Barrantagh

Investment Management

CAPITAL MARKETS REVIEW

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- The third quarter of the year brought something for everyone: Forecasts of tapering, collapse of Federal budget negotiations and government shut down, U.S. debt ceiling debate, German Federal elections and political crisis in Italy.

- Ben Bernake made it very clear that the Fed was looking at developing a strategy to slow the influx of liquidity and to finally return to a more normal rate environment. However, by the end of the quarter, the Fed appeared to be concerned on both employment growth and slower than anticipated economic growth. With the decision to commence tapering very data dependent, there should be no surprise that tapering did not start in September.

- As measured at the ISM (Institute for Supply Management) level or by consumer spending, the U.S. economy has stabilized and up until recently appeared to be recovering some of the slowdown seen at the end of the second quarter and early in the third quarter.

- The latest road block for the U.S. economy has come from budget issues and the debt ceiling debate between the White House and Congress. As of the time of writing the U.S. government is shutting down and sending workers home without pay. Depending on its length, this action may have a significant impact on domestic U.S. economic growth and on consumer confidence measures.

- This time around the rating agencies have indicated that they do not see the debt ceiling crisis as impacting U.S. credit ratings. There is a general belief in the debt markets that default must and will be avoided, and both parties in Congress, having made their points, will find at minimum a short term compromise.

- Parts of Europe appear to be stabilizing and are slowly recovering. However, it is typically the northern nations, with potential problem triggers being provided by southern countries. It would seem that the European crises are having less of an impact on markets. While not recommending complacency, it is positive to see that markets recognize that the EU is working towards resolution.

- In the equity markets, there was a leadership change during the quarter with cyclical stocks displaying better returns over the more defensive income oriented areas of the market, even in pullbacks. It is this leadership change that gives us some comfort that investors will continue to focus on the fundamentals in the lingering struggle between macro/political events and improving fundamentals.

- History shows that any negative effect on markets or the economy relating to government shutdowns is temporary with a full recovery in the markets within one to two months after the event. Therefore it would seem that the largest worry for equity markets at the moment may be short term in nature despite the copious amounts of fear reported by the press.

- In response to the uncertain environment for fixed rate bonds, we are reviewing a number of alternative strategies. We have not found real return bonds a suitable alternative, but are looking at strategies involving floating rate notes (FRN) and where permitted by policy, preferred shares.

Economic Backdrop – It's all about the U.S.

The third quarter of the year brought something for everyone: Forecasts of tapering, collapse of Federal budget negotiations and government shut down, U.S. debt ceiling debate, German Federal elections and political crisis in Italy.

The second quarter of the year ended with Ben Bernanke bringing the markets to focus on the realization that Federal Reserve purchases of debt instruments would slow and ultimately cease ("tapering"). In his joint address to Congress and at his press conference following the June FOMC meeting, the Chairman made it very clear that the Fed was looking at developing a strategy to slow the influx of liquidity and to finally return to a more normal environment. The tone was very much "when, not if", and economic forecasters around the world interpreted this to mean that tapering would start following the September FOMC meeting.

The much awaited September FOMC meeting came and to most participants' surprise did not launch the tapering program. Slowing economic growth in the U.S. overwhelmed the desire to ease back on the tap. As we have pointed out in previous commentaries the U.S. economy needs to create between 200,000 and 250,000 new jobs each month to absorb growth in the workforce from new entries and return back to pre-recession unemployment levels. This is not yet happening, and the Fed appears to be concerned on both employment growth and slower than anticipated economic growth. The change in tone communicated at the start of the quarter by the Fed was obviously premature. However, Bernanke has made it clear at all times that the decision to commence tapering would be data dependent, and so it should not have been too great a surprise that tapering did not start in September.

The market does not seem to appreciate that tapering is a slowing of the addition of liquidity and is not tightening.

As long as concerns persist, tapering will not get underway. On the other hand, as measured at the ISM level or by consumer spending, the U.S. economy has stabilized and up until recently appeared to be recovering some of the slowdown seen at the end of the second quarter and early in the third quarter. The consensus now appears to be that tapering will begin well into 2014 unless things pick up unexpectedly. The addicted market is not yet ready to accept withdrawal therapy. The market does not seem to appreciate that tapering is a slowing of the addition of liquidity and is not tightening. Tightening will come in a year or two when the Fed finally starts raising rates and/or reserve requirements.

