Barrantagh

Investment Management

CAPITAL MARKETS REVIEW
THIRD QUARTER 2012

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- The challenging economic environment continues with all participants doing their utmost to stimulate the economy and maintain positive global growth. China has the most room to move and has invoked both monetary and fiscal stimuli in an effort to keep its GDP growth above 7%. To date China has eased banking conditions and investment funded from the state budget is up over 30% in the year to July. Meanwhile, most other major nations have sustained coordinated efforts to reduce or keep interest rates low in an effort to support global growth.
- Europe, despite a toughened policy on the part of the European Central Bank, remains in the grip of oncoming recessionary forces. To help debt laden countries, the European Central Bank has promised unlimited short term bond buying intervention, which is an improvement on previous programs but is not in the final analysis a "game changer" for all of Europe's problems. A distressed country would first have to apply to either or both of Europe's rescue funds for emergency assistance. If the country asking for help meets certain conditions, the program would commence. As one can imagine, concerns abound that this is paramount to giving up their sovereignty.
- Spain continues to be a deep source of concern. The bail out of the banking sector is plodding along slowly, and the Spanish government continues to resist pressures to apply formally for a bail out. The government's new budget allows for an increase in taxes and a cut in spending which continues to draw large demonstrations into the streets in violent anti-austerity protests.
- To maintain low interest rates, Bernanke, head of the U.S. Federal Reserve, launched an unlimited Quantitative Easing (QE3) program to try and stimulate a moribund economy and promises to maintain the stimulus even if growth starts to pick up. Meanwhile, the U.S. still faces the election in November and an oncoming "fiscal cliff" which could derail all growth efforts if a compromise is not reached by the two parties. Back room discussions are ongoing as all parties understand the severity of the situation.
- Equity markets continue to climb a wall of worry based on the view that longer term, better global growth will resurface. Current market multiples seem to already discount much of the concerns in the economy and reflect optimism that in a moderate economy, companies can maintain growing bottom lines. Much of the equity markets support lies in the relative valuations and gentle improvement in many macro concerns suggesting better upside versus other asset classes. Should the perceived improvements falter, the equity market will react quickly.
- The Bank of Canada remains ready to increase rates, which suggests rates are probably as low as can be expected. However, the bond market continues to be driven by global macro news and the safe harbour that it offers investors. As central bankers are driven to keep rates low for an extended period of time corporate bonds continue to have appeal as treasurers are prone to lock in these low rates through new issues and rolling over maturing issues.

Economic Backdrop – Moderate Growth Forecast

The preponderance of recent economic data confirms that the slowing trends in global economic activity commented upon in our last investment letter are proving to be somewhat intractable. In the U.S. the recession technically ended in mid-2009, but despite a degree of recovery in housing and consumer spending, a self-sustaining recovery has not materialized. Overall, anemic growth does not permit the U.S. economy to achieve what economists call "escape velocity". The reasons why the U.S. economy is evidently stuck in low gear have been discussed at length; consumer deleveraging, a continuing weak housing market with home prices down about 30% from the peak in 2006, unemployment above 8% compared with 4.7% in 2007, U.S. federal debt at 73% of GDP and growing (double the level five years ago) and weak manufacturing. Although businesses are flush with cash they are reluctant to invest or hire until they see signs that the risks to a more normal recovery have abated. Despite trillions in fiscal stimulus, and unprecedented quantitative easing programs by the Federal Reserve, America's economic output is about 6% lower than the country's potential, according to the Washington based centre on budget and policy priorities. Consequently, the U.S. economy managed to eke out growth at an annualized rate of just 1.3% in the second quarter (revised downward from 1.7%) and support is waning for the view that a significant rebound will occur in the last half of the year.

Meanwhile, the seventeen-nation Euro Zone contracted by 0.2% in the second quarter, even though Germany managed growth of 0.3%, marginally beating forecasts. Compared to the southern European countries, Germany is sound structurally but can't decouple from the recession in the Euro Zone nor avoid contamination from a slowing global economy. Europe is caught in a vicious circle of budget cuts, high interest rates in the periphery and rising sovereign debt which points to a further contraction through year end.

As discussed often in previous commentaries, strong growth in emerging markets has been the panacea for weak conditions in the industrialized world. However, amid a raft of negative economic data in July, China's growth engine is slowing more than originally forecast. China's factory output in July eased to 9.2% from around 10% a few months ago. With an economic model heavily dependent on investment, China's output capacity has grown ahead of demand. The International Monetary Fund (IMF) estimates that China's capacity utilization has fallen from just under 80% before the 2008 crisis to around 60% today. Not surprisingly China's gross domestic product eased to 7.6% in the second quarter down from 8.1% in the first.

