

Canadian Market Review & Outlook Commentary

Second Quarter 2009



Market Review

The North American economy remained weak in the second quarter, as negative real GDP and contracting employment persisted, and housing prices continued to fall. Despite these negative indicators, talk of economic “green shoots” began to sprout in market rhetoric. North American bond markets continued to sell off in the second quarter, as 10-year U.S. and Canada bond yields increased by 87 basis points (bps) to 3.53% and 58 bps to 3.36%, respectively. Government bonds suffered, as the flight to quality faded and the demand for stocks, commodities, non-government bonds and other risky assets increased.

Corporate bonds continued to rally in the second quarter due to a combination of large cash holdings, limited corporate new issuance and investors’ belief that an economic recovery is underway. The corporate sector was the best-performing component of the bond market last quarter and year-to-date. In the second quarter, Canadian corporate spreads tightened by 153 bps; U.S. credit spreads tightened 207 bps; provincial spreads tightened 39 bps; and municipal spreads tightened 51 bps.

In April, the Bank of Canada lowered its overnight rate by 25 bps to 0.25%, which is an all-time low for the benchmark. The bond market has no hikes priced into North American monetary policy until 2010. The Bank of England held its policy rates steady at .50% in the second quarter, while the European Central Bank lowered rates twice, for a total of 50 basis points, bringing its rate to 1.00%.

The Federal Reserve (Fed) met two times in the second quarter and held the federal funds rate steady at 0 - 0.25%, stating “economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period.” The Fed continued its policy of quantitative easing at a pace that disappointed the market, which added to the backup in government bond yields.

Outlook

We have seen a dramatic turnaround in the tone of the marketplace. Liquidity has improved in the first half of 2009, and demand for risky assets is high. Stock markets and credit spreads continued to rally in the second quarter, while North American yield curves steepened. Our economic outlook calls for mixed readings in the near term and improved readings toward the end of 2009. Central banks around the world are likely to maintain their all-time low monetary rates for the remainder of 2009 while continuing to provide fiscal stimulus and alternative measures to provide capital and ensure liquidity remains high.

The globally coordinated economic expansionary programs that central banks have put in place are likely to remain intact for some time, which will provide support to global economic growth. Corporate credit spreads and other risky assets have had a good run since the start of the year, however. Much of this performance was due to the extraordinarily oversold valuations that existed at the end of 2008. Given our view for mixed economic performance in the near term, we would expect some pullback in performance of credit toward the end of the third quarter. We continue to see corporate credit as an attractive investment and would look to add high quality spread product to current holdings on a backup in credit spreads. As the global economy recovers toward the end of 2009, corporate and provincial bonds will continue to outperform.