Barrantagh
Investment Management

# CAPITAL MARKETS REVIEW
# FOURTH QUARTER 2008

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- The migration of the global credit and banking crisis to the real economy has induced recessions in the U.S., the Eurozone, the U.K. and Japan. Economic downturns are also prevalent in many developing economies. China, India and Russia all face much slower growth.
- Canada's economy has not been insulated from the global downturn and has now entered a flat to negative growth phase.
- Faced with deteriorating balance sheets, tighter credit conditions and weak job markets, consumers everywhere are retrenching. Consumer de-leveraging has become a priority as it has in the corporate and hedge fund world.
- Central Banks and governments continue to respond decisively; delivering dramatic rate cuts, massive liquidity injections and credit market support initiatives along with the promise of large scale stimulus plans. These initiatives are powerful but will take time to take effect.
- The quasi-nationalization of the U.S. and European banking systems (through takeovers, bailouts and guarantees) has vastly expanded government's role in the financial services sector. Banks have become risk averse. Evidence that monetary ease and capitalization of banks is filtering through to bank customers will be a key that credit markets and lending activities are functioning more normally.
- Several factors suggest a more constructive investment environment will emerge in 2009 including the coordinated efforts of central banks to monetary ease, government commitment to stabilize the financial system and massive stimulus packages on the way. Mr. Obama, seems prepared to take aggressive action as needed.
- Equity markets discount economic downturns well in advance. Volatility can be expected but we believe markets are attempting to form a base for a sustainable recovery in 2009. Macro news has overshadowed the positive value added from specific stock selection.
- Within fixed income we do not expect a fast reversal in spreads, but we believe that opportunities to acquire high quality corporate issues at very attractive spreads will develop.

## Economic Backdrop – Global Recession Takes Hold

2008 was clearly a demarcation year as the credit crisis engulfed the financial industry and induced one of the worst recessions in the U.S. and elsewhere since the 1930's depression. The year was full of the unexpected including the quasi-nationalization of the U.S. and European banking industry, unprecedented intervention by governments and Central Banks in the global financial system, the steepest downturn in housing since the 1980's, the collapse of the U.S. auto industry, the spiking of oil prices to US$147 a barrel and its swift collapse below US$40, and the stampede to "safe haven" money market securities which traded at zero yield. The steep sell off in equity markets capped a tumultuous and unpredictable year. The year ahead promises to be a period of substantial adjustment to a rapidly changed economic and capital market environment as many established opinions about the financial system and the economy have been shaken.

Today's economic landscape represents a sharp break from a long period of global growth at a 4% to 5% rate. Global growth will likely slide well below 3% in 2009. Major developed economies will struggle to recover from recessionary conditions with all that entails including bankruptcies, consumer and corporate belt tightening, and rising unemployment. At centre stage is the U.S. economy which is expected to contract by an annualized 3% rate in the fourth quarter of 2008 and further slippage is anticipated in 2009. U.S. consumers have felt the brunt of this economic downturn as indicated by the third quarter 3.7% annual rate of decline in real consumer spending, the largest drop since President Carter's 1980 credit controls. The loss of over 1.5 million U.S. jobs since September portends further consumer weakness. Many households are now over leveraged and under funded after years of credit binging. Accordingly, 2009 may be a transition year away from spending towards a saving psychology which could depress economic growth for some time. On the corporate scene, capital spending cutbacks and layoffs are in the offing for many companies as the prospects for demand at home and abroad look dismal and funding for expansion has become scarce. Indices for both manufacturing and non-manufacturing activity in the U.S. have hit 27-year lows. Weak demand isn't the only issue. All sources of funding including debt and equity have become either unavailable or prohibitively expensive, and internal funds are shrinking as profits fall.

In Canada, the situation is not currently as dire as in the U.S. but the Canadian economy will be dragged down by the weakness of its global trading partners. In the emerging world meanwhile, GDP growth rates will moderate significantly but in several countries, notably China and India, solid, albeit lower, economic expansion will likely occur based on an expected shift from exports to domestic demand.

Inseparable from the state of the economy is the world's financial system where a substantial overhaul of its rules and infrastructure will begin. In the U.S. and Europe (but not in Canada) governments and Central Banks have taken control of large segments of the banking system. As well, massive market-driven consolidation has occurred and will continue. Finance will be increasingly dominated by large universal banks with a new aversion to risk. Of course the credit crisis will transform the financial landscape far beyond the government rescues. Banks will reconsider their business models, their products and their risk controls. As an aside, the struggle over how to regulate finance will not be smooth. The rescuers will demand too much and the rescued will do their best to preserve their latitude. This conflict almost guarantees an unsatisfactory outcome.

In politics a new era is unfolding in the White House as Barrack Obama becomes America's president. Political leadership is critical at this time given the new balance between governments and markets in the economy and the financial system. Together with a democratic congress, Mr. Obama has a chance to bring about bold reform. He is committed to stimulus packages to help America out of recession, but has huge promises to keep as well, including tax cuts to 95% of families and a near universal health care program. His task is daunting but his leadership may be the catalyst to restored confidence in the economy and capital markets.

## Equity Markets – Discounting the Worst

With the steep sell off in late 2008, equity markets in North America and around the world suffered through one of the worst years in recent history. The S&P/TSX Composite declined 35%, the S&P500 declined 38%, and the MSCI World Index fell 44%. The massive exodus from equities produced losses for all geographic markets, industry sectors, and capitalization categories. In the U.S. the selling erased about 5 years of gains for the S&P 500.

