Barrantagh

Investment Management

CAPITAL MARKETS REVIEW

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- As 2012 gets under way, it is apparent that the global economy will continue to grow but at a subpar rate. The U.S. economy seems to be re-accelerating but remains fragile. European leaders do not seem to be acting with any sense of urgency, even though they realize that their countries teeter on the brink of recession. Growth in emerging markets is still very high but decelerating, suggesting a lower overall contribution to global growth.

- In key countries, particularly the U.S. and France, the election cycle is not helpful. Political infighting in America over government debt reduction, fiscal stimulus and tax reform shows no signs of abating and European leaders are unlikely to agree on bold measures to resolve the Euro-zone's problems. The most likely scenario is that key economies will not quite weaken enough and the European debt crisis will not quite deepen enough to force squabbling politicians to take meaningful action.

- Led by German Chancellor Merkel and French President Sarkozy, Europe has made valiant attempts in the fourth quarter to ease investor's minds with-respect-to Europe's sovereign debt crises. As per investor's wishes, amongst other policy initiatives, the European Central Bank (ECB) has lowered rates, the EFSF (European Financial Stability Facility) was established and the banks have been offered capital. Still, against this backboard, investor angst will likely remain high until a more certain outcome takes hold.

- After a difficult third quarter for equity markets, the fourth quarter witnessed positive moves in reaction to stronger economic numbers in the U.S. and the policy moves in Europe. As long as these continue to improve, albeit at an agonizingly sluggish pace, it should be a recovery year for equities based on strong fundamentals and low valuations. Despite the potential for a positive year in equities, we believe that the macro background suggests that investors will be risk adverse. This risk aversion along with the low yields in the alternative asset classes (bonds and cash), will continue to drive investors towards dividend paying stocks while avoiding economically sensitive plays until the macro issues have stabilized and economic growth exceeds current expectations.

- Fixed income markets have benefitted from the uncertainty of the macro developments as the flight to safety/quality argument remains valid. Although steps are being taken, the European sovereign debt crisis has yet to play out to its final conclusion. Greece may have faded from the headlines as one Euro-zone country after another has admitted their shortcomings, but going into 2012, the risk to the Euro and to the integrity of the Euro-zone, remains as significant as in 2011. It is by no means clear that the European nations (particularly Germany) have the collective resolve or mandate to see it through to its logical conclusion.

- With the buying pressure focused on the long end of the curve, real rates are historically low. This movement can only be supported by further economic slowdown or continuation of the fear trade, which seems to be the most likely scenario for the near term.

Economic Backdrop – Global Policy Paralysis

The growth surge in 2009, as the global economy emerged from its deepest downturn in decades, faded somewhat in 2011 with global GDP likely coming in below 4% compared to 5.1% in 2010. In part, this trend reflects the lag effect of the efforts of banks, households and businesses to pay down excessive debt accumulated during the boom years ("deleveraging"). Of course, a more vigorous recovery was also dampened early on by high oil prices and the disruptions from Japan's tsunami. The good news in the U.S. is that private deleveraging is advancing steadily. U.S. banks have rebuilt their capital and total bank loans, which shrank from 2008 to early 2011, are now showing signs of stabilizing. Meanwhile, household saving has settled at around 5% of disposable income. There are other signs that the U.S. economy is on the road to recovery: the housing market is gradually improving; employment is growing albeit at a sub-par pace; manufacturing is recovering and retail sales, particularly car sales, have picked up. Furthermore, inflation is expected to slip below 2% in 2012 assisting consumer purchasing power and encouraging the Federal Reserve to maintain its pledge of near zero short-term interest rates. However, sustained growth is far from a certainty. The all important U.S. economy faces the disadvantage this time that much of the non-U.S. developed world is struggling to maintain growth and less able than in previous cycles to fill the vacuum of shrinking private and government spending with exports to America. Domestically, the expansion of the deficit in 2009 to head off a banking crisis and spur an economic recovery absorbed a lot of the contractionary effect of private deleveraging. Now the opposite is taking place. The congressional "super-committee" failed to tackle deficit reduction due to political posturing, which means that "by default" about $1.2 trillion in spending cuts and tax-break expirations will take effect in 2013. More ominously, it seems clear that nothing of substance will be passed to assist the economic recovery until after the presidential election on November 6, 2012. At this stage, a grand design, which the U.S. so desperately needs, involving an intelligent approach to spending cuts and reform of the tax code coupled with delays to tax increases is only a distant hope.

