Barrantagh

Investment Management

CAPITAL MARKETS REVIEW
FOURTH QUARTER 2006

- Global growth may continue at an above average trend in 2007 if the U.S. slowdown is contained to housing, and Europe and Asia stay on track.

- The U.S. economy slowed sharply in the second half of 2006 and Canada's growth ground to a halt. A U.S. recovery by mid-year is expected unless the housing downturn spills over into the broader economy and the Fed overshoots in its attack on inflation.

- European and Asian economies appear to have more self-sustaining characteristics than in previous cycles (i.e. less dependent on the U.S.) reflecting accelerating domestic demand. The resiliency of Europe and Asia will be put to the test in 2007 if interest rates rise.

- A primary risk to continuing Global growth is the possibility of monetary tightening in these regions.

- Our equity strategy reflects concerns that certain sectors of the market do not adequately reflect inherent risks. We have continued to reduce exposure to economically sensitive stocks and have been increasing our exposure to international securities where better values can be found.

- The North American bond market remains fully valued with little scope for gains beyond the current running yield. Slowing economic growth and contained inflation limit the downside but the prospects of a correction keep us on the sidelines in the near term.

- Income trust markets are in limbo pending the release of detailed legislation on the calculation of the new tax and accompanying personal tax changes. (see insert)

Global Economic Outlook –Strength in Europe and Asia

During the last few months, the global economic expansion has reached a turning point, characterized by a worrisome slowdown in the United States economy, but continuing solid fundamentals in Europe and Asia. The consensus among economic forecasters is that global growth will decline only marginally in 2007 from the 4% plus pace of 2006, even though U.S. growth has recently slipped to about 2% from 5.6 % in the first quarter of 2006. For global growth to stay strong the U.S. economy must recover from its current weakness while Europe and Asia must not falter (i.e. prove resilient to a U.S. downturn).

Not surprisingly, opinion on the direction of the U.S. economy is very divided and much depends on whether the housing downturn proves to be relatively well contained or whether it will spillover to consumer spending and the broader economy. Consumer spending, after adjusting for inflation, has in fact slowed from its peak rate of about 4% in 2004 to about 2.8% for 2006 and may weaken further into 2007. However, consumer spending is strongly underpinned by rising household income, job growth, gains in hourly pay and a smaller bite from energy costs. In particular, the recent strength of the job market heading into 2007 suggests households will be able to depend more on income growth and less on gains in their wealth going forward.

While consumer spending is the most important component of U.S. economic growth, business outlays and exports have played a growing role in 2006. Business outlays on equipment and new facilities rose over 14% through the third quarter and business investment shows continuing momentum into 2007, reflecting a healthy corporate sector. Looking beyond domestic demand, U.S. exports are playing an essential role in driving output, employment and profits, particularly as the U.S. dollar has weakened against major currencies. Shipments abroad, particularly to Europe and the Pacific Rim added close to 1.0% point to the economy's 3.5% growth rate in 2006, a contribution matching that of business investment. In summary, we lean towards the view that the U.S. economy will achieve a "soft landing", i.e. an orderly slowdown and not a recession.

Major economies outside the U.S. are wrestling with the question of what happens to the world economy in the face of a U.S. slowdown. Eurozone and Asian growth appear to be less vulnerable to a U.S. slowdown than in previous cycles based on a degree of decoupling of these economies from the U.S. The clearest sign of this is that, domestic demand and investment spending in these regions, have grown in importance relative to exports to the U.S. The World Bank estimates that the Eurozone and China each make up about 15% of global economic activity, while the U.S. and Canada account for about 20% and 2% of global output respectively. Our research gives us reason to expect considerable resiliency in other countries to a U.S. slowdown. Growth in the Eurozone has accelerated to a 3% annualized rate, underpinned by an upturn in employment, and rising wages. Japan's 2% average growth rate reflects a marked improvement on the dismal decade of the 1990's. China and India are expected to slow in 2007 but still achieve growth of about 9% and 6% respectively.

A major risk to these forecasts is that central bankers become more worried about accelerating inflation based on rising wages and a strain on productive capacity. Even with declining energy prices, core inflation rates remain a concern and therefore, tightening monetary policy cannot be ruled out. At present, policy makers have largely moved to the sidelines and are waiting to see if inflation pressures begin to subside in this slower growth environment.

Canada's economy is more vulnerable than Europe or China to a U.S. slowdown, with over 40% of Canada's GDP tied to the U.S. economy. Canada's economy geared down in mid 2006 after a 2.9% pace of growth in 2005, and 3.3% in 2004. Growth virtually halted in November with a major weak spot being residential investment plus a drag from exports. Manufacturing and trade remain under pressure due to the combination of heightened offshore competition, elevated commodity prices, and a strong dollar. However, a resilient consumer and strong business spending should ensure GDP growth in the range of 2 to 2.5% for Canada in 2007.

Equity Markets – International Diversification Underway

The year 2006 served to illustrate the extreme sensitivity of markets to economic indicators. After a strong opening in 2006 the S&P500 promptly lost about 100 points in the second quarter in just a few weeks in the wake of deteriorating economic fundamentals and then rallied in the third quarter as oil declined by about $17.