Recognizing the precarious state of the global economy, policy makers in the U.S., in Europe and elsewhere have once again reacted strongly with an array of programs to prevent a worsening scenario. In the U.S., Mr. Bernanke has announced what amounts to a third round of quantitative easing, intervening directly in the housing market with billions earmarked for purchases of mortgage backed securities. Importantly the Federal Reserve has committed to a protracted period of low interest rates and undertaken to use whatever means are at its disposal to support the economy until the unemployment rate reverts to a more acceptable level. The European Central Bank (ECB) has also announced a new assault on the Euro debt crisis with a plan to buy unlimited amounts of the sovereign bonds of deep distressed countries. In Asia, the Japanese Central Bank has lowered the bank rate and China seems poised for an accelerated policy attack if its rate of growth continues to falter. Compared to other economic regions Beijing certainly has the fire power to stimulate growth. Furthermore, European and Chinese leaders are meeting to bridge growing differences over trade.

Stepping back from the detail, there are some signs that global economic activity is forming a base but the trajectory over the next few months is not definitively upward. In the meantime the effectiveness of politicians and central bankers will command much attention. In that regard the outcome of the U.S. election is front and centre. As first mentioned in our second quarter investment letter, based on the contentious nature of the presidential election to date, worries have grown that the U.S. may not adequately address the so-called "fiscal cliff". If Obama is re-elected with the Democrats controlling the Senate and the Republicans holding the House of Representatives, political gridlock is guaranteed, but the hope remains that a pragmatic compromise will be reached on spending cuts and tax breaks worth about 4% of U.S. GDP.

Beyond the critical "fiscal cliff" resolution, questions remain as to what forces will bring about the end of subpar growth in the U.S., recession in Europe and falling growth rates in emerging markets. It is clear that a quick fix is out of the question and capital markets will therefore need to adjust to the prospect of moderate global economic conditions for an extended period of time.

Equity Markets – It's all Relative!

Contrary to the negative news that continues to evolve from Europe and the slowing economic backdrop, as mentioned in the economic section, the equity markets climbed the wall of worry throughout the third quarter. The Toronto stock exchange, as represented by the S&P/TSX climbed 7.0% bringing the year-to-date gain to 5.4%. Meanwhile, the global markets also responded well during the quarter, gaining 3.2% for a year-to-date gain of 9.9%.

Why do the equity markets continue to move upwards despite the negative news that investors are digesting on a daily basis? The answer is all "relative". The news in Europe is seemingly negative as Greece, Spain and Italy continue to be a concern, but on a relative basis the news is improving. It may only be improving incrementally, and policy risks remain, but the markets take comfort that the central powers are taking action and the debt crisis is being dealt with in a positive manner. The ECB announcement that it is going to buy the bonds of any country which requests assistance is a positive. This will stabilize and/or improve the cost to carry debt as well as give support to any new issuance. The markets also view this as a solution that can be used across a number of countries rather than one off solutions, such as happened with Greece, helping to alleviate or reduce the possibility of a break-up of the Euro Zone.

Beyond the ongoing debt saga in Europe, the world economies are slowing. China, Europe, the U.S. and many other nations are showing signs that growth has stagnated or is slowing. Despite the slowing, the International Monetary Fund (IMF) predicts the world is still growing at a rate over 2.5% and all governments and central banks are doing their parts in trying to stimulate growth. In a rather headstrong manner, investors believe that the poorer the economic numbers, the more governments will stimulate and ignite growth. For instance, China has decreased interest rates, increased government spending on infrastructure projects and reduced banking capital requirements, all in an effort to keep growth above 7%. Meanwhile, around the globe, central banks have made a coordinated effort to reduce interest rates. On a relative basis, the markets see this as a positive, because all of these actions will help to maintain the positive growth that the IMF is predicting.

These macro events continue to weigh on the markets as evidenced by the relative correlation between equities and bonds. Normally, these two asset classes have shown very little correlation historically. Over the very long term the average correlation has been slightly negative but very close to zero. Recently, the correlation has been very high (approximately 60%) and negative. This means that as bonds move up equities move down and vice versa. This high negative correlation can only be explained by the macro events in the market and implies that as investors gain confidence that the macro event risk is being reduced, equities should be favoured. Looking at valuations, and companies improving bottom lines, the global equity markets are trading at a price/earnings (P/E) multiple of 12 times. Reviewing the relative valuation, the 10 year average P/E has been closer to 14 times which mimics the historic average. As reviewed in our first quarter report, this suggests that the global equity market could move 17% higher should the macro concerns continue to be alleviated.