Overseas, the obvious failure of Europe's "muddling through" strategy continues to concern markets. The Summit in Brussels in early December failed to draw up a plan to save the Euro. The leaders did pledge extra money in the form of loans to the IMF and left open the possibility of shoring up the Euro zone rescue fund, but the "fiscal compact" reached at the Summit seem to dwell unduly on austerity at a time when growth is a priority. While the compact was heralded as a sign of European solidarity, it may in fact promote more strife as voters rebel against being required to assume a responsibility for the problems. Furthermore, the summit rejected the idea of Euro bonds to mutualize sovereign debt. Exacerbating these issues, the President of the European Central Bank (ECB) squelched the idea that the bank might step up its purchases of troubled Euro zone country debt. The summit did pledge 200 billion pounds to the IMF but, even if matched by others, the funds available would be inadequate and not persuasive to skeptical investors that Euro zone countries are safe from runs on their bond markets. Meanwhile the outlook for the euro-area economy has deteriorated rapidly, suggesting a wrenching slowdown or recession which will limit the scope for growth.

In Asia, the lift to Japan from reconstruction following the tsunami will fade moving into 2012. Nevertheless the comparison with the depressed earlier levels of economic activity should result in a better than 2% rise in GDP in 2012. Elsewhere in Asia the upcoming year is shaping up as one of transition in some key emerging markets. China's remarkable growth trajectory to date is showing signs of downshifting as a mix of policy moves aimed at controlling growth, inflation and the overheated housing market increasingly hits home. As well, the economy shows signs that it is being adversely affected by softer growth abroad. Notwithstanding these developments, a true "hard landing" does not appear likely since the Central Bank of China has begun to ease monetary policy. Accordingly, growth may slow to a 7 to 8% pace in 2012 after a rise of over 9% this year. The deceleration in global growth has been more pronounced in India with industrial production moderating and the reserve Bank of India intervening to quell double digit inflation. Nonetheless, India is expected to achieve growth of around 7% in the coming year. On balance, the emerging markets seem poised for solid growth in 2012 but their contribution to North America and Europe will not match that of previous years.

Summing up the state of the world economy as 2012 gets under way, it is apparent that the U.S. economy remains fragile, that Europe teeters on the brink of recession and that growth in emerging markets is decelerating suggesting that global economic growth will remain somewhat muted.

Equity Markets – Dividends Favoured

The overriding theme for Equity markets in 2011 was Europe and although the markets are hopeful, as always, they seem to remain skeptical that the many actions taken by Europe to solve their sovereign debt crisis will have the desired outcome. In the fourth quarter, the EFSF (European Financial Stability Facility) was funded. This is similar to the TARP funding (Troubled Asset Relief Program) that was used successfully by the U.S. during the 2008 crisis. As well, late in December, European banks were offered (and many accepted) cheap capital by the European Central Bank (ECB) through the LTRO (Long Term Refinancing Operation). Meanwhile, the ECB reduced interest rates twice during the quarter to help fend off a possible recession or at least mitigate the depth of a recession which seems to be embracing Europe. As mentioned in the Economic section, there is hope that the stronger than expected U.S. economic numbers along with China and others may help offset the European drag on the global economy. Almost unnoticed is that companies have been doing well despite the financial and economic malaise. Over 70% of companies have reported better than expected sales and earnings, while maintaining strong balance sheets. However, investors continue to focus on yield driven investments while shunning economically sensitive stocks even though valuations may favour riskier investments. The result for the fourth quarter was positive returns for all markets but the volatility remains very high. The S&P/TSX was up 3.60% for the quarter and the global markets as represented by the MSCI were up 5.33%. However the return for the year remained disappointing with returns of negative 8.70% and negative 2.85%, respectively.

As we enter the new year, the backdrop for equities remains positive but we believe the following themes will influence our equity investment discipline throughout 2012. First, although we are happy to see the positive returns in the fourth quarter, one cannot help to notice the day-to-day volatility that consumes investors in today's market. This seems to provide the best evidence that investors remain skeptical with-respect-to strong economic growth returning any time soon but are also skeptical that a double dip is about to unfold. Slow economic growth remains the most probable outcome. Secondly, Europe's debt predicament continues to be on a slow path to recovery and the credit rating agencies seem ready to downgrade several sovereign issuers in the new year. The market is already discounting this event but an adverse reaction is always possible. Thirdly, macro issues such as the U.S. budget "negotiations", European growth, China orchestrating a soft landing and the health of the consumer, cannot be ruled out as either negative or positive surprises to prolong the volatility witnessed during 2011. Fourthly, low t-bill and fixed income yields are part of the constructive background to solid fundamentals for equity securities including low relative valuations and strong financial positions, suggesting that in a more stable macro environment, investors would be driven towards equities.

