



FIXED INCOME

The stealth bull market in bonds continued in September, although it began to attract the attention of more investors who had missed the first several points of the long bond rally.

Since the summer lows in prices on June 28, the price and yield movements for Canadian bonds have been as follows:

	June 28	October 11	Price change	Yield change
Canada 3.75% 6/1/08	\$ 98.71	\$ 99.51	+\$ 0.80	- 41 bps
Canada 4.00 6/1/16	94.80	99.11	+ 4.31	- 55 bps
Canada 5.75 6/1/33	116.58	125.08	+ 8.40	- 48 bps

These prices are well below the peaks set on October 4 as, for example, the 4s of 16 have lost \$ 1.20 since then.

What drove the rally to such heights primarily was the view that the slumping US housing market would take enough off growth and consumer spending to cool inflation. This in turn led to mounting enthusiasm regarding a possible early cut in the Fed Funds rate. This market got ahead of itself. Last Friday's employment news, coupled with a slump in the price of crude oil and persistent, nagging inflation numbers, caused a "reining of the bulls."

So now the market is divided between those expecting a hard landing for the US economy and those who think that growth will be resilient.

We are in the camp that believes in a 'soft landing', one in which the ongoing weakness in US housing will outweigh the benefits to the consumer of lower energy prices.

Thus, we conclude that the Federal Reserve Board has completed the tightening cycle but remains ever vigilant on the inflation front. Any rate decreases will take place in spring at the earliest.

OUTLOOK

We believe that we are in a bull market in bonds that may be half over. Therefore, we forecast further declines of up to 50 basis points in ten year bonds which will generate additional positive total returns.

STRATEGY

We continue to recommend extending duration in bond portfolios. For taxable accounts, we recommend ten year and longer provincials and ten year good quality corporates. For RRSPs, we favour long term provincial zero coupon bonds.

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