What is surprising is that equity markets continued to rally strongly in the fourth quarter all over the world, setting new records. The markets seem largely impervious to mounting risks in the investment climate such as the sharp slowdown in the U.S. economy, Fed concerns with inflation, the blow-up of the Amaranth Hedge Fund in September, the Halloween Income Trust announcement (see insert) in Canada, and the democrats' early November election sweep of both houses in Congress. Unbending faith in an economic soft landing, a wave of momentum driven buying, a flurry of mergers and acquisitions and aggressive moves by private equity funds have supported strong equity markets. A perception of low risk has increased risk tolerance and created an interest in hedge funds, commodity ETFs, emerging markets, small cap companies, and high yield bonds.

In our view, this most unusual confluence of factors is signaling caution for the near term and suggests that the underlying positives must be balanced realistically against the risks. One concern is that market participants seem to be ignoring the fact that a majority of companies are reporting earnings and cash flow numbers less than expected. Secondly, investors are ignoring the fact that while many companies have missed inflated analyst targets, they are also reducing forecasts for the coming year. All in all, it is not clear to us that this widespread mood of optimism is fully justified.

Perhaps the biggest obstacle facing equities however, will be when investors become concerned about the pace of earnings growth. S&P/TSX companies have enjoyed steady double digit earnings and cash flow growth over the past five years, well above the Canadian historical average of 6.5%. Consensus estimates call for slowing earnings and cash flow growth, but still another year of at least 10% gains. In the U.S., third quarter earnings were up almost 20% from the year earlier and, for 2007 expectations are very high. When we compare our modeling parameters to general expectations, there seems to be an unrealistic level of optimism in terms of earnings expectations, especially in certain areas of the market. Investors may not be fully discounting the imminent risks to profit growth. It is our experience that analysts are much more accurate when earnings are recovering than on the brink of a slowdown.

While recognizing elevated risk levels in equities, we still remain positive on select companies which reflect our general preference for larger, more stable cash flows irrespective of the sector bias or capitalization category. Corus Entertainment and Shaw Communications meet these criteria. At the same time, the component of dividend paying companies in the portfolios, such as the banks and Enbridge, should help to lower equity duration and provide some insulation against a scenario where the economy weakens unexpectedly.

Our attraction to companies outside Canada reflects the strength of global economies and business valuations which incorporate an appropriate amount of risk. Our search for value has led us to redeploy funds into overseas markets. We began this process last year and have implemented some of our ideas, as entry points present themselves. For instance, Akzo Nobel, a European diversified conglomerate is the largest global player in coatings (industrial, decorative, marine and auto). It has a large pharmaceutical business based around ethical drugs. With approximately 60% of sales in Europe, a 22% return on equity and trading at 8 times cash flow, this company illustrates our global search for value.

Finally, although energy has been disappointing lately, suffering from a record warm winter, we continue to own select producing companies particularly adept at adding value through drilling and acquisitions in a weaker price environment.

Fixed Income Markets - Waiting for Better Values

Since the middle of 2006, the North American bond market has staged a strong rally propelled by a flow of weaker than expected economic news and a pause in the Fed's tightening campaign. The 10-year treasury yield fell about 80 basis points to the 4.45% level since its most recent peak set in late June 2006 and has gravitated only slightly higher recently, to about 4.60%. In our view, U.S. government bonds, indeed government bonds of the major western economies, are clearly in overbought territory, reflecting faith in a smooth transition to a period of easier monetary conditions. This strength in bond markets is surprising given Chairman Bernanke's recent comments that the U.S. economy is positioned to expand at a moderate rate and that risk to the inflation forecast seems primarily to the upside. The Chairman's message should have steered investors back toward inflation risks and precipitated a down turn in bond prices.

In Canada, the recent low level in yields, below 4.0%, also represents an overbought government bond market paralleling the U.S. situation. Moreover we expect the Canadian market to maintain its spread under the U.S. market, and the Canadian dollar to continue to decline, at least until there is a pick-up in exports. This will increase the investment opportunities in the U.S. and European bond markets for Canadian investors.

Of course forecast movements in bond prices must be judged against the current background of a flat to inverted yield curve (long yields lower than short term bond yields) and that movements at the short end (steadily upward until August of 2006) have had relatively little impact on yields at the long end. In the face of strong demand for long dated maturities (pension funds etc.), Fed monetary policy has been ineffective in moving long maturity yields upward. We expect that even if short term rates do come down (if the Fed eases later in the year) the long end of the bond market may not be affected nearly as much as in previous cycles. Long bond yields seem range bound and the opportunity for significant gains seem limited. On the other hand, investors will experience more volatility at the short end which is much more sensitive to Fed/BoC policy moves.

Regardless of the limited return opportunity in government bonds, we continue to favour them over comparable duration corporate issues. The foundation for this reflects the fact that regardless of the credit worthiness of the corporate issue or the wealth of the corporate sector, corporate bonds are more vulnerable to general economic conditions. Bond market experience has shown that credit spreads usually widen in the face of a slowing economy. We prefer to be patient and wait for a widening of credit spreads before committing further to the corporate bond market.

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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