Investor confidence has been justifiably undermined this past year by the destructive impact of this year's financial turmoil. Investors have been somewhat calmed by the proactive steps taken by governments and monetary authorities to stabilize the financial system. A rash of bank mergers may ensue in the coming year, but it appears that a collapse of the system has been averted. Going forward the focus will be more on the state of global economies and the flow of news on interest rates, consumer behavior, housing markets and employment. Last year the macro bad news on the economy swamped any specific micro news that might have helped stocks to appreciate in a more normal environment. All stocks seemed to sink together and in the short term, stock selection based on improving company fundamentals seemed to become an irrelevant skill but did actually generate a lot of positive relative performance in a negative environment. Given the expectation of worsening economic conditions into 2009 macro factors may well continue to dominate the news.

Against this background there are a number of factors in place that suggest a more constructive capital market environment will emerge in 2009. First, Central Banks around the world are fully committed to providing monetary ease. Short rates have been lowered dramatically in the U.S., Europe and China. As well, the Fed has intervened in credit markets to bring longer term rates down with some early success. Spreads between the rates commercial banks charge each other and U.S. T-bill rates has narrowed–an early sign of improving money flows between banks and their customers. Secondly, governments are standing by their Central Banks and behind the financial system. Thirdly, massive fiscal stimulus packages are now underway or planned in the U.S., the EU, Canada and even China. All of these actions will take time to have an affect but 2009 should witness results.

Interestingly, in times of market turmoil and economic downturns stock markets typically lead recession data by at least 6 to 9 months. As a discounting mechanism, today's stock markets have predicted this economic downturn by 12 to 18 months and may do so for the recovery. Meanwhile, the stock market appears to offer good value on the basis of several basic measures. First, price to earnings (P/E) ratios are at their lowest levels in the past 30 years. With interest rates roughly half of what they were in the late 1980's and early 1990's, the current market would seem particularly attractive on a P/E ratio basis. Of course, the earnings component of the P/E ratio may be questionable as companies enter one of the toughest earnings environments in years. However, even on calculations of normalized earnings, P/E ratios are low. Other measures of value such as price to book value and dividend yield also indicate attractive market valuations. Price to book values have reached lows not seen since the early 1990's while the yield on equities has risen to levels not available in over 20 years. A key indicator is the yield based on cash flows earned by a company after commitments to maintain or expand the business, i.e. free cash flow yield. By this measure, many large capitalization stocks have reached valuation levels rarely seen in recent years. Of course, stock markets have experienced extreme volatility over the past year and the path of markets in the near term is extremely difficult to gauge. The slowing global economy and the overhang from the credit and banking crisis make it difficult to pontificate on when the market will recover. Nevertheless, the above valuation measures demonstrate that equity prices provide a reasonable balance of risk and reward for the patient longer term investor.

In our screening of companies for investment opportunities we will continue to focus on companies that generate free cash flow based on the sustainability of their operations. In this environment gauging financial strength is paramount.

## Fixed Income Markets – Risk Perception Evolves

2008 ended for the fixed income markets on a similar note to the preceding two quarters. There was a steady flight to quality, with investor buying concentrated in the federal government bond market. Corporate credit spreads continued their inexorable march wider, and much of the liquidity in non-government issuers dried up.

2009 is likely to see a gentle and slow paced reversal of some of the trends of the past year. The continuous and creative efforts of the western Central Banks and government treasuries will gradually improve confidence in the corporate bond market. This will in turn increase liquidity and generate a reversal in the spread trend. A big unknown for the bond markets in 2009 is the impact that the new funding required by the multitude of government or government guaranteed activities (TARP, auto industry bailouts, etc.) will have on the government bond markets in Canada and elsewhere. For example, in the U.S. new Treasury bond issuance should climb sharply to fund $300 billion in proposed tax cuts and $775 billion in stimulus on top of the cost of the various programs already approved by Congress. In addition there will be hundreds of billions of dollars of private sector debt issued, particularly financial institutions, carrying a government guarantee. Total borrowing in 2009 by the U.S. Treasury is expected to exceed $2,000 billion, or roughly 14 percent of GDP. This will come at a time when investors have reached significant overweight positions in U.S. treasuries as a result of the 2008 flight to quality. In other words, just when the U.S. needs buyers they are likely to find sellers! This should in all reasonable expectations drive U.S. government bond yields higher through 2009 and beyond. Of course this trend will be accelerated or delayed by the rate of economic recovery and the growth of global liquidity and consumer confidence.

In Canada we have watched the widening of corporate credit spreads throughout the fourth quarter. This has been particularly impressive in the case of bank issued paper. Worth noting is that Canadian bank debt traded through lesser quality non-bank credit spreads. This is a function of the public's perception of financial institutional risk and the banks issuing huge amounts of paper to shore up their regulatory ratios. Meanwhile, non-bank entities have not been issuing debt. This amply illustrates the perils of the market, and the inefficiencies from which we hope to benefit.

As this year progresses and trends develop, we will return to the higher quality corporate bond market where mandates permit. In the meantime, we expect government bond yields to remain low, and even fall further as the full weight of the recession is felt. We do not expect a fast reversal in spreads, but we believe that opportunities to acquire high quality corporate issues at very attractive spreads will develop. We will ensure that portfolios remain short duration to protect against the possibility of rising government bond yields, and we will be broadly diversified to defend against individual company or issue structure concerns.

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**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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