

Market review

- Bond investors have had a roaring time over the last couple of years, and for those who thought maybe the Fed had used up their last tokens, in comes Bernanke et al (save Hoenig and some others) with a bag full – ready to be opened soon – in the form of a second round of quantitative easing.
- The market, or more correctly, bond investors are expecting a Treasury buying program, likely to be gradual in the short to middle part of the yield curve, so much so, that they have been happy to purchase treasuries and push yields lower.
- Indeed, during the third quarter, 10-year Treasury and Government of Canada yields fell by 42 and 32 basis points to 2.51% and 2.76% respectively, edging ever closer to the recent lows of 2.06% in the U.S. (on Dec. 30, 2008) and 2.56% in Canada (on Jan. 14, 2009)
- The Canadian bond market returned a stellar 3.15% for the quarter; (according to the DEX Universe Index), especially impressive given that the overall yield to maturity averaged only 3.04% during the quarter.
- Canadian corporate bond market returns were only average, returning 3.16% for the quarter; (according to the DEX Universe Index) despite having an average yield close to 1% higher than that of the government sector.
- While the Fed actions have caused the bond market to fluctuate, the volatility has been helped along by the generally poor macroeconomic data coming from pretty much everywhere. G7 economies have been slowing, and even dependable China has become lacklustre. (Although we would never rule out the capacity of China to turn on a dime.)
- The Bank of Canada raised rates one more time to 1%, but as we previously mentioned it might do, has used its self-declared retrospection to signal that it would likely not move again this year.
- With interest rates on hold at low levels in most of the developed world, equities and corporate bond markets have managed to remain steady, despite questionable economic prospects.
- Corporate bond issuers have taken advantage of this agreeable climate to issue in significant quantities amounting to \$365 billion in the U.S. and \$16 billion in Canada during the quarter.

Portfolio review

Positive performance factors in the third quarter

- Investors extended duration, but were only willing to do so through higher quality asset classes, which resulted in long provincials and municipals becoming the best performing asset classes within the Universe. The portfolio benefitted from being approximately three quarters of a year over weight in long maturity provincial and municipal credits, relative to the index, on a duration- weighted basis.
- In the corporate space, the same demand factors impacting government credits resulted in the outperformance of long maturity Utility, Infrastructure and Energy issues. The portfolio is over weight the aforementioned sectors in the long maturity end by two-fifths of a year, on a duration- weighted basis, relative to the index. Additionally, the portfolio's largest exposure in this space (and the portfolio as a whole) is Hydro One, whose spread compressed more than its peers. Hydro One had the added positive benefit of the Ontario government's decision, in early July, to rule out merging Crown corporations and selling an equity stake to investors.
- New Basel guidelines led to significant spread widening on new or third generation, high coupon ("par call"), innovative Tier 1 spreads. While negative for these specific issues, the news was positive for other existing subordinated and older generation hybrid issues, as under the new reforms, these structures will be phased out and replaced by securities that have contingent capital provisions. The scarcity premium attached to these grandfathered issues was positive, as the portfolio holds a number of them. We would note that we have always limited our exposure to Tier 1 hybrids, from older generation series, with holder exchange features.
- The financial yield spread curve steepened significantly over the quarter; as short-term yield spreads tightened by 14 basis points, whereas mid- and long-term spreads widened by three and 16 basis points respectively. The portfolio is fairly over weight short Financials.

Negative performance factors in the third quarter

- Dismal earnings from Manulife Financial, followed by a large \$900 million (increase from \$500 million) five-year new issue, pushed spreads on its bonds wider. It is worth noting that despite the deal coming at a hefty 185 basis points over the curve, representing a 30 basis point concession over secondary market levels, the 4.079% coupon was still well below the 4.896% paid, when Manulife last came to market in May 2009, with a similar \$1.0 billion, five-year bond (+230 basis points).

Outlook and strategy

- There seems to be little doubt among market participants that the Bank of Canada will refrain from raising rates further this year, after having raised the overnight rate to 1% on September 8th. The weaker economic data in both Canada and the U.S., has created a backdrop for the Bank to put monetary policy on hold. We also note the certainty with which the Fed has indicated that overnight rates in the U.S. will not rise any time soon.
- Members of the Fed have communicated their receptivity to further monetary stimulus through quantitative easing. We are sceptical of QE's ability to deliver more stimulus via both consumer or commercial channels and believe that the Fed will likely resort to QE only in the event that they feel capital markets need more propping up or there appears to be impasse on the fiscal front.
- As we are still in mid-term election season in the U.S., we don't expect much progress on any sort of fiscal stimulus; but we do expect the Obama administration to take up the gauntlet afterward.
- The concentration in 10-year bonds, has given the portfolio more running yield, reasonable positioning in the recent flattening, and good performance in the summer rally. We expect the 10-year part of the yield curve to stay out of trouble, and hence, we will retain the portfolio's over weight in that part of the yield curve.
- The recent underperformance of corporate bonds had presented an opportunity to increase the portfolio's running yield at attractive yield spreads. We began increasing the corporate weight during the quarter, and it is now largely completed. We would look at any further yield spread deterioration as an opportunity to increase our exposure further. Despite there being many areas of economic uncertainty, our expectation for policy support – both fiscally and monetarily -- should keep yield spreads well supported.
- Although we are not immediately concerned about the North American sovereign debt situation, we have noted that the situation in the U.S. is something to be watched. However, we believe that the trouble with European sovereign debt will likely provide a longer window for the U.S. to address its issues.

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.