Barrantagh

Investment Management

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- Global economic growth will likely remain above trend well into 2006 although a rotation appears to be underway. Strong growth in the emerging world (particularly Asia) should largely offset a moderating pace in the developed world.

- Slowing growth in the developed world will primarily be influenced by a peaking U.S. economy. In the U.S. we do not expect improving business investment and rising exports to fully replace weaker consumer spending.

- The economic fundamentals in Canada are more favorable than for other G7 countries and Canada is the only G7 country with both a federal budget and current account surplus.

- U.S. and Canadian monetary authorities will likely continue to raise rates, but rates will remain far short of levels that would precipitate a major economic reversal.

- The incoming Fed Chairman, Ben Bernanke, is widely viewed as a force for continuity of the Greenspan policy thrust, although no one knows for sure what policy differences Bernanke may have in mind.

- Our equity strategy heading into 2006 is largely an extension of the path we have taken through the last few months. Admittedly, equity market risks have increased but we continue to pursue a stock-specific approach favoring companies with growing cash flow and specific plans for its deployment to the benefit of shareholders.

- Risks to our positive framework for equity markets include a collapse of the housing market (unlikely in our view) and an overshooting by the Fed of its tightening campaign (remains to be seen).

- Ottawa's "quasi-review" of income trust taxation is complete for now and its proposal to cut taxes on dividends awaits approval. As well, income trusts have been integrated into the S&P/TSX composite. We will likely increase our exposure to income trusts as the year progresses.

- Fixed income markets rallied strongly in late 2005 reacting to a "hint" of the end to Fed tightening. We believe this reaction is premature and continue to be defensive in the overbought bond market.

Global Economic Growth – Changing Mix

A constant refrain throughout the current global economic cycle has been the resiliency of the U.S. economy. Q3 illustrates the point. Despite increasingly bearish fundamental influences (higher energy prices, higher interest rates, hurricanes) real GDP growth accelerated to 4.3%, the second highest in ten consecutive quarters of GDP growth exceeding 3%. This sequence represents the longest growth spurt in the U.S. economy in two decades.

It is likely that the U.S. economy will defy expectations for some time as the near term fundamentals are in place for a relatively strong performance in 2006. Much of the most recent economic data remains, firm, particularly, the recovering manufacturing ISM which at 58.6 for October/November exceeds the 1994, 1997 and 1999 cyclical peaks. Notwithstanding the current trend, we expect a slowing to a below potential 3% expansion as 2006 progresses. The greatest vulnerability is in the consumer sector. In the past year the U.S. personal savings rate has fallen from 1.2% to a record low of -1.5%. A 4% rate was normal five years ago and by deduction, less than one-third of the 3.9% real consumption growth over the period has come from higher disposable income. An evaporating rate of savings shows that many U.S. consumers have been monetizing the ever increasing value of their property to maintain or increase their standard of living. Admittedly, U.S. housing has looked overvalued for some time and like the economy itself, has generally defied a correction. But evidence is accumulating that a sixteen-year low in housing affordability is beginning to take hold. We believe a leveling out in housing prices, rather than a crash, is the most likely outcome; similar to what has occurred in Australia and the U.K. However, even a flattening in prices will likely negatively effect U.S. consumer spending in 2006.

More positively, much of the rest of the world has enjoyed upside surprises in growth in recent quarters, and unlike the U.S., these results look more like the beginning than the end to a growth cycle. Most notable has been the turnaround in Japan. Real GDP growth in Japan could reach a ten-year high of about 3% in 2006 with deflation finally coming to an end, barring monetary authority's intervention. Although, stock markets are increasingly discounting a more sustained recovery, we remain wary of valuations and the durability of Japanese growth. Elsewhere in Asia, developments in China remain critical with its super growth cycle becoming increasingly important as the country's share of the global economy rises. It is reasonable to expect some slowing in China's growth through 2006, but not enough to amount to a significant break in its strong growth trend. Looking at Asia as a whole, growth appears likely to accelerate, as stirring domestic demand and rising regional trade more than make up for slowing exports to a weaker U.S. economy.

