Barrantagh

Investment Management

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- World GDP in 2010 rose nearly 4%, much more than prognosticators initially expected, adding to a prevailing sentiment of optimism for 2011 with predictions of growth equal to or greater than last year on hopes that expansion in developed nations picks up.
- The BRIC (Brazil, Russia, India and China) communities continue to flourish while looking to control growth and inflation through monetary and fiscal means. Meanwhile the Euro-zone and North American economies hope to improve upon the low but positive growth in 2010. Accommodative fiscal and monetary policies are expected to remain in place until there is some assurance that consumer confidence has returned. Indications of this will arise through increased employment, increased consumer spending and possible signs of inflation.
- The picture for growth in the U.S. is mixed but current indications suggest that the optimists should prevail as President Obama has decided to renew the soon to expire Bush era tax cuts and will probably continue to use whatever means possible to bolster his party's fortunes as they look to the elections in 2012. European nations continue to display a united front as they bail out their debt laden neighbours. Even China has come to the rescue helping to support Portugal in its efforts to deal with its debt, instilling a positive mood.
- As we move into 2011 it is notable that countries are starting to become obsessed with their own internal issues, leading to policy shifts and possibly less cooperation on the global front. The net result of these changes is unknown at this point but does seem to create the greatest area of uncertainty for 2011 and therefore becomes the greatest known item of risk.
- The last six months for equity markets have been extremely positive. Therefore, equity markets may be volatile and somewhat sluggish in the first quarter as they await validation from the economy that the enthusiasm is warranted. However, based on the continuing health of the economy and corporations in general, overall we look to a positive performance for 2011 as valuations in most market sectors appear reasonable. Barring any unforeseen economic shocks the largest risk seems to be inflation which looks to be a later 2011 or 2012 phenomenon.
- The long anticipated "QE2" (Quantitative Easing) program was released by the U.S. Federal Reserve hoping to reduce interest rates. Due to a stream of positive economic news, the opposite has occurred with treasury yields rising, leading many to question whether or not QE2 was required in the first place.
- In Canada, interest rates are on hold as our growth sputters but corporate bond spreads have tightened due to the seemingly endless demand. Looking to hedge possible inflation concerns for 2011 we have added Real Return Bonds to our clients portfolio mix.

Economic Backdrop – Growth Gathering Momentum

Global output rose by close to 4% in 2010 which is a much healthier outcome than forecasters were expecting a year ago. The financial sector is much less leveraged and more closely scrutinized. A traumatic adjustment in housing prices across the U.S. and a cleansing of finance practices has occurred but the worst seems to be over. The questions now are: will 2011 see a continuation of the trend and what are the risks of destabilizing events in key regions? At this point in time optimism seems to be the prevailing sentiment. For example, the IMF expects the world to expand at close to 4% again this year. Of course, a simple summing up of Global expectations masks huge variances across regions. China, India, Brazil plus emerging markets in Asia, Latin America and Eastern Europe seem poised for continued strong growth. China is expected to grow by 9%, even with efforts by its Government to head off possible bubble effects after 10% growth in 2010. In Europe and Japan growth will be much weaker. The Euro-zone is expected to grow by 1.5% in 2011 following 1.7% in 2010. Of course the European debt crisis and Government austerity announcements could have been more damaging without the cooperation of the stronger members, particularly Germany, on rescue plans. Risks remain that countries other than Greece and Ireland, will require bailouts but the near term crises seems contained for now and the systematic risk consequences of the ultimate debt restructurings required can be delayed to a time when European banks can better absorb the outcome.

In 2011 the Canadian economy is expected to grow by 2.5% down from an estimated 3% in 2010. The strength of the Canadian dollar is a drawback for the most part and our major trading partners are expected to grow only moderately in 2011.

