

### 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 in the fourth quarter of 2009. At the end of March 2010, 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 Committee [spell out acronym] 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 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 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 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 what remains seemingly an insatiable demand and a corresponding insufficient amount of supply.
- The Federal Reserve and Bank of Canada have both nearly terminated all short-term market liquidity programs, which has forced issuers to return to the capital markets. However, with rates at historical lows, many would-be commercial paper issuers have extended term and issued bonds instead.
- The drought in commercial paper issuance in Canada has finally seen some signs abating, as the amount of outstanding commercial paper has increased from \$25 billion in December 2009 to \$26.1 billion in February 2010. To keep this in perspective though, there was \$55 billion commercial paper outstanding in December 2006, not to mention, an additional \$108 billion in asset-backed commercial paper, which now stands at \$32 billion.
- The current near-zero policy rates and narrow yield spreads have continued to force investors to extend term and move down the credit curve, in order to pick up yield to offset underwater MERS. Investor preferences will likely reverse, as yields rise and they move to shorter liquid investments, in preparation for reinvestment at higher rates.

### Portfolio review

#### Positive performance factors

- The fund maintained its overweight in Provincial treasury bills and bankers' acceptances (BAs) throughout the quarter. Although there were no significant rallies in either Provincial T-bills or BA yield spreads, the higher running yields of three and 15 basis points respectively, contributed positively to the first quarter's performance.
- The money market curve steepened during the quarter, as investors increased their expectations that the Bank of Canada would be fairly aggressive in increasing interest rates. The fund's overweight in short-dated securities sheltered it from the steepening move.

## Negative performance factors

- Investors demand for commercial paper continued from the fourth quarter of last year, through the first quarter of this year. The fund's performance suffered from its lack of exposure to riskier commercial paper assets, which outperformed the index by four basis points.

## 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 longer term bond yields. There appears to be wide spread concerns over higher inflation, which we do not 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 Canada-U.S. exchange rate, and we believe that the Bank is also paying close attention to this.
- In early February 2010, investors priced into the market expectations that the Bank of Canada would increase the overnight call rate by 65 basis points over the subsequent 12 months. By the end of the quarter, investor expectations had increased to 155 basis points. We feel that current expectations, that the Bank will hike rates six times (by 25 basis points) over the next eight meetings, are quite aggressive and unlikely. We have begun to position the portfolio accordingly. We will remain opportunistic in the commercial paper market.

*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.