Barrantagh

Investment Management

CAPITAL MARKETS REVIEW
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- Global economic factors took centre stage in 2004 and will dominate the investment landscape again in 2005. Currency movements, trade flows, Asian growth, Asian financing of U.S. debt, energy prices and relative interest rate levels are the issues.

In This Issue:

- **The Legacy of 2004 – Politics Dominated**
- **2005 Issues and Outlook – Economic Growth Continues**
- **Equity Strategy – Cash Flow Focused**
- **Fixed Income Strategy – Inflation Risks**

- It is the propensity of many of these key variables to shift dramatically within short time frames that makes investment planning particularly challenging as 2005 unfolds.

- The economic and political conditions in the U.S. are also key determinants of investment strategy and outcomes. The decisive victory of President Bush in the U.S. election provides certainty as to the direction of U.S. policy in 2005 and beyond. Mr. Greenspan retires in early 2006 but his gradual retraction of monetary ease will likely continue to influence fixed income strategy.

- The U.S. consumer and Asian demand (China, Japan etc.) were critical to the output gains of many companies in 2004. We believe that U.S. personal spending will be a less important growth component in 2005 and that the Chinese economy will slow but not likely sink into recession as has occurred in past cycles.

- The direction of earnings and cash flow generation is crucial to the performance of many companies. In general, earnings growth is slowing but the ability of many companies to generate free cash flow is at a high point.

- In our equity selection we favour companies with quality operations, demonstrably improving top and bottom lines and a cycle of free cash generation. Selected income trusts will also be deployed as a bridge between traditional equities with low dividends and cash yield requirements.

- Bond prices have remained surprisingly resilient in the face of rising short-term interest rates and signs of inflation. We believe government bonds are generally overvalued, but we still find value in the corporate market. The bond issues of companies with growing cash flow and improving balance sheets should provide returns somewhat above their running yields.

The Legacy of 2004 – Politics Dominated

The year 2004 may well be remembered for the development of a number of major economic trends which will influence global investment behavior in 2005 and beyond.

1. Global growth was well above trend led by the U.S. and China.
2. China became recognized as an economic power house; the country is a major consumer of materials and energy and a global price setter for cheap manufactured goods.
3. The weakening of the U.S. dollar to new lows against the Euro, the Yen and the Canadian dollar emerged as a potentially destabilizing factor.
4. Oil prices soared to record levels of U.S. $55 in October before easing 22% by year end.
5. The Federal Reserve began to move from a very accommodative to a more neutral monetary stance.

Political developments were also critical in 2004 ranging from the U.S. election, to attempts by the European Union to act coherently, to the evolution of political leadership in fast growing India and China, to the geopolitical trouble spots in Iraq, Palestine and North Korea. Most importantly, the clean and decisive victory by U.S. President Bush eliminated a great deal of uncertainty about the direction of U.S. leadership and the path of U.S. economic and political policy. With the Bush camp entrenched in power, investors will be very sensitive to the enormous and growing U.S. twin deficits and changes in currency levels.

In the aftermath of the U.S. election, global economic factors have resumed their central role in investor thinking. Of course, each cycle has a distinct dynamic driving it. The cycle through the 1970's/early 1980's was mostly about inflation. The cycle of the 1990's/early 2000's centered on U.S. consumerism and the technology boom. The main drivers of the current cycle appear to be global expansion - about 5% in 2004 - and debt leverage - consumer and government. North America and China have been the engines of global consumption growth. U.S. leading indicators have been gravitating lower for several months and slower U.S. growth looks to be a certainty for 2005, but the odds of a recession seem low. Investors are acutely aware of the role of China in global growth. China adopted policies of growth containment in 2004 but concerns regarding a hard landing in China have given way to speculation about a Yuan revaluation.

In the current global oriented cycle two factors have overshadowed all others —soaring oil prices and the declining U.S. dollar. The recent fall in the price of oil, has improved the odds that the current global expansion will continue beyond 2005. However, supply/demand imbalance in oil markets implies ongoing levels of much higher energy prices.

The second factor, the fall of the U.S.$ (linked to U.S. deficits) portends significant trade realignments in 2005. The catch-22 is that while U.S. exports may revive in the face of a weaker dollar, organic growth in the rest of the world may falter. Furthermore, an unruly dollar decline could prompt a switch out of U.S. assets forcing interest rates higher and consumer spending lower. In theory, a softer dollar would be a plus for the U.S. economy since it would help to reverse a sinking trade balance and restore some order to the current account. In practice, the interaction between energy pricing, U.S. $ exchange rates, U.S. deficit management and global economic activity are complicated and not likely to unfold in an orderly fashion.