In the U.S. the picture is mixed and opinion on the outlook spans wide ranges. The doomsayers see the economy as largely stuck in a rut and unable to grow above 2.5% in 2011 down from an estimated 2.8% in 2010. Their position is that companies won't hire to redress the 9.6% unemployment situation because of weak economic growth prospects. Consumer spending will be restrained because of household efforts to rebuild savings. As well, the U.S. may have some difficulty relying on exports to restore growth. China and others are biased to keep their currencies depressed to gain an oversized share of global demand and the U.S. will have difficulty competing. On the other hand, there are signs that U.S. GDP growth is accelerating faster than originally expected aided by surprisingly expansionary business, rehabilitation of consumer balance sheets and the continuing effects of accommodative fiscal and monetary policy. The optimists also point to healthy corporate profits, strong corporate balance sheets and surprising increases in productivity as further support for above consensus economic performance. All in all, the optimists suggest growth of the U.S. economy in the range of 3 to 3.5% is realistic for 2011.

So what are the risks to the generally positive scenario? At the top of the list is the extent to which the U.S. economy can become self supporting as fiscal and monetary policies wane. Secondly, the consequences of a shift to a world where a Euro-area country becomes bankrupt are not entirely clear. Accordingly, the Euro-zone remains a source of stress both financially and economically.

Turning to the larger emerging markets, isolated worries about asset bubbles have been replaced by concerns over inflation more broadly. To head off steep price acceleration, some emerging economies will need restrictive policies next year including higher interest rates, and these policies could easily be miscalculated. Accordingly, the odds of a macroeconomic shock from the emerging economies cannot be dismissed. Risks, of course, still plague the U.S. economy as it treats itself to another round of stimuli just when Europe is attempting to implement austerity programs. What stands out the most is how the world's major economic regions have shifted from the exercise of global cooperation to avoid a depression to an obsession with internal problems and widely different policies for dealing with them. As a result, the global economic environment and capital markets operating within them have become extremely complicated and vulnerable to macro-economic shocks even as global growth seems to be gathering momentum.

Equity Markets – Hangover Cure Working

Similar to a New Years Eve hangover and predictable recovery to normal health that some may have experienced, performance in the equity markets during 2010 seems to indicate that the 2008 hangover has all but disappeared and markets are feeling a lot healthier. Administered by governments around the globe, the hangover cure for the markets included a mix of artificially depressed interest rates, growth in money supply and increased government stimulus to replace the consumer spending withdrawal. Not unlike other times when we pray the pain will end, equity markets around the globe have climbed a wall of significant worry including a possible economic double dip, European debt crisis and deflationary concerns, to stage impressive gains with the S&P/TSX up 17.66% and MSCI Global index up 5.89% for the year. Much of the returns were concentrated in more economically sensitive names such as small capitalization securities, gold and resource related names in general, (which is a majority of the Canadian markets weighting) helping the S&P/TSX to excel in 2010.

Given the extreme volatility of recent economic events and the number of countries involved around the globe it was prudent to be conservative from an investment stand point. However, with 20-20 hindsight this recovery seems to display similar traits to previous recoveries which suggest it has some staying power. For instance, the persistent investor worries that the recovery will fail while using any "weaker than expected" economic numbers as evidence that a double dip was about to occur has been common in previous recoveries. This happened to an extreme in the summer months when economic numbers paused or pulled back somewhat. As well, markets reacted quite violently to the debt situation in Europe but have since regained more than the sell off even though some countries in Europe will be struggling to manage their debt for some time to come. If this recovery has some of the same "ear markings" as previous recoveries then what can we expect for 2011? Firstly, we expect positive market returns for 2011. Returns may not match 2010 but should be positive, driven by continued economic growth and multiple valuation expansion. Secondly, consumers will return to their spending ways as employment picks up. This will replace government stimulus and drive top line revenue numbers for corporations allowing dividend increases, merger and acquisition and stock repurchasing activities to continue or possibly increase. Thirdly, as mentioned in the economic section, there will be more emphasis on each country dealing with its own internal issues as opposed to the global policy coordination we have witnessed in the aftermath of the recession/banking crisis. The more isolationist approach of various countries and economic blocs is somewhat of a wildcard for individual equity markets in 2011, and the stocks within those markets, but opportunities for investment will surface. Lastly, we believe growth will pick up around the globe and inflation will become a later 2011 or 2012 concern. History demonstrates that inflation associated with an economic recovery and rising stock markets are not inconsistent but runaway inflation and a strong policy response by central bankers may have a negative impact on market valuations. We will monitor inflationary trends closely as we put money to use in 2011.