To position our clients to take advantage of these market conditions, we are investing in securities which we believe should do relatively well despite any potential negative surprises. For instance, in a slower growth environment, investors would favour dividend paying stocks. Achieving a good part of the return from less risky dividends, especially in a low t-bill, low bond yield environment makes good fundamental sense. As mentioned in the previous quarterly review, we are focused on dividend paying stocks such as BCE Inc., with a current dividend yield of over 5% and more importantly, a dividend which it can grow over time. In the retail space, companies such as Nike Inc. with a strong brand or Wal-mart with its global growth, strong inventory management and pricing advantages place them at the head of their class. With the longevity of the consumer's consumption appetite in question and the consumers accessibility to electronic shopping aids (on-line price comparisons and on-line shopping) driving the retail space closer to a commodity like business, retailers must have a brand advantage or be extremely well managed much like Nike and Wal-mart. Companies positioned in growing industries, such as EMC Corp, which supplies storage and software for the cloud computing space can prosper. Cloud computing is a nebulous term but companies are spending on the "cloud" to enhance their technology capabilities and flexibility without spending on infrastructure which ultimately drives productivity and growth. EMC Corp will benefit from this corporate spending. We continue to underweight base metal commodity stocks as well as small capitalization stocks. These business models need a strong economy to drive the revenue line. Given the uncertainty of China's growth and the global economy as a whole, we have chosen to avoid the risk and volatility inherent in these companies unless the valuations decline substantially to reflect the risk or economic growth exceeds current expectations.

Fixed Income Markets – Supported by Uncertainty

The fixed income markets rolled into 2012 much as they ended 2011: with uncertainty and doubt being the broadest held sentiments driving the U.S. and Canadian yield curves down to historic levels. In Canada, when viewed in the context of headline inflation (CPI 2.9% YoY), interest rates all along the government yield curve are below inflation, indicating that market participants would sooner hold an asset with negative real returns rather than other asset classes. In order to interpret this anomaly one can only believe that investors expect a sharp slowdown in the North American economies ultimately driving inflation lower. Alternatively one must conclude that interest rates are too low and we should anticipate an upward shift in rates along the yield curve. The general tone of economic releases in the latter part of 2011, notably the Purchasing Managers Index (PMI) and employment measures, suggests that economic growth in the U.S. and some other markets is showing signs of re-accelerating and that in fact the second scenario may be the most reasonable. Either way the rate of growth should not be expected to rise dramatically in the near term, rather over an extended period of time, consistent with the U.S. Federal Reserve policy holding administered rates near zero into 2013.

A continuing concern to the bond market is the flight to safety/quality argument. The risk of a European bank crisis is rising, and a default by any one of the Euro-zone countries would quickly spill over into the banks. The latest stress test conducted by the ECB indicates a bank capital shortfall of nearly 200 billion Euros. The process of raising this capital would put significant upward pressure on Euro-zone interest rates, at a time when those economies are already slowing. The financial markets are paying particular attention to the performance and exposures of the peripheral Eurozone financial institutions. On a positive note, the ECB is demonstrating through the LTRO mentioned in the Equity section, that they are prepared to assume the role as lender of last resort to the banking sector if not to member countries.

The ECB has cut interest rates twice to add support to the Eurozone countries and at the same time major central banks (including Canada) have reiterated their commitment to hold administered rates at current lows through the coming year and potentially into 2013. The bankers are careful to add the caveat that this is subject to changes in the direction or magnitude in economic growth or inflation, leaving one with the impression that they are keeping their fingers crossed! All the participating countries are also mindful of the currency implications. For instance, despite the rise in the value of the U.S. dollar in the fourth quarter Germany's economic growth has not benefitted due to a decline in demand for German goods elsewhere in the EU or outside. Meanwhile, the higher U.S. dollar leaves the U.S. struggling to grow its share of the international demand for product.

Adding to the cocktail of concerns is the impact of the U.S. presidential election campaign. American politicians tend to forget that the world is listening when they make speeches or propose policy changes as the campaign unfolds, adding to the probable sources of market volatility. Given the importance of the stability of the large holdings of U.S. treasury notes and bonds worldwide, the bond market will be a very interested observer. Building on the pressures in the bond market is the U.S. budget deficit and the steps being taken (or not taken) to bring it under control in time to deal with the 2013 expiry of the federal debt ceiling.

With inflation having proven to be transitory, in line with the central banks' projections, we sold most of the FRN (floating rate note) positions in the portfolios and added duration. Our portfolios remain short duration, but not to the same degree as through the last quarter of 2011. Corporate credit spreads have trended wider through the fourth quarter. We have reduced the exposure to corporate debt slightly and are now monitoring the impact of these moves. We have replaced the corporate debt positions that have been sold down with Provincial and Federal bonds. We expect an increase in the volume of new corporate and Provincial issues in the first quarter of 2012, with the corporate issuers more focused on the "all-in" cost of borrowing rather than the spread. This should provide opportunities for investors to earn excess return in the form of new issue concessions versus outstanding secondary pricing.

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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