

Market review

- After a pullback in January 2010, the S&P/TSX Composite Index resumed its upward trajectory, ending Q1 2010 with a total return of +3.1% for the period.
- Health Care (+10.3%) was the best-performing sector, followed by Financials (+8.1%) and Consumer Discretionary (+6.2%).
- Energy (-2.0%) was the only sector with a negative return. The Consumer Staples (+0.2%) and Materials (+0.3%) sectors also underperformed, on a relative basis.
- The recent string of better economic data has made many bond investors anxious and has resulted in higher bond yields across the entire yield curve.
- The front end of the Canadian yield curve has been particularly hard hit, as investors anticipate higher interest rates from the Bank of Canada, in response to strong economic data. Recent communiqués from Bank of Canada officials have only increased investor expectations.
- However, the front end of the U.S. yield curve has been relatively stable. Investors have been reluctant to aggressively price in Fed rate increases, given little change in tone from Chairman Bernanke and other Fed officials.
- In Canada, the economic data has been impressive, considering the strong Canadian dollar and the relatively weak U.S. rebound. At the end of March 2010, the Bank of Canada was estimating Q1 growth at 5.5% and 2010 growth at 3.4%, after January's huge increase of 0.6%.
- While Canada is showing signs of a V-shaped recovery (some still believe it may be the first half of a W), the U.S. recovery has been far more modest. The Federal Open Market Committee projections in January were for the GDP range to be between 2.8% and 3.2% for 2010. In our opinion, we think their projections would have moderated slightly since then.
- Although there has been a rise in commodity prices, the overall inflation picture remains benign, with unemployment rates high and capacity utilization low. Unemployment in the U.S. has been steady at 9.7% this year, and the so-called underemployment rate is now at 16.9% (including part-timers and discouraged workers). In Canada, unemployment is just above 8%.
- While in the past we have commented that we were not particularly concerned with the outlook for inflation, we have mentioned our concern about rising real yields. Our concerns have generally stemmed from the deteriorating state of sovereign finances.

- Net Debt to GDP now stands at 56% for the U.S., 29% for Canada and 47% for the U.K. Contrast this with 56% for Portugal, 97% for Italy and 86% for Greece. One might consider the U.S. and the U.K. already in danger territory. (source: OECD)
- However, perhaps a more telling number is External Debt to GDP (including foreign exchange reserves) which is only 1% for the U.S., 6% for Canada, 9% for the U.K., 4% for Italy but 90% for Portugal, and 84% for Greece. (source: OECD and BCA)
- The recent panic over sovereign Greek debt and the "knock-on effect to debt of other troubled Eurozone members is not surprising, and is likely the early signs of sovereign debt troubles elsewhere. While the yield spread widening experienced by Greek bonds is likely overdone (10-year Greek yields are now close to 400 basis points higher than 10-year German yields), it is suggestive of the trouble that can befall government [real] yields.
- There is still clearly time for the U.S. to improve its debt picture, although this will require fiscal measures that we are not convinced will be embraced by the government.
- In the corporate bond market, yield spreads continued to grind tighter on the back of seemingly insatiable demand and a corresponding insufficient amount of supply.
- New issuance was up significantly from 2009, with \$16.8B in new issues versus \$9.3B in Q1 2009. First-time and lower rated issuers continued to come to market, capitalizing on the lack of supply, the market's demonstrated interest in lower-rated credits and the absolute low cost of funding.
- Investors favoured higher-beta long exposures versus shorter-term defensive sectors, and, as a result, the credit curve flattened. Short, mid- and long-term corporate spreads tightened by six, 18 and 21 basis points respectively. For the quarter, on an absolute basis (which includes changes in the yield curve), short, mid- and long-term corporate bonds returned 0.88%, 2.77% and 5.02%, respectively.

Portfolio review

Positive performance factors

Asset Mix

- A continued under weight cash position added modestly to performance.

Security Selection

- Strong stock selection in the Canadian equity, particularly in the material sector, contributed positively to performance.

Negative performance factors

Asset Mix

- A slight over weight to international equities detracted slightly from performance.

Security Selection

- U.S. stock selection was slightly negative for the quarter.

Outlook and strategy

- Recent U.S. and Canadian economic data provides evidence that the recovery remains very much on course, with the unemployment rate peaking and now slowly recovering, inflation continuing to remain contained and signs that consumer confidence is improving (housing market, retail sales). Corporate profitability has also improved on the back of cost cutting and the resumption in revenue growth. An improved profitability scenario provides companies with confidence to invest in new opportunities. With financing rates still very stimulative, and banks willing to extend credit, it is highly probable that job creation will follow. We are still in the early stages of this corporate investment cycle, and as the jobs recovery unfolds, consumers will garner a greater degree of confidence and resume their spending habits. All of this is very bullish for equities, and we expect the uptrend to continue.
- With the S&P/TSX Composite Index trading at a 12-month forward, price to earnings ratio of 15.2 we are essentially back to the historical average of 15.3. Going forward, further upside potential will be driven by earnings momentum coming in better than consensus expectations. Furthermore, corporate balance sheets are very healthy, and we've seen companies return capital in the form of dividend increases and share buybacks. From a sector orientation perspective, we are very much in a market where you want to spread your eggs among many baskets and we remain neutral across the board. Stocks we highlight as having positive operating and earnings growth potential are Arc Energy Trust, Eastern Platinum Ltd., Gildan Activewear, and Brookfield Asset Management.
- The Government of Canada yield curve has begun to flatten in anticipation of increases in the Bank of Canada interest rate. We are generally in agreement with this move, but believe investors may have been a touch too hasty and zealous.
- We are less in agreement with the recent push on long-term bond yields. There appears to be widespread concern over higher inflation, which we do not fully share. This presents some, albeit limited, opportunity for the longer end of the yield curve to do better.
- While we believe that the Bank of Canada will ultimately have to raise rates in Q4, and maybe sometime in Q3, we have not abandoned our caution vis-à-vis the rise in the Canadian dollar. Much of our export sector is still widely influenced

by Canadian - U.S. exchange rate, and we believe that the Bank is also paying close attention.

- Although corporate yield spreads have been on a tear for the last 12 months, the backdrop is still relatively friendly. We don't expect the pace of narrowing can continue indefinitely, but we see little cause for concern of an imminent reversal. Having said that, the substantial yield pick-up afforded corporate bonds a year ago, has largely disappeared.
- We have lengthened the duration of the portfolio slightly while shifting exposure away from the short/mid-term part of the yield curve to the 10-year area. The portfolio should benefit from further flattening of the front end of the yield curve as well as a rebound in the long end.
- We are selectively looking for tactical opportunities. In the shorter term, we feel there will be opportunities to capitalise on some remaining steepness of the credit curve. We continue to have a conservative bias and feel the risk-reward trade-off in the long-end is most compelling in defensive sectors whereas in the shorter-end we continue to favour subordinated issues of high quality names.

Any amount that is allocated to a segregated fund is invested at the risk of the contract holder and may increase or decrease in value.

This report is published to provide additional information on economic conditions and investment performance. It was prepared by Laketon Investment Management.