Barrantagh
Investment Management

CAPITAL MARKETS REVIEW
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- The market was not anticipating the start of tapering (the throttling back of the Federal Reserve's program of purchasing U.S. treasury bonds and mortgage backed securities) and was caught off guard when the Fed stepped up to the plate and initiated the first round of tapering. This is expected to lead to higher interest rates which will eventually force a slowing in the rate of economic expansion.

- Some slowing would be natural and may be healthy. For instance, U.S. auto sales have continued to expand and house prices rose at a staggering 13.6% rate in 2013. Of course, as we experienced in previous housing booms, home purchases lead to furniture and appliance sales as well, suggesting that the sector contribution to economic growth should endure going into 2014.

- The key events in the fourth quarter were the effective appointment of Janet Yellen to replace Ben Bernanke as Fed Chair, the apparent resolution of the U.S. budget negotiations and the onset of tapering. All of these items are highly significant and auger well for the coming year.

- Geopolitical risks continue to abound. The sabre rattling between China and Japan has moved up a step or two as both countries have increased their defense budgets and Japan is taking the first steps to create a more outward looking military. Meanwhile, both economies continue to perform well with Abenomics (new economic policies in Japan) having the desired effect and China's economy continuing to provide a steady growth rate albeit lower than originally forecast.

- Unemployment remains a key issue throughout the EU, and carries with it the risk of political disorder. In addition, the lack of inflation in the EU remains problematic. On the other hand, EU PMI (Purchasing Managers Index) readings have returned to an expansionary level, indicating slow but positive economic growth.

- Despite equity markets advancing over the last few years and setting "new highs", we do not believe that global equity markets have formed a bubble from a valuation point of view. We believe that this great year for markets can be followed by a good year but concede that volatility may pick up.

- Today, equity markets are trading around their long term average multiple of 16 to 17 time's forward earnings estimates. However, historically when inflation is low and the outlook for earnings is growing more positive, stock multiples tend to trade at higher levels. This supports the view that there is still room for improvement from today's average levels.

- The most evident risk for equity markets, the start of tapering, has always been feared as the beginning of the end for equity markets because interest rates will rise. Rising rates will have a slowing and potentially negative effect on market fundamentals but only when there is an actual tightening in interest rates designed to mitigate the excesses in the economy and possibly speculative extremes in the market. That is certainly not the case today.

- In Canada, the DEX index duration shortened marginally both in the quarter and for the full year. Our continuing strategy of staying short duration paid off handsomely.

Economic Backdrop – Tapering is not Tightening

As the end of the fourth quarter approached, most economic forecasters had convinced themselves that tapering would not begin until well into the first quarter of the New Year. Reasons given ranged from the lack of strong employment growth to an expected slowing of the housing market due to the inevitable rising mortgage rates. For all of the reasons cited, the market was not anticipating the start of tapering (the throttling back of the Federal Reserve's program of purchasing U.S. treasury bonds and mortgage backed securities) and was caught off guard when the Fed stepped up to the plate and initiated the first round of tapering. This is expected to lead to higher interest rates which will eventually force a slowing in the rate of economic expansion.

Some slowing would be natural and may be healthy. For instance, auto sales have continued to expand and house prices rose at a staggering 13.6% rate in 2013. The average age of the car fleet in the U.S. is near 12 years, which is well above the level that normally should stimulate replacement purchases. The steady rise in auto sales in the fourth quarter seems to be confirmation. The housing market survived the government shutdown and the rise in mortgage rates, and shows every sign of continuing its expansionary path in the New Year. The strong performance of the stock markets has contributed to the wealth effect, and so between buyers feeling more confident and the general deleveraging of consumer balance sheets, housing demand has continued to grow. Of course, as we experienced in previous housing booms, home purchases lead to furniture and appliance sales as well, suggesting that the sector contribution to economic growth should endure going into 2014.

As has been observed on a number of occasions the U.S. economy needs to create 225,000 new jobs each month in order to absorb new workforce entrants. Job creation in 2013 has been disappointingly slow, but in the fourth quarter finally started to expand. The average for the last two months has been in excess of 200,000 with manufacturing picking up. The expansion in auto sales bears witness to this trend.

The key events in the quarter were the appointment (subject to final approval by the senate and house) of Janet Yellen to replace Ben Bernanke as Fed Chair, the apparent resolution of the U.S. budget negotiations and the onset of tapering. All of these items are highly significant and auger well for the coming year.

Janet Yellen is credited as the driving force behind quantitative easing. In speeches and statements made in the last month she had indicated a growing concern with the disinflationary forces at play in the economy, and was seen as being more concerned about this than the growing Fed balance sheet. While the role of Chair remains Bernanke's until the end of January, it is safe to assume that he deferred to her leadership in December.