The latest road block for the U.S. economy has come from the budget and debt ceiling debates. As of the time of writing the U.S. government is shutting down and sending workers home without pay. The furloughed workers actually account for about 15 percent of the federal government workforce. This is the first shut down in 17 years. Depending on its length, this action may have a significant impact on domestic U.S. economic growth and on consumer confidence measures. As we move through this issue, one must keep in mind that the debate on extending the debt ceiling is still to come. Following the various time lines the real deadline on negotiating the extension of the debt ceiling is mid October. By that time the U.S. government coffers will be empty. This time around the rating agencies have indicated that they do not see the debt ceiling crisis as impacting U.S. credit ratings. There is a general belief in the debt markets that default must and will be avoided, and both parties in Congress, having made their points, will find at minimum a short term compromise.

Still to come is the appointment of a new Chair of the Federal Reserve to replace Bernanke. The current Chair's term runs out at the end of January. Larry Summers, one leading candidate, removed himself from the race, leaving Janet Yellen (the current Vice Chair) as the leading choice. This will be one more issue for the market to digest.

Along with growing concern about the likelihood of tapering starting in September, came concern about the German elections, and the need to provide an additional tranche of funding for Greece. This became an election issue, but did not prevent Angela Merkel and her party from making solid gains. The opposition parties tried to make the latest tranche for Greece a key issue, but were unable to make it stick. Particularly key is the fact that Germany's economy appears to be picking up steam. Whether measured at the PMI, employment or GDP level, the environment is slowly improving. Parts of Europe appear to be stabilizing and slowly recovering. However, it is typically the northern nations recovering, with potential problem triggers being provided by southern countries. For instance, the recent near collapse of the governing coalition in Italy caused by the withdrawal of Berlusconi's party from the ruling coalition brought the country close to political and financial crisis, saved only by his backing down at the last minute. It would seem that the European crises are having less of an impact on markets. While not recommending complacency, it is positive to see that markets recognize that the EU is working towards resolution.

Equity Markets – Leadership Change

In our second quarter equity review, our outlook surmised that the most probable outcome for the second half of the year was a continuing equity rally and we also suggested that there may be a leadership change with-respect-to industry performance within the equity market. Fortunately the performance in the equity market during the third quarter seems to agree and to-date we have not observed anything that would change that view. The S&P/TSX was up 6.25% during the quarter, which was very similar to the global markets which were up 5.96% as displayed by the MSCI in Canadian dollar terms. There was also a leadership change during the quarter with cyclical stocks displaying better returns over the more defensive income oriented areas of the market, even in pullbacks.

It is this leadership change that gives us some comfort that investors will continue to focus on the fundamentals in the lingering struggle between macro/political events and improving fundamentals. Historically, the first leg of a longer term equity rally commences with multiple expansion. Stocks move up as investors are willing to pay higher valuations on corporate earnings as the relationship between risk and return changes. In the second leg, there is usually a change of leadership to more economically sensitive equities because economic surprises, supporting continued earnings growth, materialize. Throughout the last several months we have witnessed improving economics including: Global PMI's (Purchasing Manager Indices) above the magic 50 threshold for growth with the breadth improving; China's stimulus showing results; Euro zone fortunes turning, led by the U.K. (despite their austerity program) and Germany, while even Italy and Spain show improvement; And the U.S. continuing to show positive growth despite the government squabbling. Driving the uneven recovery in the economic numbers has been the consumer. Real consumer spending provided the largest boost to GDP growth over the last quarter while government spending continued to be a drag. As we have mentioned in previous write-ups, companies have been disciplined on the cost side, allowing them to maintain high margins despite a cautious consumer who is 70% of the economy. We prognosticated that the consumer needs to be healthy to drive the corporate revenue line and therefore we are delighted that the consumer is feeling healthier and spending.

We did witness several major events that caused turmoil for the markets during the quarter, all macro related, including: Syria (war seems to be averted); tapering possibility in September (market positively surprised at no tapering decision); new Federal Reserve chief decision; and the U.S. debt ceiling/budget debate. These macro concerns seem to be short term in nature, and although causing volatility, there does not seem to be any long lasting concerns by investors. For instance, the largest concern for the upcoming fourth quarter is the deadlock between the Republicans and Democrats over the budget and debt ceiling debate. However, if you put this into perspective, history shows that any negative effect on markets or the economy relating to government shutdowns is temporary with a full recovery in the markets within one to two months after the event. Therefore, it would seem that the largest worry for equity markets at the moment may be short term in nature despite the copious amounts of fear reported by the press.

The actions we have taken within clients accounts reveals a bias to more cyclical names and a liquidation of defensive names when cash is required.

