



GUARDIAN CAPITAL LP

Guardian Capital **Pinnacle High Yield Bond Fund** **First Quarter, 2009**

REVIEW

Credit spreads finally stopped their almost 2 year march wider by mid-quarter, but few issuers showed any real improvement until near quarter-end. In Canada, investment grade corporate bonds outperformed government issues for the first time in several quarters, returning +3.5% vs. just +1.5% for the overall universe. High yield spreads showed little improvement though, with the DEX Canadian High Yield Index falling -15% and the Merrill Lynch Canadian High Yield Index off -2.1% for the quarter.

During the first eight weeks of the new year investors remained preoccupied with failing financials, auto companies on the verge of bankruptcy, rising unemployment and a long list of new and confusing government bailout/stimulus programs. Volatility peaked and stock markets made a near term bottom by early March, however, and financial conditions appeared better at quarter-end than they have in more than a year.

Credit markets re-opened to new issues during the quarter, stimulated first by government program backed financial issues, moving on to select higher quality corporates and even some high yield by quarter end. Coupons and yields remain extreme for new issues, and covenant packages for corporate issues are more investor friendly than we have seen in recent years, but companies that must borrow are beginning to find investors. We expect this trend will continue through Q2, as many companies have delayed borrowing money in the 'broken' capital markets of the past year or so.

We began adding hedges against our USD exposure (protecting against a rise in the CAD) late in Q4 and became fully hedged by mid Q1. Although the CAD did decline by about 3% in the first quarter, any slowing of bad economic news or recovery in capital markets and commodities should be supportive for the CAD, considering its 30%+ fall over the past six months.

OUTLOOK & STRATEGY

While the speed of decline in economic activity has clearly slowed, the recession is likely to prove longer and deeper than many forecasters have currently discounted, possibly lasting through all of 2009. Recovery, once it begins, will likely be one of sluggish growth, especially in the U.S.

Consumers have begun a long, potentially painful process of de-leveraging, and increasing their savings rates. However, they're doing it while housing values and other investments have fallen precipitously in recent years, and worries about their jobs have increased. Unemployment rates in both Canada and the U.S. are likely to get worse in the months ahead, and although employment is a lagging indicator, the negative headline impact will be enough to keep consumer spending at very weak levels throughout the year.

At the same time, corporations have seen a significant deterioration in order books and a corresponding build in inventories. Capital spending budgets are being slashed and projects delayed

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or cancelled across a wide range of industries, as companies focus more and more attention on preserving their balance sheets and surviving this cycle, rather than expanding.

A deep recession, falling profits, volatile capital markets and severely restricted access to credit means default rates will have to rise in the months ahead. To date, corporate defaults have remained low, partly due to the huge government bailouts and lifelines we have seen around the world in the financial, auto and related sectors. However, as we move through 2009 and 2010, hundreds of billions of dollars of corporate (and emerging market) debt will be coming due for refinancing, in a world in which there are simply fewer investment dollars and fewer investors than before. As a result, companies with the weakest balance sheets or those with less desirable assets will find themselves quickly 'crowded out' for refinancing, leaving bankruptcy the only alternative. Increasing bankruptcy rates at time of reduced access to capital means recovery rates will also be depressed this cycle, as fewer potential buyers will be available to buy bankrupt assets.

With our largest trading partner (the U.S.) in a deep, prolonged recession, our own economy contracting, huge fiscal stimulus is going to result in a return to government deficits and if commodity prices remain low, it is difficult to see the CAD holding at current levels. While it already weakened substantially in 2008, in a slow growth environment the CAD will have to fall further to support export activity in the medium term. At the very least, the CAD is unlikely to be appreciably stronger vs. the USD in 2009. As a result, we will likely reduce our hedges (currently 100% of USD exposure).

While 2009 may be a tough year, economies and markets will eventually recover. Faster growing Asian countries have begun to ease monetary policy months ago and have implemented stimulus plans in response to the global downturn. U.S. and European policy makers have slashed rates (the U.S. has even adopted a 'zero' interest rate policy) and launched some of the most massive stimulus efforts ever imagined. Perhaps most importantly, governments around the world have recognised the need to salvage and recapitalize the banking system, and allow it to return to the job of supplying credit to allow economic growth.

Risks in the year or two ahead center around whether these huge stimulus programs fail, or work too well. Either way, it looks like we will be left with huge government debts and deficits for years to come. However, success of the plans could trigger a difficult period of high inflation and higher interest rates down the road. Failure, on the other hand could lead to further asset deflation, further economic contraction and even a collapse in the USD (which would also have inflation implications).

Corporate credit spreads, while somewhat narrower than year-end, have moved to levels never seen before, and are simply un-sustainable. In the U.S., the Fed has adopted a 'zero rate' policy, with the intention of making Treasury bond yields so unattractive that investors will be forced to move into alternative credit vehicles, especially corporate bonds. In addition, the cost of borrowing for most corporations has become uneconomic at current levels. At some point, the banking system will heal enough that borrowing costs and therefore corporate spreads will contract to a point that once again make economic sense. That move tighter, will generate attractive returns for investors as it happens. In the meantime, running yields on corporate bonds currently more than compensate for the risk of rising defaults and ongoing economic weakness.

Our intention is to avoid debt maturing in the next two or three years, issued by companies that require access to capital markets. We wish to avoid those companies, no matter how attractive the business model, who may find the borrowing window closed when they most need it. However, this area remains attractive for issuers with strong cash balances, un-drawn bank lines or attractive

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assets, as bonds in this term have become deeply discounted yet should mature on schedule and at par, offering very attractive returns in the next 12-24 months.

In terms of specific industries, financial issuers in both banking and insurance became steeply discounted in 2008. We believe governments around the world are committed to supporting the financial sector, at least for the next 2-3 years as the healing process unfolds. In the insurance sector, large losses and write-downs in recent years is expected to lead to a period of stronger underwriting and higher premium revenue. We expect to focus on these sectors in 2009. Similarly, commodity prices have fallen significantly, and credit spreads are reflecting the expectation weak prices for years to come. However, a large chunk of the trillions of dollars being spent through stimulus programs is moving into infrastructure projects around the world. These projects will support prices of many commodities including minerals and energy. As a result, issuers in those sectors can be expected to continue to form several core positions in high yield funds.

The weakening consumer will spell bad news for many retailers, airlines, hotels and other issuers and we intend to continue to avoid most of this sector. In addition, while U.S. auto bailouts will help the automobile industry in the short term, we continue to believe a court directed restructuring (through bankruptcy) remains likely, and will be avoiding that sector as well.

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