CORPORATE BOND Newsletter

April 2007

Our lonely view has been for some time that slowing growth might not lead to lower inflation and interest rates in the U.S. This has been confirmed in the first quarter of 2007 as an obviously slowing U.S. economy has seen accelerating inflation. We have now been joined by many commentators, including some who are using the dreaded "stagflation" word. Thanks to the enterprising Daniel Kruger of Bloomberg News, we turn to economist Paul Samuelson, whose textbook was the Economics 101 primer for a generation, for validation:

""We have a measure of stagflation", said Paul Samuelson, who was the second recipient of the Nobel Prize in economics and helped popularize the term to describe slowing growth and accelerating inflation in the U.S. during the 1970s ..... Samuelson, 91, said rising oil prices and the bursting of the "housing bubble" remind him of the 1970s, when former Fed Chairman Arthur Burns overheated the economy by holding interest rates low through the 1972 presidential election." Stagflation Deja Vu Prompts TIPS Demand, Loss of Fed Respect, Daniel Kruger, April 9 Bloomberg.com

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Bond investors are only now getting their heads around the evident possibility that slower growth and higher inflation can comfortably coexist. This realization set back bond prices and raised yields over the first quarter of 2007. This had been our expectation, as we believed that still ample money and credit would win the see-saw economic battle with the slowing U.S. housing sector.

Discombobulated Mortgages

Indeed, the discombobulated sub-prime mortgage market in the United States surprised the credit markets with the speed and severity of its meltdown. We were not surprised, as we have followed the U.S. sub-prime closely for the last two years. As we have remarked in our prior reports, lenders who don't intend to hold their loans and who don't care who they're lending to have a propensity to make stupid loans even by banker standards. The good news is that the turmoil has been so far contained to the portfolios of institutions and hedge funds since most of the loans had been packaged in collateralized debt obligations and taken off the originators' books.

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Stubbornly high inflation does not give Mr. Bernanke much policy latitude to deal with the mortgage problem. Both face and core inflation have moved well above 2% in the U.S. and we continue to believe that the Fed will refrain from a premature easing in monetary policy despite the increasingly strident cries from Wall Street. It doesn't help Mr. Bernanke that his predecessor, Alan Greenspan, is earning his healthy speaking fee by prognosticating publicly about the rising chance of recession. Certainly Mr. Greenspan's trigger finger must be twitching since he would likely have eased monetary policy at the first sign of trouble in the mortgage market. This is troubling to investors who aren't quite sure of what to make of Mr. Bernanke's independent streak, having been habituated to Greenspan's market friendly monetary easings given real or imagined financial crises.

A Rocking Outlying Scenario

With yields at just over 5% at the short end and with long bonds at 4.9%, not

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much inflation is currently priced into bond yields. Sustained U.S. inflation nearing 3% would cause both domestic and foreign holders of U.S. treasuries to rethink their conditioned "low inflation" outlook and challenge the consensus belief in monetary ease and lower interest rates in 2007. They will not be alone in their worries, as the Federal Reserve could be forced to act at a later date if inflation accelerates further. The outlying scenario of a Fed rate increase would rock the bond markets.

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Lamentable Inaction?

We believe the Bernanke Fed is reticent to raise interest rates and will wait until it is forced to act. Professor Bernanke is not a doctrinaire monetarist and has Mr. Greenspan heckling from the stands with his predictions of recession which are thinly veiled calls for monetary ease. This means that the Fed will probably be on hold for 2007, unless core inflation accelerates beyond 3%. Bernanke will find it hard to embark on an aggressive monetary tightening in 2008, a U.S. Presidential election campaign year. The Fed traditionally stays on hold during elections, as Paul Samuelson lamented about the ill-starred Fed of Arthur Burns.

The risk to our scenario is that the contagion spreads from sub-prime mortgages to the broader credit markets. This could lead to a premature easing by the Fed that would cause longer-term interest rates to trend up, given strong wage growth and nagging core inflation well above 2%. The bond market would quite rightly fixate on the potential for inflation to accelerate even though administered short-term rates would fall under Fed direction. This would put pressure up on long bond yields.

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Ebullient to Safe

Without further monetary tightening in the U.S., we continue to believe that outright recession is not in the cards, given the continuing strength of world economic growth outside the U.S. This means the risk to corporate bonds and the credit markets comes not from economic weakness but from ebullient lending practices, which is what has occurred in the sub prime mortgage area. As defaults and portfolio credit losses increase over time, the lenders will begin to implement "safe lending" practices. This is already occurring in the U.S. as Fed surveys of loan officers show an increasing quality bias.

Inevitably, real interest will rise as lenders are forced to recognize the increased risk of default. Credit spreads are still expensive and this keeps us oriented towards higher quality bonds. The credit risk in lower quality bonds is not compensated for with today's thin credit spreads. Until credit cheapens, we will be concentrating our portfolios in higher quality issues.

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On the interest rate front, all eyes will now be on Mr. Bernanke, who is doing his best to avoid doing anything. Given his unfortunate comments on dropping money from helicopters to defeat deflation when he was a Fed Governor, he is well aware of market fears that he is soft on inflation. If inflation continues to accelerate, he might be forced to raise rates prior to the traditional Fed policy hold for the 2008 Presidential election campaign. If he doesn't do anything, he risks joining the unfortunate Arthur Burns as a Fed Chair who unleashed inflation. The bond market would not be amused.

