

North American Fixed Income Outlook

North American credit spreads widened in the second quarter of 2010 as risk premiums rose against a backdrop of European sovereign debt worries and a slowing economic recovery. Canadian investment grade credit spreads widened by about 30 basis points (bps) to about 250 bps inside their recent peak, but still about 50 bps above historic averages. U.S. investment grade credit spreads widened by 45-50 bps and are now back in line with historic averages.

Canadian corporate bond issuance is still healthy, with over \$35 billion in new debt coming to market in the first six months of the year. Firms continue to bolster their balance sheets before interest rates rise further. Despite the recent rise in risk premiums, absolute borrowing costs remain low. This is providing firms the financial flexibility to ramp up capital expenditures and other initiatives that were put on hold during the recession. Demand for corporate credit product is firm, especially for floating rate notes that can provide fixed income portfolios at least a partial shield in a rising interest rate environment.

Short-term Canadian bonds continued to underperform longer maturities in Q2. Inflation remains under control and most investors still expect the Bank of Canada (BOC) will boost borrowing costs further. We expect that the shorter end of the yield curve will come under more pressure as rates rise. At the same time, credible monetary stances by both the U.S. Federal Reserve and BOC have largely contained inflation expectations, and that should restrain yield increases at the long end. These trends are expected to continue through next year. We expect the BOC to have raised administered rates by 250 bps to 3% by the end of 2011.

Despite the recent weakness, Canadian credit markets should benefit from a rather resilient economic landscape. The recent pull-back in spreads has provided something of a buying opportunity in credit, although a replay of 2009's blistering 16% corporate credit return in 2010 is just not going to happen. Meanwhile, the promise of higher rates favors a shorter duration stance over the intermediate term.

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