Barrantagh
Investment Management

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- The resiliency of the U.S. economy to the headwinds of a worsening housing contraction, financial system dislocation, tightening credit conditions, and anemic employment will be sorely tested in 2008.

- The debate over a U.S. recession is somewhat academic as major parts of the U.S. economy are facing recessionary conditions.

- Strong exports are not a large enough component of U.S. GDP to offset a potential retrenchment by the consumer.

- Global growth seems destined to slow in 2008 influenced by the ongoing credit squeeze, a weaker U.S. consumer and various local issues that will curtail specific economies.

- In our equity selection process we continue to prefer relatively defensive, counter cyclical and interest-sensitive areas and remain underweight cyclicals and resources.

- The Federal Reserve and other central banks have put aside inflationary concerns (still present in the U.S. and rising in China) in favour of lowering interest rates and injecting liquidity into debt markets. Capital markets are pricing in further rate cuts but the inflation fight may resume later in the year.

- Opportunities in the bond market, the usual safe harbour in uncertain times, are limited because government bonds have been overbought in the flight to safety while many quality corporates (although likely oversold) are not immune to the repricing process underway in the overall financial system.

Economic Backdrop – Growth Impediments Mount

The financial system stresses that roiled capital markets in 2007 show no signs of abating as the new year gets underway. What began in mid-2007 as a supposedly discrete sub prime mortgage issue quickly morphed into a global credit squeeze necessitating unprecedented remedial action by governments and central banks. Coordinated efforts by leading central banks have resulted in an infusion of well over $600 billion into money markets, and more action may be required. As well, the banking industry recognizes it could not simply abandon its failing network of structured credit conduits and is absorbing large losses as liabilities are booked that were expected to be off balance sheet. Some banks have responded by raising fresh capital, ironically from previously shunned Middle Eastern sources. Regardless, it is apparent that the global banking industry will tighten lending standards, thereby drawing money out of the economy at a time when it is perhaps most needed. The inevitable tightening of credit availability will curb consumer and business spending and exacerbate the global economic slowdown already underway.

The U.S. economy will feel the brunt of the global slowdown as it grapples with declining home prices, surging energy prices, lackluster job creation and declining consumer confidence. So far the U.S. economy has held up well with the largest contributor being the consumer, but business investment and the trade sector were important components. In fact, in 2007 strong exports (and slowing imports) almost completely offset the direct negative of falling residential construction on GDP growth. The fear, however, is that such growth is unsustainable in the face of severe headwinds. Most critically, the U.S. housing downturn is getting worse. The sharp decline in existing home sales combined with a glut of unsold homes (ten month supply) represents an inventory overhang not seen since the 1981-82 recession.

Overall, key economic trends such as the housing contraction, anemic job creation (only 18,000 new jobs in December), credit rationing, and high energy prices all point to a period of sub par growth in the U.S. through 2008. The odds of an outright recession have increased. Monetary ease by the Federal Reserve will help, but interest rate relief requires months to take effect. Foreign trade (fueled by a weak U.S. dollar) should continue to offset some of the expected weakness in domestic demand but it is not a large enough GDP component to offset significant consumer weakness. Prominent forecasters expect U.S. growth for 2008 of 2% or less (about the same as in 2007) but they may well be optimistic.

The remaining question is the extent to which an American slowdown will drive down growth in the rest of the world, particularly in China, Japan, India, and the Euro zone which account for about half of the world's GDP. The IMF is optimistic that global growth will remain strong at about 4.6% compared with 5.1% in 2007. The IMF has been downgrading its forecasts since the spring - Canada 2.3% compared with 2.9%; the Euro area 2.1% from 2.3%; Japan 1.7% from 1.9%. Interestingly, China, India and Russia made up about one half of global growth in 2007 with rates of 11.5%, 8.9% and 7%. The IMF expects lower but still strong growth rates for these countries in 2008 - China 10%, India 8.4% and Russia 6.5%.

The story for 2008 isn't going to be about global growth, it will be about the global slowdown and when a recovery can be expected.

Equity Markets – Uncertainties Abound

The euphoric state of equity markets last fall, prompted by a cumulative 100 basis point Fed fund rate cut, seems to have given way to a much more fragile market dominated by a host of uncertainties. It is these uncertainties that will create one of the main themes that we believe will develop in 2008 – volatility. Ultimately, it is this volatility that will create opportunities for astute investors.

