



## FIXED INCOME

The bond market limped to a weak close in 2006. From a new cyclical low in yield of 4.44% at the end of November, the US Ten year note climbed 28 basis points to 4.72% by year end. The market was spooked in December by economic evidence suggesting that the economy was not as weak as pundits had been proclaiming and that the Federal Reserve Board would delay easing until the second quarter of 2007.

For the entire year, bonds turned in relatively meager performance with the composite bond indices showing total returns in the range of 4%. The December slump made a big dent in these returns. The annual performance masks what was a bifurcated year; from the beginning of 2006 until June 28, yields rose steadily. Staying with the US 10 year note, it rose from 4.39% to the yearly high of 5.24%. When it became apparent that the Fed was finished tightening and the bond market began to gain confidence in the new Fed Chairman Bernanke's inflation-fighting ability, the 10 year note fell to 4.44% by the end of November. Timing was everything in 2006!

### **OUTLOOK**

The market closed the year on a bearish note and has continued to slump under the weight of rising rates in Euroland and England as well as some unexpectedly strong employment and retail sales reports. As well, the housing market slump in the US has shown some preliminary signs of bottoming. The Federal Reserve Board spokespeople, while less hawkish, are still repeating the inflation vigilance mantra.

We remain bullish on the bond market. The current downdraft in bond prices should end soon. The accompanying chart on 10 year US Treasuries dates back to 1996, displaying the cyclical swings since then. At present, the 10 year yield is comfortably below its 200 day moving average of 4.85% and that should be as far as this sell-off is likely to go.

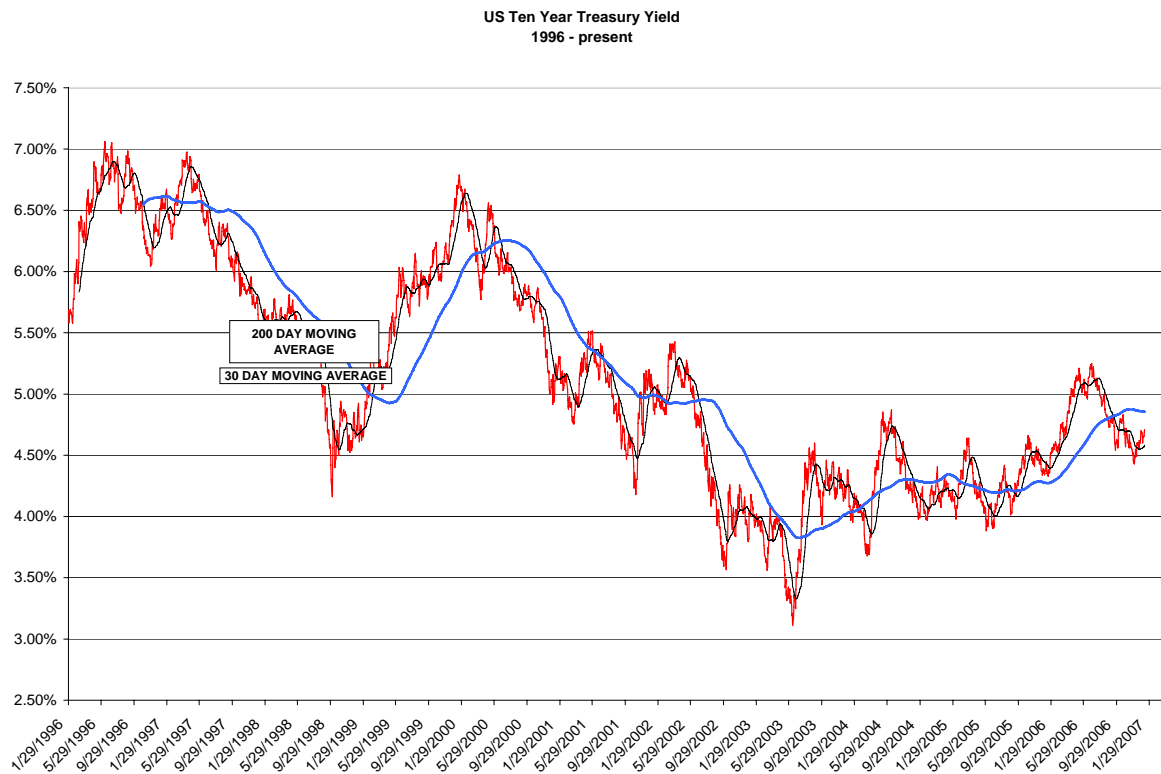
While the short term economic data has firmed somewhat, we continue to foresee below trend growth and a fall in the core inflation rate below 2%. These two factors will lead to easing by both the Federal Reserve Board and the Bank of Canada of 50 basis points in the second quarter and perhaps further cuts after that if deemed necessary.

## STRATEGY

We are close to a significant buying opportunity which should produce good returns. Our target for the US 10 year note is 4.25%, which would be a new cyclical low. As mentioned previously, we favoured buying US bonds for their higher yield and the vulnerability of the Canadian dollar. The Loonie has sunk like a stone since, thus providing the Bank of Canada with a de facto easing, and has reached a level which leads us to remove that recommendation.

Corporate balance sheets will experience some deterioration this year, so we advocate prudence in the selection of corporate bonds.

Extend duration.



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