Our bottom up, fundamental research for investment opportunities, reflects the ongoing shift in the market discussed above. The actions we have taken within clients accounts reveals a bias to more cyclical names and a liquidation of defensive names when cash is required. For instance, we purchased Penske Automotive Group (PAG) earlier this year at less than 7 times cash flow. This equates to approximately 10 times earnings per share and compares favourably to the historical long term average of 15 times. PAG is one of the largest U.S. public automotive dealerships with a meaningful presence in both the U.S. and the UK. The company continues to have remarkable top line growth, driven by the consolidation of non-Detroit automotive brands, continued growth in same store sales, expansion of its parts and service business and acquisitions. In addition, PAG is able to achieve notable SG&A leverage helping to drive higher margins and material earnings growth which should allow the company to maintain or exceed its consistent 16% return on equity.

Another name we added to client's portfolios in the last six months is Raging River, an energy company focused on light oil in the province of Saskatchewan. Their current large inventory supports 30% annual production growth through 2016 and they have a drilling inventory of greater than 10 years. Given the track record of strong growth exceeding expectations and a history of management monetizing companies (Wild Stream Exploration and Wild River Resources sold to Crescent Point Energy), Raging River meets our stringent requirements and has added to the cyclical component of client's portfolios.

Fixed Income Markets – Alternative Strategies

The bond markets in Canada and the U.S. continue to languish. The yield curve remains pinned to the 1% level at the short end as monetary policy remains unchanged. If anything, the economic data released in the third quarter has forced a more dovish policy on the Bank of Canada.

There is an approximately 90 percent correlation between rate movements in the U.S. and Canadian bond markets, which has endured for a great many years. Consequently, Canadian rates should be expected to follow U.S. rates when there is a resumption of activity. Of course, with the Canadian economy expected to slow and the ongoing transfer of manufacturing activity out of the country, a rising trend in rates is not a positive development. However, after a poor performance in June, the GDP did pick up smartly in July (+0.6%), beating expectations

Canada's yield curve has continued to steepen in the course of the third quarter, with the yield at the long end Government of Canada curve about 17 basis points higher than at the end of June. We expect this steepening to persist. With the earliest tightening action expected from the Bank of Canada in late 2014 or early 2015, there should be no let up in this steepening trend.

Throughout the third quarter, corporate credit spreads have widened out slowly, the opposite to what one would logically expect.

Meanwhile, there has been substantial new issuance of government and corporate debt. A significant industry, in volume terms for new issuance, has been real estate investment trusts. Some of these issues have been better received by the markets than others, but all appear to have settled into a trading range. As we suggested last quarter, companies are realizing that current all-in medium and longer term funding costs are both great opportunities and unlikely to get any better. The third quarter saw new issue volume rise by roughly 20 percent over the already high volumes experienced in the second quarter (corporate volumes rose from $25 billion to over $30 billion).

Throughout the third quarter, corporate credit spreads have widened out slowly, the opposite to what one would logically expect. Under normal conditions, as benchmark yields rise, credit spreads would be expected to tighten. However, there was a great deal of new issuance particularly in September, leaving investors suffering from indigestion, and the brokers holding exceptionally large inventories. The process of clearing out the inventories pushed yields up (prices down). In addition, the market participants were generally expecting tapering in the U.S. as we approached the end of September. Investors and traders alike did not want to be long product which increased selling and decreased demand.

Telecom spreads, which were pushed wider by the rumours of Verizon's imminent entry into the Canadian market, have clawed part of the way back to their pre-Verizon levels, contradicting the broader trend. This story has not yet come to conclusion, with the Federal government still intent on increasing competition.

Although our clients have no exposure, it is interesting to note that the real return bond market and the long bond market (maturities over 10 years), continued to underperform the DEX Universe bond index. Clearly, with no sign of inflationary pressures in the Canadian economy, real return breakevens are unattractive, and of little interest within our strategy.

In response to this uncertain environment for fixed rate bonds, we are reviewing a number of alternative strategies. As described above, we have not found real return bonds a suitable alternative, but are looking at strategies involving floating rate notes (FRN) and, where permitted by policy, preferred shares. The FRN strategy worked well at preserving capital for our fixed income portfolios in 2011 when rates rose sharply in anticipation of rising inflation, which did not ultimately develop. We are also keeping duration relatively short, and will continue to do so. Although corporate spreads widened during the latest quarter, we are continuing our core strategy of careful credit analysis to ensure that we hold corporate debt that offers the potential for capital preservation and growth in the current environment.

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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