

Market review

- For those who “believe”, the third quarter is proving to be the turning point for the global economy – from recession to recovery.
- For those “non-believers”, the third quarter is demonstrative of the power of government intervention and is no more than the nexus between a V and a second V – i.e. the midpoint of a W.
- Nevertheless, the quarter did demonstrate the power of the U.S. government as “Cash for Clunkers” and “Hope for Homeowners” managed to generate benefits for the auto and housing sectors respectively.
- U.S. auto sales rebounded from 9.64 million units in Q2 to 11.51 million units in Q3 (annualized monthly averages). At the same time, the pipeline of unsold homes declined from 3.8 to 3.62 million units over the quarter.
- While the U.S. was clearly one of the worst and first hit economies, the conventional wisdom held that it would also be the first to recover. However, early signs are that more robust recovery is emanating from emerging economies compared with developed economies (Q3 GDP at 1.7% year-over-year compared to -3.4% year-over-year according to IMF forecasts).
- On the other hand, non-U.S. dollar-block economies, particularly commodity-rich Australia and Canada are showing signs of a more robust recovery, particularly in terms of industrial production and commodity exports.
- Unfortunately for Canada, the precipitous decline of the U.S. dollar against all currencies, and more importantly the CAD\$: -8.7% over the quarter, has meant that net exports of goods and services to the U.S. have suffered.
- Overall, there was global economic improvement in the third quarter. However, government bond markets did not cue off the improving (or less bad) economic data, or the continued supply of government bonds. Demand from domestic and foreign investors was sufficient to keep bond yields contained.
- In the U.S., 10-year government bond yields traded within a 50 basis points range during the quarter, with yields 20 basis points below where they began. Other developed bond markets were even more stable with most 10-year government yields trading within a 25 basis point range.
- In Canada, 10-year government bonds began the quarter yielding 3.36% and ended the quarter yielding 3.31%, moving within a 24 basis point range. Two-year bonds showed similar low volatility, with yields rising slightly from 1.21% to 1.26% over the quarter.

- In dollar terms, volatility of short term government bonds has been almost non-existent, exacerbating the miniscule yields being offered by the sector. It is interesting that there continues to be substantial demand for 2-year Government of Canada's yielding below 1.5%.
- As stable as government markets were, corporate bond markets continued their dramatic improvement during the quarter. Investors have shown a willingness to move from complete risk aversion to a post credit crisis - handicapped version of the pre-Lehman risk frenzy environment. By August, corporate yield spreads had returned to their pre-Lehman levels in the higher quality credits, with spread narrowing having taken place across most sectors and industries.
- The corporate and government markets have proved to be perfect foils for each other, combining to generate reasonable returns for the bond market as a whole. Despite the low level of absolute rates, the DEX Universe returned 2.7% in Q3, and 5.58% for the year. Compare this to Q4 of 2008, when the returns were 4.5% for the quarter and 6.4% for the year.
- The return data above is more interesting at the sector level. For Q4/08: Canadas + 7.4%, all Corporates – 0.25%; for Q3/09: Canadas + 1.2%; all Corporates + 4.5%.
- Prior to the credit crisis, provincial yield spreads had become narrow and stable, limiting the opportunity from the sector. However, the crisis caused yield spreads on all spread products to widen – provincial spreads widened to referendum levels. Provincial yield spreads have narrowed substantially and are now more representative of the fundamentals of the economy and financing requirements.

Portfolio review

Positive performance factors in the third quarter

- During the quarter, the portfolio maintained an overweight in both corporate and provincial credit. In Q3, mid-term corporate and provincial credit spreads narrowed by 60 and 23 basis points respectively.
- Financial institution earnings globally presented few negative surprises. This was positive for the Maple Financials held in the portfolio, i.e. J.P. Morgan, Bank of America.
- Domestically, investor confidence in the Canadian banking system was already high and the positive results only served to further fuel demand for subordinated and hybrid issuance. Since their peak in January 2009, domestic subordinated and hybrid spreads have tightened by approximately 350 and 500 basis points

respectively. This has been positive as our holdings of banks and insurance names are principally in subordinated and hybrid issues.

- The portfolio's corporate holdings are concentrated in the short end of the yield curve; while the provincial holdings are concentrated in the long end – both were positive for the portfolio. Average corporate yield spreads narrowed and steepened over the quarter with short-term corporate spreads tightening by 65 basis points on average versus 38 basis points for long-term spreads. The opposite was true in the provincial market where long provincial spreads narrowed by 26 basis points versus 15 in the short-end.

Negative performance factors in the third quarter

- The portfolio is structured with higher beta short-term issues and more defensive long-term bonds, i.e. regulated utilities, pipelines and infrastructure issuers with unfettered rate setting ability. With less investor risk aversion, there was increasing demand for higher beta names resulting in defensive industries underperforming. However, by quarter-end some of this underperformance reversed itself as buyers shed higher beta issues on profit taking and disappointing economic data.

Outlook & strategy

- The global economy is recovering at various speeds, with the best prospects coming from emerging Asia – namely China and India. There is a certain amount of inertia that is inherent in the emergence of these economies that should be sustainable in our view.
- The developed world is more of a question mark. Commodity-driven economies will benefit from emerging economy growth – Canada and Australia should do fairly well. However, we are less optimistic for the rest of the developed world.
- The U.S. economy is still very much a work-in-progress. The letter W has its origins in the letter V (7th Century Old English), and so too will the U.S. W-shaped economic pattern have its origins in the alacrity of the V-shaped economic rebound of late. In our opinion, too much of the strength of the recovery has been closely tied to government intervention – a factor that we don't believe is sustainable.
- We don't expect to fall into a technical recession of anywhere near the magnitude of the one we've just been in, but the economy is vulnerable to a significant setback.
- The fortunes of the bond market are however, more complicated than just the prospects for the economy. We expect substantial government supply to continue – 2010 forecasts for the U.S. and Canada are U.S. \$2,300 billion and CAD \$85 billion respectively (RBC Economics). We are not as certain about demand.
- Government bond demand can be divided between domestic and foreign sources. In terms of domestic demand, we expect it to continue as consumers, particularly American, continue to save and these savings eventually make their

way to government bond markets. In terms of foreign demand, the picture is less clear – currency will be a factor and could cause funds to be diverted away from U.S. Treasuries.

- Nevertheless, we still expect yields to stay low, and any rise in yields will present a buying opportunity. Government bond market volatility should also remain low.
- As far as short term interest rates go, at the beginning of the year we were confident that we would not see any interest rate increases in North America until at least 2010. We are comfortable taking the Fed and the Bank of Canada at their words with both indicating short term rates will be kept at historically low levels well into 2010.
- As we have mentioned earlier, we have seen substantial recovery in the corporate bond market and the easy money from the crisis level yield pickup is behind us. Investors have shown some predisposition to tighter spreads and more risk – more than we would have otherwise felt possible given the events of the last 12 months.
- Supporting the narrower spreads is the skinny new issue calendar that we anticipate over the next year. Despite low financing costs, we don't expect a flood of supply in the corporate market given overall economic prospects.
- Demand for corporate bonds is substantial, although we are less certain that it has staying power. Demand is made up of far more opportunistic investors, who will likely make a quick exit the moment returns and risk appetite reverse.
- We expect yield spreads to continue to be volatile, and we have become more defensive at this juncture.

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.