In our last report we mentioned that the quality and/or growth in earnings for companies may come into question as the macro issues continue to chip away over time. In fact, many companies have reported earnings and cash flow numbers for the most recent quarter in-line relative to expectations, but have cautioned on the outlook for the next few quarters. Nearly all companies refer to a lack of clarity due to the murky economic outlook. Interestingly, market valuations suggest the growth concern has already been discounted and governments will continue to deal with the macro issues in a positive manner ultimately allowing for better growth. In looking for investment opportunities around the globe, readers may find some of our security selections at odds with a value based manager. Specifically, as we review the relative valuations, technology names continue to surface as displaying great value from both an absolute and relative basis. For instance, we purchased SAP, a multinational software company providing enterprise management software and consulting services. The stock has done well relative to the market and relative to its competitors. However, on a valuation basis, we now look to other potential names such as IBM which has much the same industry exposures as SAP but trades at much cheaper valuation multiples. It would seem that all things from the macro economic developments to the micro stock choices are relative, leaving one to watch for continuing incremental improvements on both fronts.

Fixed Income Markets – Overweight Corporate Bonds

We have reached the end of another quarter, and yet the surroundings look strangely familiar! In Canada signs of a slowing economy abound. However, the Bank of Canada remains steadfastly hawkish. The Governor of the Bank bases this strategy on concerns about the output gap and rising price pressures. This is contradicted by the economic indicators, most noticeably in the condo housing market where condo sales and sale prices are starting to slip. The bond market to a great extent is being buoyed up by massive pools of cash. Individuals and companies are sitting on cash that has either been generated by coupon flows or held back from the stock market. Despite the slowing economy, pension funds and savings continue to grow. In the Canadian bond market, provincial and corporate treasurers are recognizing that interest rates are too low to be ignored and new issue volumes have stepped up substantially. Our market is on track now to have issued $77 billion in new bonds by the end of this year, tying with 2010 and slightly ahead of 2011's volume. The sporadic new issue supply has kept downward pressure on corporate credit spreads, with September debt showing the best performance in the quarter, after a slow July and August. As we transit out of September the yield curve has resumed its flattening trend. The long end of the curve continues to respond to nervousness in other markets. As a further sign that rates are as low as should be expected, the Canadian government has announced an additional 10 year bond auction for Q1 2013 and intends to suspend the current bond buy-back program, moving to take advantage of historically low funding costs. In addition the Treasury has increased the size of the individual auctions.

In the EU, generally speaking, sovereign spreads have narrowed. This has been brought about mainly by the announcement of Outright Monetary Transactions (OMT) by the ECB. While the details of execution remain uncomfortably vague, the principal plank is in place. The ECB will buy sovereign debt from countries that request a bail out by the European Stability Mechanism (ESM) or the European Financial Stability Facility (EFSF). As planned, the mere announcement of the program has calmed spreads significantly. The international bond markets are keeping the pressure on Spain and Italy, expecting ultimate capitulation through an EU bail out. The latest bone of contention in the EU is the position put forward by the northern European nations that the new EU bank regulator should not be responsible for funding "legacy bad debts", meaning that Ireland, Spain and Portugal in particular should not look for relief to come from the bank regulator for debt already taken on at the national level to recapitalize their banks. The report from the external consulting house that implemented the latest stress test applied to the Spanish banking industry was released at the end of September, and provided some encouraging news as it appears the maximum funding required to recapitalize the Spanish banking industry will be less than €60 billion.

In the U.S. bond market, September started off with a significant sell-off as the Fed announced the QE3 program. That sell-off has now been completely reversed, with 10 year Treasury yields down to 1.5% from the high of 1.9%. The market appears to be focused on the demand for mortgage debt and not the potential inflationary impact of the latest form of QE. The Fed needs to create inflationary pressures to pull off an economic recovery. However, growing skepticism about the possible effectiveness of QE is keeping the bond market off balance. The latest iteration of QE calls for the Fed to purchase on an unscheduled basis mortgage backed debt instruments, and opinions are divided as to how successful this will prove.

The last month has seen a slow but steady tightening of credit spreads in the Canadian market. This has provided a number of good opportunities to take profits and to reposition the portfolios to benefit from the improvement in spreads. We remain overweight in corporate debt and will continue to apply our strict credit analysis as we watch carefully what the Central Bank says and how it acts.

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