bought companies such as Wal-Mart. Alcoa is a good example of an economically sensitive security that could have a lot more downside than the market expects. Meanwhile, through acquisitions and its targeted economic cross-section Wal-Mart has built in growth and carries a dividend of approximately 3%. We have reduced resource and industrial exposure in general, favouring companies such as Fortis Inc., an electrical distribution company that supports a 3.8% dividend yield. Until the current structural impediments in the economy are dealt with to relieve the anxiety and lift the cloud in the market place we will continue on this strategy. Policy makers are aware of the issues and now need to find a coordinated resolve to implement the solutions and create stability in the market place.

Fixed Income – Flight to Safety

With very little effort we can characterize the bond market as highly volatile and see it as the logical outcome of a series of bad political decisions in the third quarter of this year. We can start by looking at the damage done to the world's reserve currency by the political wrangling in Washington as the U.S. government was taken to the brink of default on its debt. This can be followed by the inability of the European governments and agencies to recognize the severity of the debt and confidence crisis forming rapidly around them. Meanwhile China started to slow the rate of credit expansion in their economy by raising interest rates, increasing reserve requirements significantly and imposing limitations on housing sales and purchases. Unfortunately the PBoC did not anticipate the rapidly slowing demand in the Western economies and overshot the mark causing a slowdown in the Chinese economy. Added to the mix was the downgrade of the U.S. government credit rating. The crowning touch came in late September when Mr. Bernanke announced the launch of "Operation Twist". This involves the sale of securities with a maturity of less than three years paired with the purchase of U.S. treasury notes and bonds with a maturity of more than six years. This program is intended to push down longer term interest rates while raising shorter term rates, thereby driving investment into riskier assets. A side effect is also the anticipated reduction in mortgage rates, thereby stimulating the housing market. However, along with the announcement of Operation Twist, Bernanke offered up a very negative and sobering assessment of the economy, "significant downside risks". This ignited a massive rally in the long end of the yield curve in the U.S. (and on a similar scale in Canada) coupled with a sharp sell off in the equities markets around the world. This cast a serious doubt on the ability of the Fed to manipulate markets to achieve their stated objectives.

As the various crises unfolded the Canadian and U.S., government bonds played their well choreographed roles and rallied. Long bond yields in Canada fell from 3.54% at the end of June to 2.77% by the end of September, and from 4.37% to 2.91% in the same period in the U.S., setting a string of post war records. Corporate debt tended to see its spreads widen out to match the decline in yield of the underlying government bond, producing much smaller net changes in corporate bonds.

Inflation has been creeping upwards in the U.S. and Canada, particularly in commodity related situations. This was dismissed earlier in the year by the central banks as "transitory". As the chaos of the past month unfolded commodity prices retreated, and the central banks were largely vindicated. We are now returning to a low growth with low inflation environment.

As noted in the equity section of this letter, the financial condition of corporate issuers remains strong, but the market remains transfixed on the macro conditions. This has meant that corporate debt has languished amid the sharp rally in government bonds. In turn the government rally has been focused on the long end of the yield curve, and mid term (6 to 10 years) and short term (under 6 years) have significantly underperformed the longer maturities. We expect this to stabilize and for the market to recognize the value in the better quality corporate debt. In the meantime we have reduced our holdings of corporate debt issued by financials, and generally increased the average credit quality of the debt we hold. We have retained the FRNs ("floating rate notes") discussed in last quarter's letter as a hedge against rising short to medium term interest rates.

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