***Fed policy remains solidly expansionary, but notice has been delivered that the punch bowl won't be there forever*.**

The relatively minor reduction in bond purchases ($10 billion reduction from the current $85 billion monthly total) is not important in its magnitude, but rather in the change in direction. However, "lower for longer" remains integral to monetary policy which implies that the unexpectedly low inflation rate will fix itself as the stimulus is withdrawn over time. In addition, Yellen is often quoted as saying "tapering is not tightening". Therefore, Fed policy remains solidly expansionary, but notice has been delivered that the punch bowl won't be there forever.

Geopolitical risks continue to abound. The sabre rattling between China and Japan has moved up a step or two as both countries have increased their defense budgets and Japan is taking the first steps to create a more outward looking military. China has taken two overtly aggressive steps of note. The first is the establishment of a substantial blue water fleet, now including an aircraft carrier. China wants to be taken seriously as a naval power as well as an economic power. The second is the imposition by China of an air defense identification zone (ADIZ) over Japanese-held or disputed territory. While ADIZs are not unusual in general, at issue is the question of how aggressively China will enforce its zone. Accidents happen, and in this setting the consequences can be dramatic. Meanwhile, China's economy continues to provide a steady growth rate albeit lower than originally forecast. The Chinese manufacturing PMI is flat month over month but mitigating this is a positive shift towards consumer consumption.

In Europe, France has taken the next step in implementing the "millionaires tax", intending to levy a 75% income tax on salaries over one million Euros. The London property market is primed and waiting for the inevitable wave of buyers. The irony is that in the 1970s a similar punitive tax regime in the U.K. drove British taxpayers into France! Unemployment remains a key issue throughout the EU, and carries with it the risk of political disorder. The lack of inflation in the EU remains problematic. On the other hand, EU PMI readings have returned to an expansionary level, indicating slow but positive economic growth.

Equity Markets – Bubble Talk

Throughout 2013 we continued to be bullish on stocks, especially versus other asset classes, and we are gratified that it has been a great year. However, as equity markets have moved higher there is a growing voice that suggests markets may be in a bubble and it will have to burst. Despite the markets advancing over the last few years and setting "new highs", we do not believe that global equity markets have formed a bubble from a valuation point of view. We believe that this great year for markets can be followed by a good year but concede that volatility may pick up.

For the first time in several years there is no obvious systemic threat to stoke the embers of fear...

The Canadian equity market had a good year and was up 13%. Nonetheless, this paled in comparison to the global markets which were up over 36% in Canadian dollar terms. In our previous write-ups we discussed how investors have switched from a macro focus to a focus on fundamentals for individual industries and companies. We argued that this switch in focus was a large driver of markets moving higher as investors gained confidence and fear was not the overriding factor. Interestingly, for the first time in several years there is no obvious systemic threat to stoke the embers of fear and this should allow fundamentals to reign and confidence to grow. To be comfortable that the markets can continue to move higher after such a great year, we need to review the opportunities for companies in the current improving economic environment and ensure that market valuations allow for further upside as we look to 2014.

As mentioned in the economic section, all economies around the globe seem to be improving, giving a solid backdrop for markets as we move forth. Even with the economic recovery entering its fifth year, demand continues to be below the long term average suggesting there is room for growth to move back to trend line while inflation remains muted. Today, markets are trading around their long term average multiple of 16 to 17 time's forward earnings estimates. However, historically when inflation is low and the outlook for earnings is growing more positive, stock multiples tend to trade at higher levels. This supports the view that there is still room for improvement from today's average levels. Most importantly, micro factors within the markets are supporting this view. For instance, revenues for economically sensitive industries are increasing faster than revenues for defensive sectors such as utilities. Industrial production numbers, auto sales, and the inventory cycle all continue to favor revenue growth for cyclical industries including technology, industrials, consumer cyclicals and financials. Meanwhile, corporate returns-on-equity and operating margins are back to pre-crisis levels; balance sheets are flush with cash; short and long term interest rates are moving in a direction that will induce banks to lend and governments are reducing austerity. All of these factors and more continue to support a positive outlook which drove company share repurchases in 2013 to levels higher than witnessed in 2007, suggesting a high level of confidence.

