CORPORATE BOND Newsletter

2nd Quarter 2005

The bond market is in a state of denial. The Federal Reserve is tightening monetary policy and raising short term interest rates. Economic growth continues to surprise with its underlying strength. The bond market in its infinite wisdom has decided to rally.

Bond strategists have broken new ground with their offered explanations. *"High oil prices are deflationary"* is the popular choice. *"China has to buy all the Treasuries in existence"* is a close second. *"Alan Greenspan has all the answers"* is the persistent and obvious truth for those too young to remember his mistakes.

We're not on the side of the consensus at present. The bond market has rallied because investors decided to buy bonds. There really isn't much economic reason to it. Ringo Star, the ex Beatle, has a lyric for our view: "It don't come easy, you know it don't come easy". An underlying inflation rate of 2-3% does not warrant interest rates of 3-4% no matter how creative your explanation for it.

Get the Shorties!

Markets have a way of building up a comfortable consensus which remains firm for some time. It then finds reasons to blow that consensus apart in a sudden and violent move. The bond market reacted in the first quarter to Fed tightening by selling off. It then decided to make those investors who stayed short pay for their brief period of defensive bliss with a strong rally in the second quarter. Those who were short fought it at first, but probably capitulated in June when the under performance pain became too great. Since most bond investors were schooled in the black art of bond management in the last twenty five years, they have only known falling yields for the most part. The fatal flaw of a bond manager is well known to all: staying short in the face of a rally.

Since the bond market has rallied supremely in the face of economic growth, we are unsure what a weakening of economic growth will mean for the credit markets. Long-term interest rates are near historic lows despite monetary policy tightening by the Federal Reserve. Investment managers have learned to buy bonds when the Federal Reserve is tightening monetary policy and interest rates are on their way up. The timing of this move seems to be advancing. Where the average bond manager would once move longer as the economy slowed, it now seems she or he is extending term just after the tightening begins, well before economic weakness. This could explain the current rally in long-term interest rates.

The other culprit probably is the currency interventions by the Chinese and other Asian central banks. Where the Fed can manipulate short-term interest rates through their open market operations with Treasury Bills, it is much harder to do it farther out the curve. The Chinese putting their hundreds of billions of currency reserves to work in Treasury and Agency bonds puts pressure downward on longer term interest rates.

Unconventional Bond Markets

The conventional bond market model has interest rates and inflation falling with a weakening economy. We have had falling long-term interest rates with a strong economy, high energy prices and a tightening Fed. The outlook for the bond market could potentially be as perverse as the current market's defiance of market and economic convention. We could very well have flat to rising long-term interest rates as the economy weakens, the Fed loosens and energy prices decline. In the 1970s, we frequently had economic weakness coupled with inflation. Is it likely that we could have rising interest rates and inflation with a weakening economy? The prospects for this scenario depend on the reaction of policy makers to economic weakness.

In the past few years, Federal Reserve policy has kept interest rates well below the level of inflation. U.S. and Canadian inflation has been subdued, but has still run at or above 2% for much of the period that short-term interest rates were well below this level. Over the longer term, the Fed and other world central banks know that negative real interest rates cause financial asset price inflation. We believe that the target or "neutral" level for short-term interest rates for the Federal Reserve is 1-2% above inflation. This would put short-term rates at 3-4% given a long-term inflation expectation of 2%. The prospect of a positive return on investment might even cause some Americans to actually save instead of spending.

Most observers believe that the Fed response to a weakening economy will be a relaxation of its "measured" interest rate increases. This might not be the case. Just as we had a policy of very low administered interest rates in a situation of economic strength, policy makers might decide to keep interest rates at a more reasonable level in the face of an economic slowdown. In our opinion, Alan Greenspan just has to look at the housing market to understand the tremendous speculation that his ultra low interest rate policies have engendered. Sometime in the future, Alan Greenspan or his successor must restore some semblance of order to the U.S. financial markets and return them to their role of efficient allocation of capital. When this happens, we believe that real interest rates will increase for financial assets. Long term-assets will not be immune from this restoration of pricing power to investors.

GM and Ford Ease Into Junk

Corporate bonds seem to be in the final phase of the credit cycle. Although some bad news on credit is emerging, such as the GM and Ford rating downgrades to below investment grade, investors can't escape from their performance imperative that urges them to buy risky bonds at tight spreads. This part of the cycle is normally finished when a financial panic causes investors to liquidate their riskier positions.

The credit markets dealt with the downgrade of GM and Ford below investment grade with seeming ease. This surprised us. The reported problems of hedge funds with credit derivatives have moved from the front pages and seem to be far less systemic than the Long Term Capital Markets implosion in 1998. We appear to be through the worst, although credit problems usually compound for some time before becoming evident to the markets.

We are seeing an up tick in corporate and personal default rates. One thing that particularly worries us is the continued relaxation of residential mortgage underwriting criteria. The lax credit standards of today's loans will be seen in higher default rates two to three years from now. Interest only and reverse amortization mortgages that are becoming popular in the United States only work with rising housing prices. Canada is not immune from this trend. A recent survey by the Toronto Star found that 60% of all new mortgages had a down payment of less than 10%. This leaves little room for a fall in housing prices.

Marginal Bonds and Yield Spreads

We are seeing continued issuance of very low quality and risky bonds at very tight spreads to higher quality issues. The ease with which marginal BBB (low) issuers can tap the markets for 10 year money at spreads not much above 100 bps (1%) above Canada bonds is an ominous sign at where we are in the credit cycle. Considering the historical loan losses on a portfolio of these bonds would approximate their current yield spread above Canadas, there is little room for maneuver should one of these issuers eventually run into trouble.

The current credit markets do not compensate investors for the default risk in many lower quality corporate bonds. We cannot say which issues will have problems in the next few years but we know from history that many will. When risk makes its return to the corporate bond market, spreads will widen substantially.

CANSO INVESTMENT COUNSEL LTD.
is a specialty corporate bond manager based in Richmond Hill, Ontario.

Contact: Heather Mason-Wood (905) 881-8853; heathermw@cansofunds.com