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Laketon Fixed Income (SMA Wrap)

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Brent: Greetings**.** Welcome to this installment of the Laketon audio series, my name is Brent Joyce, Vice President at Laketon, joining me today is Gary Morris, Senior Vice President and Director of Fixed Income.
Gary, the bond market over the past year has played out as a "Tale of Two Cities"; two divergent markets: Government bonds and corporate bonds. And a la Dickens, we have seen the best of times and the worst of times for both markets, would you agree?

Gary: Well it really has been an extraordinary year – but rather than just looking at what happened in 2009; not surprisingly, I really think you have to include what happened in the last quarter of 2008, in order to put this year into its proper context.

As you suggest in your question, government bond markets have made big moves in both directions. In the fourth quarter of last year, following the Lehman collapse, we had an extraordinary move in government bonds. In the flight to safety following the collapse U.S. Treasuries were clearly the preferred recipient of this flight, as investors put their money in the safest assets possible. As an aside, I think it is a fair comment to say that today investors may not be as convinced that the Treasury market is the kind of safe haven that it traditionally has been thought of. Never-the-less, investors did head for the Treasury hills and we saw a dramatic decline in Treasury yields, particularly in the shorter part of the yield curve. In Q4, the Treasury market returned 9% (according to the then Lehman Bond Indices – of course they are now the Barclay Indices). And 2 and 10-year yields declined by 120 and 160 basis points respectively. Of course government of Canada bonds and other federal government debt also benefitted from the move to liquidity and safe assets, but not to the same degree. According to the Canadian version of the Lehman indices, the DEX Universe bond Index, Government of Canada's returned 7 ½% in Q4.

However, as well as Canadian investors faired in the government bond market during the fourth quarter, they faired as poorly in the corporate bond market. Looking again at DEX Universe indices, investment grade corporate returns were close to zero. The fourth quarter capped off a classic flight to safety move in the bond market. Investors were clearly responding to an elevated sense of credit crisis fears rather than recession expectations.

This calendar year has been an entirely different story. We have essentially come full circle, since just before the Lehman collapse, if one looks at corporate yield spreads. (However, if one were to include the period prior to the Lehman collapse – when corporate bonds began their underperformance, we still have a ways to go.) The first 9 months of the year have been so positive for the corporate bond market, such that the 9-month returns in Canadian and U.S. corporate bond markets were 18% and 15% respectively and just under 22% and 15% on a 12 month basis.

While global corporate markets have been stellar so far in 2009, the government bond markets have not been as good, but they have not been terrible either. Corporate performance has largely been about removing the enormous risk-aversion priced into riskier debt, while government bond performance has been only partially about risk appetite. Other themes that have been driving government bond performance include, monetary policy expectations, inflation expectations, government budgets and related supply and investor demand for government bonds.

Brent: You point out that government bond performance was extraordinary in the fourth quarter of 2008. However, since the low in government yields we saw in December, we have seen Government yields move up some. Perhaps the worst of times is a bit strong, but certainly investors have been left feeling reasonably flat owning government bonds year-to-date. You pointed that the corporate market ran the reverse; performing poorly in 2008 and roaring back so far this year. Is this kind of inverse correlation typical in the bond market?

Gary: Let me begin by saying that in the context of a core portfolio, we believe that a diversified portfolio is going to serve the best interest of the client over the longer term. While the last 12 months have been particularly volatile, it has demonstrated that a balanced bond approach including government and corporate bonds is going to generate a less risky return profile than would be the case with a pure corporate or government mandate. But to answer your question directly, corporate and government bonds typically do move with an inverse correlation, but not nearly as strong as we have seen recently. In weaker growth environments, when government bonds will typically do better, corporate yield spreads will widen; and vice-versa. However, we typically do not see the kind of recent extreme yield spread volatility, alongside trending government bond markets.

Brent: Given the kind of moves we have seen, the question that must be on people's minds is where do we go from here?

Gary: For better or for worse, I believe the kind of volatility that we have seen in the bond markets will not reappear for quite some time. In our view, monetary policy will be well anchored in most countries with developed government bond markets for at least the next twelve months, with notable exceptions Australia and Norway. At the same time, the big move in corporate yield spreads has already taken place, and while there is still clearly room for yield spreads to narrow further – that move will probably take some time.

