

**Milos:** Hello and welcome to another Laketon audio commentary featuring Gary Morris, Senior VP and Director of fixed income here at Laketon. Gary is responsible for overseeing the management of the firm's fixed income portfolios. Welcome Gary.

**Gary:** Thank you Milos. It is a pleasure to be here.

**Milos:** Gary, it's certainly been a tumultuous year for investors with uncertainty and volatility being ever present factors. Can you give us some sense of what's transpired so far, particularly as it pertains to both the differences and similarities here and south of the border?

**Gary:** Well, let me begin by saying I think at this point in time it is probably convenient to talk about the year. Not so much on a calendar basis, as a year to-date, but over the last twelve months, because August kind of represents the anniversary of the beginning of the real credit problems in U.S. I think when you put it in the context the last twelve months or a year if you will, have really been a very very interesting trying and unique episode, certainly in the history of the U.S. economy and that what has happened, or what has transpired south of the border in the U.S. has certainly found itself in other parts of the world. Certainly, Canada is no exception and we are certainly feeling the pain of what is going in the U.S. but also you're seeing Europe, Asia etc. also feeling the brunt of the economic problems and sorry not economic but credit problems.

So let me begin by talking about the credit crisis because I think that really is where a lot of this has started but in terms of talking about the credit crisis you probably want to go even step further back and talk about the housing markets and you know that is a communion points to talk about contrast between Canada and the U.S.

So you know if you look at the housing market which had really been in a boom phase for certainly the balance of this decade and the late 90's as well, the housing growth in the U.S. was spectacular and in terms of the broader economy if you look at the gains in employment generally speaking if it were not for the health-care sector, the housing market really would be responsible for a lot of employment growth. You know we are not talking necessarily just about those who are building houses, but those who were employed in terms of services related to construction and sale of houses, but also offset industry whether be furniture, renovation, etc, so you know a lot of the growth in the U.S economy was certainly on the back of the strength of the housing market. Now you contrast that to Canada, we were a little late to the party in terms of housing growth and again you can also contrast that with Great Britain, and Australia who certainly had stronger housing markets than in Canada so we were a little late to party and you know we're probably not as badly as we didn't really suffer the same kind of explosive growth and overbuild that they had in U.S. and so consequently, as we're going through the sort of expected if you will slow down on the back of the housing boom we're not feeling it the same way.

So you have this this exceptional housing growth in the U.S. and what facilitated that was the availability of capital and extremely low interest rates and bond yields. Inevitably I think the party was going to end at some point and generally speaking with any kind of asset inflation at some point you see a deflationary episode. The housing market is no exception and so we're going through that housing market deflation if you will and in Canada again you know to contrast things because we did not see so much dramatic growth on the upside, we are not seeing the same kind of fall on the downside. Although, for those of you, our listeners out there, who feel that we are not necessarily going to see the pain in Canada, certainly from my perspective and our team we would not really try to disappoint our listeners anyway but we think you will have already seen some of it anyway that the housing slow down will not avoid Canada. So we are going to see the price decline etc. but not anywhere close to the magnitude we are seeing in US. At any rate the housing decline in U.S. really has been sort of what has been the catalyst for the credit problems in the U.S., and I think if you look at what is going on you got this sort of dual scenario, one where you got extreme housing weakness and then from that broader economic weakness and then in tandem with that you seeing problems on the credit side. And you know in the U.S. the problems on the credit side are having their impact on the banking sector in a dramatic fashion it hits Wall Street in a very dramatic fashion. It has also hit the government or quasi government sector in a dramatic fashion, take for example the government sponsored enterprises most of the listeners will be familiar with, Freddie Mac and Fannie Mae certainly, so they weren't affected a year ago but they are now, and those institutions have been severely impacted and they have been responsible for the kind of dramatic housing growth partly responsible anyway, for the kind of the dramatic housing growth you had in U.S. Now you look at those institutions and you contrast that to Canada, where we have market really is in the arm of the government, our secondary mortgage market for residential mortgages if you will is not as exposed as in U.S., most of it is the government entity and also because in Canada we have been traditionally a lot more conservative in terms of the kind of mortgages the home owners have had. The housing market has really been a catalyst for the credit problems, and so in the U.S. where you see the big banks JP Morgan, Citi etc you know these institutions have all been suffering dramatically, and dramatic declines in stock prices from a pure credit perspective, excessive widening in yield spreads between financial sector bonds and U.S. treasuries and you can contrast that to Canada in the sense that the our institution have not been hurt as nearly to the same degree. Now that is not to say they have escaped unharmed entirely, certainly that there are some vulnerable names in stock prices. You can also see in their yield spreads but generally speaking the Canadian institutions have not been as severely impacted as in the U.S. Part of that is that generally speaking, the more aggressive practices of the U.S banking sector, the investment banking sector and generally speaking the derivative markets in US the exposure derivative is more rapid I guess if you will in the U.S.

