

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).
- Outside of North America, sovereign yields of the G7 also fell. British and French yields led the way lower, dropping 40 basis points, followed by German, Italian and Japanese yields, which were lower by 29, 27 and 15 basis points respectively.
- 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.)
- Whereas expectations of a prolonged low interest rate environment in the U.S. resulted in the dollar dropping globally, improvements in the perceived economic recovery of the Eurozone accelerated the euro to the upside.
- The Bank of Canada raised rates twice to 1%, but as we previously mentioned, it might do, it has used its self-declared retrospection to signal that it would likely not move again this year.
- A lack of structural imbalances has also led four other central banks in Australia, Norway, New Zealand and Sweden, to hike policy rates in the first seven months of 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.

Portfolio review

Positive performance factors in the third quarter

- The rally in global yields contributed to performance, as the fund held a significant duration over weight in U.S., German, French, Canadian and Australian sovereign

bonds. In total, the portfolio is approximately one year longer in duration relative to the index.

- Higher commodities and policy rates led to an appreciation of the Australian (AUD) and Canadian (CAD) dollar, versus the U.S. dollar – 15% and respectively. The over weight in both AUD and CAD was positive for the fund's performance.

Negative performance factors in the third quarter

- The fund's under weight in the euro (on a percentage-weight basis) negatively affected performance, as after the Australian dollar, it was the second best performing reserve currency, relative to the U.S. dollar (USD). For the quarter, the euro appreciated 11% against the USD.

Outlook and strategy

- There seems to be little doubt amongst 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.
- 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.