FORTRESS Global Bond Fund (Laketon) — Investment Review

Fund Highlights — 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 have begun to anticipate higher interest rates from the Bank of Canada, in response of 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, the Bank of Canada was estimating first quarter 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 Community projections in January were for the GDP range to be between 2.8% and 3.2% for 2010 (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. Unemployment in the U.S. has been steady at 9.7% this year, and the "so-called underemployment rate" is now at 16.9% (includes 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 however, mentioned our concern with 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 several of the PIIGS at 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.
- 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.
- Despite the turmoil related to Greek finances, the Greek government was still able to raise funds at a steep premium to Bunds – at roughly 325 basis points yield spread; but an attractive yield to investors – close to 7%.
- Amidst all the turmoil during the first quarter of 2010 global yields remained largely range bound. U.S treasuries traded between 3.60% and 4.00% while Canada, Germany and France mimicked this range at tighter levels.
- In the corporate bond market, yield spreads continued to grind tighter on the back of an insatiable demand and a corresponding insufficient amount of supply.
- Nevertheless, 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.

Portfolio review

Positive performance factors

- The fund's overweight in Canadian, U.S. and Australian dollars contributed positively to performance, as those currencies appreciated by 9%, 5% and 9% respectively against the euro, and 10%, 5.5% and 9% respectively against the pound. The fund is underweight both the euro and pound.
- During the first quarter yields in Canada, U.K., France and Germany decreased by four, eight, 28 and 30 basis points, respectively. The rally in global yield contributed to performance, as the fund held a significant duration overweight in these sectors.

Negative performance factors

- Australian bonds did not fair as well as other global bonds, during the first quarter of 2010, as rates increased by 15 basis points. The fund holds a slight overweight in Australian bonds, which detracted from performance during the quarter.

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.
- We do not expect imminent increases from the Fed or from the European Central Bank.
- European yields are clearly becoming unhinged and we believe this is only the beginning. Investors are responding to the deteriorating credit fundamentals of certain European Union members and translating this into significant yield spread movement. We expect that this volatility will likely continue for some time.
- With respect to Greece, volatility will likely continue until political agendas of the key parties have been satisfied. Germany, the ECB and the IMF are trying to work through a support package. Although still unsuccessful, we feel there is a huge incentive for all parties to find a common ground.
- Given that Greece's competitiveness cannot be directly impacted by sovereign monetary policy and currency movements, it is likely that the period of fiscal adjustment will be long, arduous and potentially disinflationary.
- Greece is perhaps the canary in the gold mine. There is clearly concern over government fiscal positions, with the biggest concerns being saved for the European basket cases. Contagion has begun to spread from Greece to other problem EU members. Closer to home, there is still clearly time for the U.S. to improve its debt picture and avoid the troubles befalling Europe. Unfortunately, U.S. deficit improvement will likely require fiscal measures that we are not convinced will be embraced by the government. At any rate it is still early days.
- 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 remain underweight both currency and debt exposure to Europe.

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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