Looking Forward to 2005 – Economic Growth Continues

Investors have listened to market observers (including us) evaluate concerns including the weak U.S. $, the U.S. twin deficit issue, high energy prices, rising interest rates, elevated consumer debt and moderating earnings growth. It is the perception that these factors could move dramatically that distinguishes the current investment environment from previous periods. Nevertheless, our preliminary thoughts on the direction of key trends in 2005 are as follows:

1. Global growth will moderate but respectable growth in the order of 3 – 3.5% will be achieved. The U.S. economy has resilience and we believe China will orchestrate a soft landing.
2. We expect further short-term interest rate increases in the U.S. as the year progresses but inflation will remain in check and the yield curve will therefore flatten rather than rise across all maturities. Interest rate increases in Canada will lag those in the United States.
3. China and Japan will continue to buy U.S. treasuries but at a slower pace in response to a further drop in the U.S. $. China will not repeg its currency at a higher level against the U.S. $ anytime soon.
4. There will be increasing political conservatism in the United States and Canada in response to the twin deficits and pressures to preserve financial wherewithal for future social spending needs.
5. Oil and gas prices will likely moderate in the first six months of 2005 possibly pushing the price of a barrel of oil down to U.S. $35, still well above historical levels.
6. The global reallocation of investment spending away from technology and towards basic materials that occurred in 2004 will continue in 2005 providing opportunities in natural resource projects and related infrastructure.
7. Corporate earnings growth will moderate as companies adjust to the higher costs of basic inputs, slower revenue growth and more difficult comparisons. Cash flow generation will be evident in well-run companies and the deployment of it for the benefit of shareholders will be a central focus for investors in 2005.

Equity Strategy – Cash Flow Focused

Fundamentally, earnings/cash flow and interest rates are key to equity market potential. On the earnings front, stocks began to struggle in the first quarter of 2004 despite stellar reported earnings on the back of expanding margins and booming global growth. According to our analysis, profit margins are relatively high although a peaking of earnings/cash flow generation has yet to occur and a sharp recovery in operating margins like that driving the 2002/2003 appears unlikely. Revenue growth is key for further operating margin expansion and yet, intense global competition will remain a great enforcer for pricing. For many companies revenue growth will come more from market share gains i.e. exploiting competitive advantage rather than from general expansion. For some companies (materials and oilfield services) pricing power has returned. Many other companies are dealing with heightened cost pressures (labour and materials). It is still uncertain how much of the higher cost structure companies will be able to pass through to consumers. What makes the potential cost squeeze even more threatening to profits/cash flow is the ratcheting down of productivity growth.

The combination of rising interest rates and a more problematic earnings picture in a complex macro environment argues for a stock selection strategy that emphasizes earnings quality together with free cash flow generation. Barring an economic shock, 2005 should prove to be another good year for basic materials within a longer secular bull market for commodities. Strategically focusing on efficiently managed low cost producers can mitigate the risk involved in investing in commodity producers. On the energy front, oil and gas prices are expected to remain high compared to previous cycles. Smaller entrepreneurial energy producers are well positioned to grow volumes at reasonable cost by exploiting the downsizing by major oil companies. Canadian companies, such as Duvernay Energy, led by experienced exploration teams, are developing high quality, large scale assets and creating shareholder value in the process. In the industrial sector the positive impact of a relatively strong North American investment spending cycle, lack of infrastructure in some industries, and transportation backlogs point to further upside in such companies as CP Rail. In Canada, the industrial sector is beginning to feel the impact of both higher energy prices and more importantly the strong Canadian dollar. Canadian manufacturing and auto parts are sectors to avoid.

Fixed Income Markets – Inflation Risks

By year end, the U.S. economy had substantially returned to where it left off before the summer softness but with an important distinction, inflation is on the rise, albeit far from the runaway inflation of the late 70's. Treasury yields at present do not appear to reflect this risk. Several factors appear to be at work to keep treasury yields low including - a) suspicion that the economic recovery is not sustainable b) recognition that the U.S. economy is still operating with excess capacity (manufacturing utilization in the U.S. stands well below its long term average) and c) Asian central bank buying of U.S. treasuries.

With inflation on the rise in the U.S. and the likelihood that Asian central banks will begin at some point to diversify away from their U.S. dollar assets, higher U.S. yields seem probable in 2005 and we continue to recommend an underweight position in conventional U.S. government bonds. Given today's moderating factors, with core CPI inflation rising from 1.1% a year ago to 2% at present and trending higher, the rise is modest relative to historical standards. Nevertheless it will likely be sufficient to cause yields to rise and bond prices to fall.

In Canada, the Bank of Canada is expected to stay on hold until the end of 2005 to support adjustment to a higher Canadian dollar. This position represents a departure from the Bank's stance earlier in the year when GDP growth was in an accelerating phase while U.S. growth was faltering somewhat. The Bank does not usually react to economic trends other than inflation but the move of the Canadian dollar above U.S. 80¢ in 2004 was supported by positive Canadian fundamentals as well as the continued unwinding of the U.S. dollar.

With respect to investment strategy, our analysis suggests that U.S. treasuries are expensive and vulnerable to even modest inflation surprises. Canadian government bonds will eventually weaken in sympathy with treasuries but will likely outperform on a relative basis if current trends continue. The Fed will be more active in tightening monetary policy than the Bank of Canada. Therefore we believe there is a better, but still limited opportunity, in Canadian government bonds.

The ongoing opportunity on which we rely for fixed income performance is in the corporate bond market. Many companies are generating high levels of free cash flow and continuing to improve their balance sheets. Corporate issues of such companies are attractive in the present 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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