CANADIAN CORPORATE BONDS

Canadian Economic Warming

While U.S. monetary policy will fixate global bond investors in their deliberations on interest rates and inflation, Canada looks to benefit from global economic warming. Continuing global demand for Canadian resources means that Canada might escape the worst of the slowdown in the U.S. Certainly the drop in

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Like our American cousins, the Canadian corporate bond market is expensive, especially in the lower quality credit sectors.

U.S. housing starts will continue to drag on lumber and the Canadian forestry sector, but the still strong global demand for resources should moderate any damage to the Canadian economy. This would be good for the economy but might not be good for Canadian bond portfolios.

The booming Australian economy gives us a sense of Canada's prospects. Despite prior tightening by the Reserve Bank of Australia, the global resource boom means that labour is tight and the Aussie economy is running at capacity. Like Canada, a pause in monetary policy tightening seems to have reinvigorated the economy. In the article *"Australian Unemployment Rate Falls to 29-Year-Low 5%"*, Bloomberg News summarized the situation well:

"Reserve Bank of Australia Governor Ian Macfarlane said in February interest rates are more likely to rise than fall as declining unemployment fuels inflation. Reports the past week have shown gains in borrowing and home building, bolstering confidence the economy is rebounding from its slowest growth in four years." April 6 Bloomberg.com

Like Australia, good commodity markets mean that the Bank of Canada could be forced into further monetary tightening after its recent pause, which could put further upwards pressure on the Canadian dollar. Canada's resource base has driven up the Canadian dollar to levels which are hurting the manufacturing sector, particularly in Ontario, but Alberta oil and the resource boom continue to power growth for the rest of Canada. Further Canadian dollar appreciation would not be popular with manufacturers, labour groups or politicians. The Bank of Canada has seen core inflation move above its 2% target and does not look ready to lower interest rates for this reason. It will also be extremely reticent to raise interest rates to avoid further increases in the Canadian dollar.

Long Bond Pain from Inflationary Gain

Our Canadian outlook is for the Bank of Canada to keep administered rates on hold unless core inflation moves well above 2%. The pain from inflation rising above expectations would be felt first in the long end of the bond market. Global bond investors who view Canada as a lower inflation and harder currency alternative to the U.S. bond market would likely flee for safer climes. With current long term Canada yields at a very low 4.3%, any move upwards in inflation expectations would cause a sharp move up in longer term yields. If the BOC is grudgingly forced into action by rising inflation, the entire yield curve would move up and steepen as inflation risk premiums return to Canadian long bonds.

Foreign Issuance Dominates Canadian Credit

Much of the Canadian dollar issuance in the first quarter of 2007 has been from foreign issuers. We think this trend will continue and cheapen expensive domestic issues to global levels. We are now seeing lower quality foreign issues come to market as was the case with the recent deal by Iron Mountain, the U.S. documents management company. We think that Canadian spreads will increasingly move with global trends, particularly given the foreign issuance unleashed by the removal of the Foreign Property Rule.

Like our American cousins, the Canadian corporate bond market is expensive, especially in the lower quality credit sectors. We think that AAA and AA bonds are relatively cheap on a quality adjusted basis, given the vast new issuance by foreign Maple Bond issuers. Second tier provincial and municipal bonds have always been expensive in Canada, given the need for diversification. We expect the wide variety and high credit quality of foreign issuers now available in the Canadian market to remove the "scarcity bid" for these issuers and widen their spreads over time.

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Wringing the Bell Bondholders

As our readers know, we have expected for some time that easy credit and the large sums invested with private equity managers would lead to a rash of "privatizations" of large public companies. While the current vogue is to call these transactions "going private", they work because they layer on debt and are essentially the good old Leveraged Buy Out (LBO) of Michael Milliken and his cronies from the late 1980s. Gordon Gecko, the slicked back corporate raider of the movie "Wall Street" would be right at home in the greed and avarice of today's financial markets.

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The problem for bond investors is that these deals "maximize shareholder's value" by destroying bond investor value. The case in point is the current frenzy over the potential privatization of Bell Canada Enterprises. Reputable pension funds are lining up with private equity shops to probably pay the long suffering shareholders over $40, a steep premium to the recent $28 low. The holders of the long term Bell and BCE bonds have seen the price of their issues drop 25% as the market recognizes the debt laden successor will drop below investment grade.

In the United States, the management of Sallie Mae has dug themselves out of dropping lending spreads, a negative legislative environment and a bizarre and ill-conceived stock forward purchase program by borrowing enough money to pay $60 for their shares which had been languishing at $42. The bonds of Sallie Mae have fallen with a thud felt in investors' portfolios worldwide as their eventual downgrade to junk was priced in by the fixed income market.

Fixed income sales staff and analysts are now machine gunning their terrified buy side clients with volleys of "Who's Next?" emails. As a result, "safe" and event-risk free names are in vogue with bond investors. Given the continuation of easy credit conditions, we think the worst is yet to come. Easy money is the fuel for credit conflagration and the world's central banks have sprayed enough since 2000 to keep the flames burning for some time.

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Looking for Yield in All the Wrong Places

Until the Bell and Sallie Mae news broke, Canadian corporate bond investors were looking for yield in all the wrong places. This is normal at the peak of the credit cycle, as a strong economy and good financial markets increase investors' risk preferences. It was not fun to watch from the bench as credit continued to perform. It was, however, necessary for long term investment success.

We continue to think that the highest quality bonds are still good value in Canada, as the development of the Maple Bond market moves Canadian spreads to more ample global levels. It does not yet pay to take risk on credit. When the credit pain becomes unbearable to those with losing positions, we will be ready to exploit the values that will surface.

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