In our outlook, the risks for the market appear to be to the upside for 2014 but it is always healthy to give a balanced view and look at the downside risks. The largest risk, a slowing in world growth, would have a negative impact on the equity markets, but with a reduction in fiscal austerity as we move forward and consumers continuing to spend, economic growth rates equal to or above 2013 seem to be the status quo. The most evident risk, the start of tapering, has been feared as the beginning of the end for stocks because interest rates will rise. We proposed that tapering will only begin if economic numbers are strengthening and that this would support stronger equity markets. In May, the suggestion by the Fed that tapering might begin didn't have a lasting effect on the market as evidenced by the positive moves between May and year end. With the announcement in the fourth quarter by the Fed that tapering will begin, the market responded with a large daily gain as economic growth, inflation and unemployment projections all exceeded the most optimistic forecasts. We are not trying to confuse the reader or change what history has shown to be true. Rising rates will have a slowing and potentially negative effect on market fundamentals but only when there is an actual tightening in interest rates designed to mitigate the excesses in the economy and possibly speculative extremes in the market. That is certainly not the case today.

One of the industries we added exposure to is the life insurance industry with the purchase of Manulife Financial and Industrial Alliance. Lifeco's have emerged from a long and protracted downturn since the onset of the financial crisis with much improved business models and prospects. Balance sheets have been repaired, exposure to high risk products has been reduced and a greater emphasis on the growth of fee-based and higher margin revenue streams has been implemented. An improving economy and rising rates both contribute positively to projected double digit earnings growth while valuations remain average versus historical standards. With Manulife maintaining the best position to Asian growth and Industrial Alliance benefiting from the greatest leverage to rates rising, our clients are well positioned.

Fixed Income Markets – Defensive Duration

As the year drew to a close, the Canadian bond market set a new record for bond issuance, with over $106 billion in new corporate issuance happening in the first 11 months, well ahead of 2012's full year record of $90 billion in issuance. Participants expected December to continue at a torrid pace. Unfortunately for the investment banking community it did not work out that way as new issuance seemed to dry up with only $3 billion issued during the month. The steadily growing pool of cash waiting to take up a new wave of issuance in the last month of the year was disappointed, and investors turned to the secondary market. Consequently there has been a slow but steady tightening of credit spreads which benefitted our overweight in corporate bonds.

The softer economic news in Canada has caused the spread between our rates and the U.S. to widen but nonetheless, rates continue to be poised to move higher in the confines of a bearish bond market environment.

Longer duration bond strategies had to be pulled out of the cupboard, dusted off and put in play as the yield curve flattened. However, this shift did not last long as the broadly unanticipated launch of the Fed’s tapering program, coupled with better jobless claims than expected at the end of December started to push U.S. rates upward. The softer economic news in Canada has caused the spread between our rates and the U.S. to widen but nonetheless, rates continue to be poised to move higher in the confines of a bearish bond market environment. As an aside, this has also served to keep the Canadian dollar exchange rate consistently around 95 cents.

The Bank of Canada is widely expected to keep monetary policy on hold until 2015. In the most recent communications from the Bank of Canada the removal of a tightening bias has become clearer and less a case of divining the Bank’s real intent. With no change in short term rates, there should be a continued steepening impact on the Canadian yield curve with short rates moving up less than long rates. The onset of the latest round of capital adequacy rules (Basel III) will also serve to reduce the magnitude of bond inventories at the Canadian banks and should increase volatility somewhat, as the bank desks respond to investor inquiries.

The basic fundamentals for the bond market look soft which continues to create a challenging environment for bond managers to earn the coupon. As the Fed starts to get more serious about stemming the flow of liquidity into the economy and ultimately starts draining excess liquidity, this challenge may increase. In general the market expected 10 year U.S. Treasury yields to end 2013 at about 3% which they did. At that level U.S. Treasury bonds are seen to be near fair value. Further out, the 10 year should finish 2014 around 3.5% and 2015 at 4%. That should keep steady upward pressure on the shape of the Government of Canada yield curve.

In the meantime, serving to soften the blows, Central Banks around the world have begun adding Canadian dollars as part of their IMF (International Monetary Fund) approved reserves. This will provide a floor for the currency, and stimulate more buying interest in the fixed income market.

In Canada, the DEX index duration shortened marginally both in the quarter and for the full year.

Duration will continue to be a flexible target and a defensive tool, driven more by the credit opportunities, but likely to remain significantly shorter than the index.

Our continuing strategy of staying short duration paid off handsomely. For instance, the overall performance of longer maturity bonds was down over 6% in the year and we have avoided this area of the bond market to the benefit of our clients.

We will strive to continue to add value through careful credit analysis and an ongoing overweight position in investment grade corporate debt. Duration will continue to be a flexible target and a defensive tool, driven more by the credit opportunities, but likely to remain significantly shorter than the index.

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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