With these thoughts in mind we have taken steps in the fourth quarter to position client's accounts for 2011 and remain cognizant of any "binge investing" which may cause frothy valuations that usually result in unwelcome hangovers. For example, we purchased General Motors (GM) which has returned to the market after transforming its operations and repairing its balance sheet. The valuation relative to the other automotive players is cheap at 6 times cash flow. Automotive sales around the globe have been improving and GM should be a large beneficiary with its high sales exposure (40% of sales) to the BRIC (Brazil, Russia, India, and China) communities. Another name we purchased for clients is Gasfrac Energy Services which is in the business of fracturing oil and gas wells to increase the productivity of the well. Not only does the supply/demand equation favour companies who perform fracs at this time, Gasfrac is uniquely positioned because it is the only significant player to use liquefied propane gas to perform fracs. This results in higher productivity in certain reservoirs versus conventional fracturing and is also more environmentally friendly.

Fixed Income Markets – Demand/Supply Imbalance

The global economic scene has been rife with developments that have caused day-to-day changes in bond market prices as investors are driven by short term global movement between more risky assets (corporate debt and equities) "risk-on" and low risk assets (government bonds) "risk-off". The most recent concern has been the funding woes of Ireland which had to be bailed out by the International Monetary Fund (IMF) and the European Central Bank. A brief calm ensued but sovereign concern erupted for Spain and Portugal creating further gyrations for bond markets. On a positive note, news that China has emerged as a buyer in Q1 2011 of 4 to 5 billion Euros of Portuguese government debt buoyed the market substantially. The Chinese government has stated clearly that they are prepared to take "concrete action" to help Euro zone countries deal with their funding crises and also to support the IMF in this effort.

In North America, after much posturing, the U.S. Fed finally embarked on the much anticipated quantitative easing program dubbed "QE2". The stated objective of the QE2 program was to drive government bond interest rates down to a level that will encourage investors to rotate to higher risk, higher yielding assets. The effect so far has been largely the opposite as a plethora of economic news, some with inflationary consequences, overwhelmed the QE2 initiative and caused treasury yields to rise sharply, driving up the cost of funding for corporate America. President Obama ultimately had to find other means to support economic growth, and found it in a deal with the Republicans to retain the Bush era tax cuts (which were expiring shortly). This step, coupled with a 2% reduction in payroll taxes and the extension of unemployment benefits, is expected to put money directly in the hands of those consumers that have shown the greatest propensity to spend: the U.S. consumer. The estimated cost of these programs ($500 billion) in addition to record new debt issuance required to fund the $1.4 trillion budget deficit will have to be financed. The U.S. will have to walk a tight line in 2011 between letting interest rates rise to make U.S. debt attractive for investment while not punishing existing holders of the $8.75 trillion already outstanding.

The Bank of Canada has put its program of tightening monetary policy on an indefinite hold. In the course of the quarter the Canadian yield curve shifted upwards by 30 to 40 basis points. New corporate and provincial issuance continued strongly through the quarter, despite the slowdown enforced by the Canadian banks financial year-end at the end of October. In contrast to previous quarters, this time around the new issue concessions have been scant and many of the issues have been aggressively priced. On the other hand, the sheer volume of investible funds has meant that the new issues have been heavily oversubscribed and buyers had their allocations cut back sharply. This highlights the paradox. So much money has flowed into the fixed income market this year that spreads have been pushed gradually tighter. This is not because all issues have compelling credit stories but simply buyer demand overwhelming the supply.

We continue to look for compelling credit opportunities, but at the same time have added Real Return Bonds ("RRB") to the portfolio mix. We expect that inflationary pressures which have been absent this past year will emerge as economic growth takes hold in the U.S. and ultimately in Canada. RRBs provide a gentle hedge for the bond portfolios against the impact of rising inflation and interest rates as the central banks act to fight inflation. We believe that central banks will be distracted by the need to encourage economic growth and will be prepared to let "a little" inflation bubble up.

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