The economic story in the rest of the world looks more mixed but generally with more of a recovery tone than a weakening trend. The ECB's (European Central Bank) first rate hike in five years will test the nascent firming of Europe's economy while emerging markets outside of Asia should make some contribution to growth.

From a top-down point of view, exchange rates will play a role in fixing the glaring imbalance between the huge U.S. current account deficit and surpluses elsewhere. But weaker U.S. demand relative to foreign demand will also play a key role. In summary, we see a global economy in 2006 in transition from strong U.S. consumer-driven growth to a greater reliance on Asia as the engine of global growth. Europe will make a small and positive contribution. Whether the changing global growth mix will proceed smoothly is a good question. Increasing angst in the United States over its loss of clout in global markets could lead to a dangerous rise in protectionism. If so, global growth in 2006 could slow more dramatically than we currently expect.

The international environment always matters to a small open economy like Canada and the above-described shifts will have important consequences in 2006. First, solid growth in Asia should support an extension of the secular bull market in commodities. As well, strength in commodity prices will benefit the favorable trend in Canada's trade and the related boost to domestic incomes. However, any shift in global growth away from the U.S. will act as a drag on the Canadian economy. The U.S. market is Canada's most important, by a wide margin, absorbing more than 80% of exports or about one-quarter of total GDP. While exports to Asia have been growing fast, it is from a very small base and insufficient to offset waning exports to U.S. markets. The greatest impact of weaker U.S. demand will fall on Canada's manufacturing sector which has already been buffeted by a high Canadian dollar. On balance, Canada's economy will likely outperform all other G7 economies in 2006 and this outperformance will be accompanied by a growing Federal and current account surplus. As in 2005, the year 2006 will see the resource-oriented west outperforming the more industrially based center. Economic divergence will likely interact with an already divided Federal political situation. If each region including Quebec sends a different party to Ottawa in the upcoming election, the country's fault lines will certainly widen, introducing a wild card to Canada's otherwise strong economic and market outlook.

Equity Markets – Further Gains Ahead

The S&P 500 and TSX (excluding energy) delivered single digit returns in 2005 and we do not foresee either a significant acceleration in the current upward path of equity markets nor a major sell off either. We expect a similar overall experience in 2006, as in 2005, accompanied by considerable volatility as a trading mentality permeates a growing body of investors.

At this time, we do not think that enough has changed in the overall landscape to alter the equity market direction we have pursued over the last few months. Our constrained view of the potential for equity gains in 2006 is dictated primarily by two factors:

1. According to the U.S. national accounts, profit margins are at a three-decade high, but cost pressures are beginning to build even as pricing power returns to some industries. Interestingly, third quarter profits in Canada were 14.4% of GDP, a four-decade record. Corporate profitability and cash flow generation will remain strong, but we expect that increased earnings disappointments and downward earnings guidance will become more prevalent as the year progresses.

2. Tightening monetary policy and the associated decline in financial market liquidity have historically triggered a contraction in valuation multiples. While it is possible the Fed could bring to an end the tightening campaign over the next several months, there is no certainty. On balance, we see little potential for P/E multiple expansions from current levels.

Of course, these are broad generalizations and we believe it will be possible, as we demonstrated in our portfolios in 2005, to achieve gains, by continuing our disciplined approach to security selection. We are confident we will be able to accomplish this task again in 2006 based on the opportunities available through our bottom-up, company-specific approach to security selection. We continue to advocate companies that have historically shown an ability to perform well in the face of the perceived headwinds of slowing earnings growth and rising interest rates. Companies such as: Fairmont Hotels, Shoppers Drug Mart and Talisman Energy, fit these criteria.

While financials do not rank highly on our valuation screen, they are standouts on the basis of absolute and relative return on equity. As well, they rank highly on dividend yield relative to long bond yields. We will continue to hold bank stocks for dividend yield and modest capital appreciation.

The energy and materials sectors deserve special mention for two reasons. 1) They now comprise close to 30% of the S&P/TSX Composite and 2) They have been important contributors to our portfolios in recent years. With Asian growth expected to remain strong in 2006, we expect commodity prices to hold up well. Nevertheless, commodity movements are expected to be less important market drivers in 2006 than company specific factors. Accordingly, individual investment selection should be critical, particularly since differentiation between the out-performers and the under-performers will widen.