**Milos:** For the bond investors as a whole, what can they expect particularly in our fund here at Laketon Investments the Fixed Income Product?

**Gary:** You know again, our investments generally speaking are Canadian investments and so if you look at our portfolios you know they are not going to have the kind of exposure that U.S portfolios would have. For example, you know we are exposed very much to the Canadian banking sectors, Canadian life insurance sector, and those that have been hurt for sure, you can talk about a couple of Canadian banks have been hurt more than the others don't have to mention the names but I am sure all our listeners are familiar of those names. They have certainly been impacted more generally speaking since their level of exposure in the Canadian bond market has been a lot less. If you look at our portfolio specifically, we invest certainly in governments that will include provincial and government of Canada and the corporate market

and we know the corporate market has been very much under pressure. If you look at, as a rough guide a 5-year bank yield spread that was yielding perhaps 50-60 basis points above Canada's over twelve months ago, today is close to 200bp. And so what that has meant that the bond price on a corporate bond or a bank bond has underperformed probably by maybe 3 or 4 dollars relative to a government of Canada so portfolio holdings of those securities would certainly be more exposed and if you look at our portfolio, we have 30% let's say corporates, those corporates generally speaking have underperformed government of Canada bonds and so the portfolio has been impacted, but on the other hand, we don't hold non-investment grade securities. The corporates that we do hold and the financials that we do hold in particular, are not those that are not going to be much exposed to the kind of weaknesses that we have seen in some bonds in the U.S.

**Milos:** Much has been said and analyzed regards to the U.S. banking/credit crisis and how it affects the global economy, but I think depending on who you talk to and certainly according to some economists, there's a much bigger problem and that's the U.S. government debt. Estimated at about \$50 trillion now. Do you see this as a problem going forward, as a major obstacle, and what near-term effects does this debt have on the U.S. economy if any.

**Gary:** Well, let me begin by, let me ask that question in the context of the first question you asked, which is contrasting some of the situations in the U.S. versus Canada. You know the debt situation is certainly a situation that is very different between the two countries and one that is ultimately benefiting our bond market relative to that of the U.S. So, if you look at the U.S. deficit and the reasons for the dramatic increase in the deficits are many. Perhaps, one of the most clear ones has been the extreme defence and securities spending over the last five years. Since 9/11 there has been the U.S. expenditure both domestically and abroad that has increased dramatically and that's show up in the deficit but in the addition to that you have got a slowing economy and that also creates slower tax revenues, that is another one and finally the U.S. government takes long measures to offset some of the domestic problems in the economy. So those also contributed to a higher deficit so you've got a bunch of different factors and unfortunately you have got a deficit which if you go back about 7 or 8 years ago looked like the deficit was going to be entirely wiped out. Before we had a chance to really see that probably to the surprise of many, we saw mounting deficits obviously to the surprise of many before 9/11, but we saw a growth of the size of the deficit and again this has been year of relatively strong economic growth. The deficit though does come with a lot of problems and the major problems are as follows. First of all it is a negative for the U.S. currency and that is a negative on the inflation side. It's perhaps a positive for export growth in the US and we have seen some export growth in the U.S. over the last 12 months

**Milos:** Vis a vis China

Gary: Exactly, China and even Canada felt that and that is another area of contrast with these economies where we have had very much a slow down in export growth while the US had an increase on the other hand. It comes with inflation problems. At the same time as the devaluation in US dollar is going to support one part of the economy, it has come with the problems of inflation and that unfortunately has central banking implications. For example, with the FED in U.S. one of the problems of having some of these higher inflation expectations and concerns is that the Federal Reserve has become somewhat constrained in terms of its ability to act in slowing the economy. You can contrast that with Canada where our inflation situation is a lot better than the U.S, the bank of Canada probably has a lot more freedom to act should they

feel it necessary to respond to the significant slowing in the Canadian economy so that's is one problem in the deficit.

