

### Market review:

- The second quarter will go down in the record books as the quarter delivering the biggest outperformance by corporate bonds versus Government of Canada 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. The similar returns for the Mid Term Index (sometimes a better basis for comparison) were 8.3% and -3.07%.
- In the U.S., the Merrill Lynch Index corporate component returned 10.8% versus -3.1% for the Treasury component.
- Finally in Q2, investors backed away from the fear (or Armageddon) trade, opening the door for corporate bond (and equity) buying, causing yield spreads to narrow in the process.
- Issuers responded with a flood of new issuance, relieving the financing backlog that was building since 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 change)

#### Positive performance factors in the second quarter

- The portfolio's insurance holdings - Manulife and SunLife, rallied as regulatory capital was increased to historical highs, equity markets rebounded and credit losses appeared manageable. Further, concerns over M & A activity possibly depleting the capital cushion were allayed as potential takeover targets were either taken off the selling block due to government bailouts, or were no longer at fire sale prices.
- Domestic bank earnings brought few negative surprises and as a result hybrid and subordinated debt outperformed. Further reaffirming investor confidence in the Canadian banking system was the ability of domestic banks to launch hybrid and subordinated debt issues, something their global peers have been unable to do on a large scale.
- An exceptional performer amongst U.S. bank issuers was J.P Morgan, which during the quarter repaid in full the \$25 billion preferred stock investment it accepted through the Troubled Asset Relief Program (TARP). Morgan also clearly demonstrated that it had access to public debt and equity markets. Consequently, yield spreads on the issue held in the portfolio rallied over 500 basis points over the course of the quarter.
- The absence of long corporate issuance coinciding with increasing demand resulted in long corporate yield spreads narrowing. There was particularly strong demand for non-Financial long bonds which was positive for the portfolio, as the long bonds held are all non-Financials.

#### Negative performance factors in the second quarter

- The portfolio began the quarter with a duration of 0.25 years longer than the duration of the benchmark. Although by quarter end the duration position was allowed to decline to around .05 years longer than the benchmark; the rise in bond yields did have had a negative impact on the portfolio.

### Outlook and Strategy:

- 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 but 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.