But there will still be opportunity for some yield volatility as investors struggle with the scope and pace of recovery and the implications for inflation. Investors are clearly at a crossroads, with some looking at the housing market – the place where this recession really began – as bottoming, while others point to the consumer and her lack of confidence as indicative of the challenges that remain. We would definitely consider ourselves sceptics. We don’t believe that economies of Europe and North America, not to mention Japan, are on the road to a V-shaped recovery; we see more of a W-pattern, with the second V likely not as deep as the first. Of course, government involvement will continue to be important and certainly a wildcard. Our best guess is that governments will be forced to continue their stimulus, but that resistance will be more acute.

Brent: For the government bond market, the specter of inflation seems always to loom large, particularly as we see prospects for economic recovery. Compounding the yield outlook, are the rising

deficits and corresponding borrowing requirements across all levels of Government. Is inflation a threat? And in light of Government borrowing needs are yields headed higher from that perspective?

Gary: With the recovery struggling, we don't believe inflation will be a factor. Although, there will probably be some differentiation between the U.S. and other economies that have seen their currencies appreciate versus the U.S. dollar. Unemployment rates have risen everywhere which has contributed to the much lower capacity utilization. With wider output gaps, we don't see the case for higher inflation 'til much further out. Of course, the weak U.S. dollar will result in slightly higher inflation prospects in the U.S.

I mentioned at the outset that predicting the direction of government yields at this juncture involves more factors than predicting the level of yield spreads. Yield spreads have been largely a matter of renewed risk tolerance, while yield levels have been influenced by several factors. Supply and demand of government bonds is clearly a big factor in today's market and will likely continue to be for some time. Unfortunately we don't see supply coming down very quickly as aggressive fiscal policy will take some time to unwind. Furthermore, we are not yet in the position to conclude that there will be no more additional policies that will further erode government finances and result in more bond issuance. This is true of most federal and provincial or state governments in North America; and to a wide variety of degrees in Europe.

On the demand side, investors have not yet tired of their renewed interest in Treasuries and other government bonds. Rising domestic savings rates (albeit temporarily halted by stimulative fiscal policies such as "Cash for Clunkers" and "Hope for Homeowners" programs in the U.S.), as well as financial deleveraging, have directed more money toward government bonds. Foreign demand will continue to be a wildcard, which will make forecasting the demand picture difficult, but for the time being it seems to be resilient.

Brent: With regard to the corporate environment, we've seen yield spreads contract in dramatic fashion; do you have a sense of why this move was so abrupt? Where do we stand now and what are the prospects moving forward?

Gary: One of the most interesting charts I have seen recently is the ISM Manufacturing which is (former NAPM) index plotted besides the BBB yield spreads in the U.S. inverted. While the yield spreads go through the roof towards the end of last year (or the bottom on the plot) manufacturing plummets, but not anywhere near the magnitude of the change in the spreads. In our view investors were responding to a need for safety or liquidity, which caused yield spreads to widen to unprecedented levels. Looking back 9 months, I remember how market making all but disappeared and dealers became agents, unwilling to take on any new inventory. Consequently, spreads blew out to levels that did not reflect assessment of economic prospects, but rather risk aversion. As soon as the risk appetite reasserted itself, yield spreads narrowed quickly.

Given that we are now more sceptical of the recovery than consensus, from an economic perspective we are slightly negative on spreads and hence corporate bonds. On the other hand, we have seen how supply of corporate bonds has been insufficient to meet the demand coming from asset mix shifts into bonds and demand from retail and other opportunistic investors. We don't expect new supply to emerge quickly; in particular there has been a substantial decline in financial issuance which is a large portion of our corporate market. The recent move in yield spreads was abrupt and we

have chosen to lighten up a little, but will look for widening as an opportunity to add back to our weight.

Brent: Thank you very much for joining us for this installment of the Laketon audio series, and Gary, thanks to you for sharing your views.

Gary: Thank you Brent

Brent: Join us again next time.