FORTRESS Canadian Bond

Fund Highlights

Investment Review

First Quarter 2010

Market review

- 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 officials have only increased investor expectations.
- However, the front end of the U.S. yield curve has been relatively stable as 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 estimated 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, if anything, we think their projections 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. U.S. unemployment 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), while Canadian 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 [what is 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.
- 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 last year, 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 in the first quarter

- The portfolio benefited during the quarter from being positioned advantageously for flattening of the yield curve. In the beginning of the quarter, the portfolio was underweight five years and overweight two, three and seven years – which benefited from the initial flattening of the very short end of the yield curve. Towards the end of the quarter, the portfolio was shifted to an underweight three, five and seven years and an overweight two and 10 years which benefitted from flattening further out the yield curve.
- Commensurate with the cessation of bank subordinated and hybrid issuance, spreads on these issues have outperformed. Since their peak in January 2009, domestic subordinated and hybrid spreads have tightened by approximately 400 and 575 basis points respectively. This has been positive for performance, as the portfolio's holdings of bank and insurance companies are primarily subordinated issues.

- Liquidity improved in the Canadian market, resulting in a return to some degree of normalcy for issues that were being priced at a significant discount to where similar issues were priced globally. Notably, the Halifax Bank of Scotland held in the portfolio returned a substantial 11.56%. In recent weeks, the credit has passed a number of positive milestones: lower impairments, a rising net interest margin and an expected return to profitability this year. However, the HBOS still trades at a discount relative to other HBOS issues internationally.

Negative performance factors in the first quarter

- Investors favoured higher-beta long exposures versus shorter-term defensive sectors such as Utilities and Infrastructure. The portfolio's higher-beta exposures are limited to shorter-term (ie. seven years or less) issues, which did outperform for the quarter; however, this was offset by the relative underperformance of the more defensive longer-term holdings.

Outlook and strategy

- The Government of Canada yield curve has begun to flatten in anticipation of Bank of Canada interest rate increases. 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 the 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-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 short-term, we feel there will be opportunities to capitalize 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.

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