I think ultimately a deficit in US is going to push bond yields higher. If you look at bond yields, and you think about what drives bond yields in its simplest form you can talk about two components. One being what I call real yields, and the other being inflation expectations, so real yields typically respond to the demand and supply of capital and so when there is greater demand for capital it tends to push yields higher. In a market place in the U.S. where you have got the government demanding a lot of capital, it pushes the whole level of yields higher and that's a negative for the economy because particularly in today's environment where you got wide corporate bond yield spreads on top of higher long-term yields that is more constraining on the business side of the economy for sure. And also for the housing market on the continuous side so that is a bit negative

If you look at the deficit, it is having problems and I think the other sort of major problem really with the deficit is continuing dependency of the U.S. on foreign investment. That in itself is a bigger problem because what you then have is an economy that is very dependent on other economies etc, investing in your own economy so you dependent on the swings of global economies, so that is a negative and then I think you tend to have a situation where future generations are constantly paying interest expenses overseas so that is a negative.

**Milos:** I know certainly a lot of people ask portfolio managers about their crystal ball. I know there are a lot of naturally anxious investors certainly in terms of what is going to happen in the next 6 months to a year in terms of both equity and bond markets. I guess my final question is what you see from your perspective in the financial markets going forward.

**Gary:** This is probably the most fun question for me actually.

The reality I think is that I see troubled times for awhile and certainly in my career this has been a unique episode, I mean probably as a portfolio manager always saying that this time it is slightly different. But I think the magnitude of the problems out there is enormous and I've never experienced this type of turmoil in the credit markets and so it is certainly a very unique episode. I think that if you look forward there are certainly going to be continued problems in the credit markets. I don't necessarily think that yield spreads between corporate bonds and government bonds are going to get a whole lot wider, I think you are going to see some improvements in U.S. for example, the government is going to come in and bail out Freddie Mac and Fannie Mae but on the flip side you're going to have other problems so you are going to continue to see a very volatile environment on the corporate side and that is going to keep yields higher than they would otherwise be. That is a problem from a stimulus perspective of the economy so you've got issues there. You've got a situation I think where the slow down in the economy is going to start showing up in more places. For a long time it was felt the housing market is going to slow, but with the unemployment rate at historic lows that doesn't really matter. The reality is that the unemployment rate is starting to move up in U.S, you've got non-farm payroll reports in U.S which are weak and so broadening out of the economic problems you have central banks that don't have huge ability in my view to act until they feel the inflation situation calms down. We haven't talked about oil in this discussion, but certainly high energy prices, really have contributed enormously in adding negative or poor inflation outlooks for the environment and so you got that as a backdrop, At the end of the day what this is going to mean is as follows; corporate market which I don't think will settle down in the next twelve months. Bond yields which on one hand should benefit from weaker economy etc, but on the other hand real yield is still vulnerable and I mentioned that earlier. What that means probably is that yields aren't

going to move a ton, but returns are going to look reasonable and probably a 5% rounding point for the benchmark and the fact of the matter, with higher corporate yields you get a higher running yield in a portfolio which is beneficial. The Canadian situation on one hand is not as bad as in the U.S. but on the other, our manufacturing sector has been very much devastated so I think we are going to muddle along with the U.S. Yes, our central bank has perhaps a little bit more ability to act, but I am not sure its going to be able to do it this time either.

**Milos:** Well Gary thank you for your comments I think you have given our listeners some food for thought and I hope and I know we will have you along again soon. I want to remind everybody to log in next month at [www.laketon.com](http://www.laketon.com) and listen to our October Audio commentary. Thanks again for tuning in everybody.

**Gary:** Thanks Milos.