

Market review

- Both equity and fixed income markets rallied strongly in the second quarter, as the so called "green shoots" started to appear.
- The S&P/TSX Composite Index finished the period with a total return of +20.0%.
- Information Technology (+43.3%) was the best-performing sector, followed by Financials (+34.5%) and Energy (+21.6%).
- Telecommunication Services was the only sector with a negative return (-1.0%). Materials (+4.3%) and Health Care (+8.0%) were other notable underperforming sectors.
- The increase in investor risk tolerance also significantly impacted the bond market, where corporate bonds registered their largest out performance of government bonds for as long as decent records have been kept.
- In Canada, the DEX Universe All Corporate Index returned 6.5% versus -1.8% for the DEX Universe Canada Index.
- In the U.S., the Merrill Lynch Index corporate component returned 10.8% versus -3.1% for the Treasury component.
- Issuers responded to improved investor sentiment with a flood of new issuance, relieving the financing backlog that that started in Q4 of last year. In all, the Canadian and U.S. markets saw \$18 billion and \$396 billion of new corporate issues in the second quarter, respectively.
- Perhaps the best illustration of how the flight to safety in the bond market has eased is to look at the liquidity premium experience of Canada Mortgage Bonds ("CMBs"). CMBs are issued by Canada Housing Trust -- a vehicle set up by the CMHC and fully guaranteed by the Government of Canada. The credit crisis caused 5-year CMB yield spreads over Canadas to widen from 12 basis points in March of 2007, to 60 basis points at the end of December 2008, and now sit at 44 basis points. Given the Federal guarantee of CMBs, the bulk of the spread widening was liquidity driven – a direct result of a flight to safety.
- The corporate bond market has also benefited from a new found interest amongst equity managers, private equity and hedge funds, and retail investors amongst others, who have all been looking for higher returns. This new level of interest suggests to us that the movements in the corporate bond market may not be as reliable a barometer of traditional corporate bond investor sentiment as in the past.
- Additionally, the reduced allocation of capital by banks to their fixed income trading operations is resulting in greater volatility of bond prices.
- While corporate bonds were doing well, the opposite was true of the government

bond market. 10-Year Government of Canada and U.S. Treasury yields were 58 basis points and 83 basis points higher at the end of the quarter vs. the beginning.

- Many commentators and the media, in particular, have suggested that the rise in yields was mostly in response to investor fears of inflation on the back of extremely easy monetary policy.
- We contend that most of the rise in yields relates to the supply demand imbalances emanating from the gargantuan treasury issuance schedule, the uneven participation of domestic and foreign buyers and the unpredictable intervention of the Fed.

Portfolio review (all figures, Price Return)

Positive performance factors in the second quarter

Asset Mix

- A modest over weight Canadian equities added about 0.32% to performance versus the benchmark .

Security Selection

- The fixed income portfolio benefits from its over weight corporate bond position, adding 0.33% to overall performance.

Negative performance factors in the first quarter

Asset Mix

- A modest over weight to Fixed Income detracted slightly from performance.

Outlook and Strategy:

- Markets have stabilized and continue to tentatively recover from one of the most debilitating downturns on record. With central banks and governments doing "everything in their power", the liquidity tap is once again pumping oxygen into the room. Issuance activity in the debt markets has come back with a vengeance as \$18 billion of corporate debt was issued in Q2 which compares to a trailing twelve-month quarterly average of \$11.7 billion. Furthermore, with a 16% quarter over quarter increase in the number of IPOs and a stronger secondary issue market, the equity market provided an added boost to liquidity. Risk appetite is growing as reflected in the VIX index falling back below the pre-Lehman bankruptcy levels of less than 30. Credit spreads and credit default spreads continue to contract and the significant contraction in the LIBOR/OIS signals banks are once again lending to one another.
- With the equity market keying off "less bad" news, the consensus view for the U.S. economy is that they'll exit the recession by the end of this year or early next (aside:

index of leading economic indicators show the recession ending within the next few months). Real GDP growth in the next few years is expected to be between 2% and 3% and the unemployment rate is expected to peak some time in 2010 at between 10% and 11%.

- While banks remain cautious with the excess capital they have recently accumulated, recently their CEOs expressed excitement at the opportunities available to put some of this capital to use, with the most often cited beneficiaries being corporate lending, capital market activity and acquisition opportunities. From an equity market vantage point, all this is healthy and positive. However, the S&P/TSX has just delivered a 20% total return in the second quarter and the direction of markets is never just straight up (especially when you're in a recession). We don't expect the market to deliver double digit returns over the coming quarter. From a valuation perspective, the S&P/TSX is currently trading at a multiple of 14.9 times 12 month forward earnings which compares to its long run average multiple of 15.3 times. S&P/TSX consensus earnings expectations are for a decline of 28% in 2009 and a recovery of 27% in 2010. Given the forward looking nature of equity markets, stocks are initially rewarded with an expanded multiple when forward earnings estimates are close to bottoming (witnessed in Q2) and with time, earnings growth will need to materialize as the main catalyst for higher stock prices, otherwise the risk becomes skewed to the downside.
- We expect the bond market to take a breather in the third quarter. In Q2, government yields rose in concert with the fall in corporate yield spreads. In both cases, we feel the market has got ahead of itself and we would expect to see some correction.
- We don't expect the fear trade to re-enter the psychology of investors, however, we do expect investors to be more fearful of a disappointing recovery from recession.
- We will look for opportunities to lengthen the duration of the portfolio – our bias is for yields to trend lower. However, we will put in the qualifier that further government intervention has the capacity to derail any rally in bond yields.
- We are selectively looking for tactical opportunities in the corporate sector. We are overweight and prefer to remain so over the longer term. However, in the shorter term, we feel there will be some opportunity to capitalize on spread widening, notwithstanding liquidity constraints of the sector.
- There has been a lot of corporate issuance recently. We don't expect the pace to continue into the next quarter. There was clearly a backlog of supply, and issuers took advantage of the narrowing yield spreads and investor excitement. We don't feel this demand for capital will follow through over the balance of the year.

Any amount that is allocated to a segregated fund is invested at the risk of the contractholder 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 the fund manager, Laketon Investment Management.