The challenge for oil and gas producers will be to execute efficiently and on time in a continuing tight oilfield service and labor market while at the same time attempting to control costs. We continue to find companies which should execute well. Furthermore, downside protection is evident as the laggards will likely be swept up in an industry consolidation phase in 2006 as takeover activity increases by cash rich, reserves poor companies. We believe the superior cash flow generating capability of oil and gas producers and service companies will afford investors good gains again this year.

Of course, commodities and energy are volatile and the Canadian capital market is highly leveraged to these areas. We are cognizant of the merits of diversifying into non-commodity sectors and into international markets. In 2005 we correctly forecast that the rising Canadian dollar would negate gains in international stocks and we therefore down played international equities. We are constantly re-evaluating that stance with a view to increasing our exposure to international equities as market conditions dictate.

Ottawa's recent decision to level the playing field for dividend-paying corporations relative to income trusts will, if adopted, attract income-seeking investors to high dividend companies. Financial stocks and diversified telecommunication companies will benefit. Utilities also qualify, although they are not as attractive on a relative valuation basis.

Fixed Income Markets – Monetary Policy the Key

Over the past year the fixed income markets have been dominated by the steady rise in U.S. administered rates, with the trend setting discount rate raised a quarter of one percent at each of the eight meetings of the FOMC in 2005. Ultimately other central banks have followed, with the ECB embarking on a long anticipated course, and the Bank of Canada raising the Bank Rate at each of the last three meetings. Of course, U.S. monetary policy will soon come under new leadership. For now the bond market has a blind faith view that the coming transition in Chairman of the FOMC (from Greenspan to Bernanke) augurs well for continuity of the policies and approach adopted by Greenspan. Under Greenspan the Federal Reserve became a powerful and highly credible force not only in monetary matters, but also in shaping broad economic issues. Bernanke will need to be a strong chairman and able to guide the FOMC without public dissent in order to maintain investor confidence.

The much discussed and debated "conundrum" for Mr. Greenspan has persisted, and as we end 2005 and roll into 2006, - short rates have risen, long rates have not responded and the U.S. yield curve has tentatively inverted. Generally speaking, inverted yield curves in the U.S. have accurately predicted recessions. In the present cycle, the arguments for recession are much less compelling. The economy continues to grow at real and nominal rates of return that used to be described as strong, above 3 percent. Inflation, while periodically worrisome, has not soared out of control despite high energy prices. On top of that, the magnitude of bond yields is much lower than it has been in past episodes.

Demand remains strong for longer dated maturities in the bond market, with the U.S. Treasury planning to recommence issuance of the long bond in February. In the meantime, demand from insurance companies, pension funds and other investors looking to match long term liabilities, has remained strong, and has kept long yields low and bond prices high. As well, the factors that have conspired to ensure inflation is contained, have kept long rates down. Given the high price environment for government bonds we have not been active by design in most treasury markets.

Corporate credit spreads in North American markets were buffeted by the crisis in the auto industry (Ford and GM both downgraded to junk), but the much expected broadly-based widening of spreads did not happen. We have seen credit spreads widen slightly, and expect that trend to continue through 2006, but at a manageable pace. Spreads have generally tightened through the last 4 years, and had reached a logical impasse. The expected widening will create investment opportunities which we will take advantage of as the year progresses.

While the final months of 2005 witnessed a surge of new supply (corporate, provincial, federal and foreign) the market remains supply restricted. The largest area of growth for the market came following the elimination of the foreign content limits. Foreign borrowers have started to access the Canadian fixed income market, and will do so whenever the swap spreads make it attractive.

Income Trusts – Stability Ahead

The income trust sector performed well in 2005, but with much more volatility than many investors could readily accept. Rising interest rates and Ottawa's review of the taxation of trusts were central to the erratic performance of the sector. As well, a number of trusts disappointed and cut distributions. Looking ahead, we expect the income trust market to offer a very useful supplement to portfolios requiring income. As well, the integration of trusts into the S&P/TSX Composite will create a favourable funds flow. Over the year, we will take steps to increase the exposure to income trusts, recognizing that differentiation between trusts will increase and security selection will be key.

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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