At the heart of investors skittishness is the realization that the credit crunch, and the complex dysfunctional subsets of credit securities within it, is not going to be sorted out overnight. Restricted credit availability is a foregone conclusion with negative repercussions for the real economy. Investors are unnerved by the huge loans being booked by the banking industry which has been forced to take responsibility for billions in over priced and illiquid structured debts. Accounting for about 30% of the Canadian S&P/TSX composite and 20% of the U.S. S&P 500 index, banks have been a mainstay of portfolios for years but are now tarnished and underperforming in equity markets. However, not all banks are equal. At Barrantagh, we have been underweight banks for several years and now believe that over the course of 2008, an opportunity may be presented to increase our clients weighting to banks, specifically, Canadian banks which have shown strong resiliency time and time again. Investors are concerned about earnings decline, major right offs, and possible breaches of financial regulatory limits with respect to capital. When analyzing Canadian banks, if investors look at normalized earnings power, they will witness an industry trading at 10 times earnings (very low), dividend yields of 4-5% and little possibility of breaching regulatory limits. This is an opportunity that we are watching closely for an entry point for our clients.

Another reason to expect increased stock market volatility is that earnings disappointments may become more common especially in some previous leadership sectors such as materials. With oil and metals prices at high levels one would think that the backdrop would be quite favourable for all these companies but that has not consistently been the case. Obviously the commodities story has begun to wane as operating costs have risen, commodity prices have leveled or declined (except oil), and economies have begun to falter. These are the key reasons that we have reduced client exposure to these areas.

Looking at corporate profits overall, a diminished profit picture emerges which is particularly apparent in domestic U.S. companies (i.e. low international business exposure) and in Canadian manufacturing (curtailed by the high Canadian dollar). In general, a primary reason for the declining earnings trend is the squeeze on margins as labour costs have risen, and productivity gains have eroded. Of course, many financial services, consumer discretionary and housing related companies are facing large profit declines or outright losses. This is not meant to scare the reader, but rather to emphasize the need to focus on individual securities and the opportunities they offer within sectors or markets that may look to be out of favour.

We are mindful that the stock market can be a leading indicator but our investment focus will be defensive until we know with some comfort, how much of the uncertainty is reflected in stock prices. High quality companies that are largely self-financing, with improving fundamentals that have generally been ignored and will continue to build value for investors will be our focus.

Fixed Income Markets – Limited Opportunities

Regardless of the efforts by the central banks worldwide to restore liquidity to the financial system, severe dislocations in fixed income markets remain. Globally, all but the safest of government bonds have been contaminated by the carnage in structured credit markets. Spreads across a wide spectrum of quality and term are much higher today then at mid year. The dislocation in credit markets witnessed downgrades of major bond insurers who have exposure to the collapse in structured finance vehicles and sharp downgrades in the ratings of a host of fixed income products.

In Canada, corporate spreads across the yield curve have ballooned. Investors are clearly seeking safe haven by aggressively purchasing government bonds, especially those at the front end of the yield curve, causing yields to drop. The yield on ten year government bonds has also dropped significantly but the net result has been a steepening yield curve. The rally in government bonds has meant significant gains to investors in longer dated securities and there is no doubt that the fixed income market is pricing in a very bleak economic outlook for the coming year. Heightened demand for liquidity and safety will ensure a high floor under government bond prices. An abrupt shift in inflation and/or growth expectations would be needed to uproot the leadership displayed by government bonds but that seems doubtful in the near term.

However, this shift cannot be ruled out. We are cognizant of the financial market maelstrom in 2007 which led major central banks to shift their policy 180 degrees from a tightening mode in mid year to an easing stance by mid September. The central banks all set aside inflationary concerns in their coordinated efforts to deal with the credit crunch. Unfortunately, in acting decisively to rescue the financial system today, central banks may be even more determined to demonstrate their anti-inflation credentials in the future. Another swift change in direction by central banks may be an attempt to balance conflicting objectives.

Currently, our strategy is to remain defensive. We are maintaining durational exposure significantly lower then the broad market and have been steadily expanding our holdings of Canadian government bonds. We continue to track corporate spreads, and will be prepared to add corporate credit exposure once we are convinced that the steady widening in credit spreads has stabilized.

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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