SENTRY

Fixed-income commentary

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Sentry Tactical Bond Fund

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Market environment
A sour mood permeated much of the global credit market in June with Greece, a sputtering US economy and Sino Forest all playing a part in the re-pricing of risk. This cost the Fund a few cents in valuation. That Greece is sputtering towards restructuring should not be a surprise to anyone – except maybe the European Union. Let's face the facts. If it is costing you 28% to borrow funds for two years, this indicates the market is pricing in the negative outcome. The real question: how will this impact the broader financial market? For starters, I do not see this as another Lehman Brothers. There should not be a surprise outcome to this event, but the uncertainty will overhang credit markets until the European Union either succeeds in putting a viable support plan in place or concedes to reality.

Sino Forest, a Chinese forestry company which is basically a shell corporation listed on the TSX, gave the market a real wake-up call when accusations of business irregularities dramatically cut both debt and equity valuations. We have shied away from structures like Sino Forest, and while Chinese companies form a big part in what we do on the emerging-markets side, the companies we look at are real, tangible corporations in the Asian economic space. These are companies that are leveraged to the growing domestic economies in the developing markets, companies that have a large presence in the local economy and companies that hold a dominant position in their industry sectors. While initially, all Asian credits were painted with the same "Sino Forest brush," the market correction has proven temporary for the names we focus on; we have used this opportunity to add to positions where possible.

Despite a few rays of sunshine, the US economic growth story took a sharp step backwards in June with even the Federal Reserve revising its 2011 forecast down from 3.1% – 3.3% to 2.7% – 2.9%. While some of the slowdown can be attributed to short-term supply disruptions resulting from the recent Japanese earthquake and an unusually wet spring, I continue to believe that there is something deeper at work. Strangely, both the US and Europe are following similar paths despite structurally different economies. I first ran across the concept of "balance sheet recession" when looking at Japan and while the circumstances are different, the economic path is consistent. Simply put, you get a balance sheet recession when the consumer levers up to buy an asset, which in turn, significantly falls in price. With the asset devalued and the debt still around, cash flow is directed at paying down the debt. The housing market is the easy target in the US, while in Europe, we are seeing it more at the sovereign level where leverage was used to support generous social programs. As we have seen in Japan, it takes a long time to work out of a balance sheet recession and this can lead to choppy markets as expectations are moderated.

Portfolio review
Is the picture all doom and gloom? For credit, I am seeing it as just the opposite. Corporate bonds have at least three things working in their favour. First, slow subpar economic growth tends to support a stable credit environment where companies are focused more on defence then offence – i.e., improving credit fundamentals. From a credit perspective, offence is usually where companies wind up in trouble. Second, global liquidity is still abundant and while central banks have slowed the flow, they are generally not expected to pull the plug. Don't be surprised to hear more talk of a third round of quantitative easing if the economic soft patch turns into more of a quagmire. Third, and probably most importantly, absolute interest rates are going to remain low for quite some time; this means investors will likely be drawn to the higher yields offered by corporate bonds. There is a fourth factor and that is emerging markets, which we see as offering a positive environment for credit improvement. Through all this, it is surprising that the prospect of a US Treasury default has really not been a focus, with 10-year government bonds hovering around 3% and the debt ceiling date of August 2nd quickly approaching. This may be a topic for the next bimonthly commentary.

Company in the spotlight
As usual, we want to shed some light on one individual emerging market company to whom we lend money. China Shanshui Cement is the most recent emerging market addition to the portfolio. It is one of the largest cement producers in China and has been identified by the Chinese regulator as an industry consolidator, as the country enters into its 12th five-year plan. The company is benefiting from the fixed-asset investment, continuous urbanization and the social housing program that is accelerating in China. The government's official plan is to build 10 million units of affordable housing for mid-to-low income people in 2011 and much more in the years to follow. Therefore, while people are worrying about China's property bubble, the cement industry is being boosted by a different source of demand. This is reflected in capital markets: when property developers were under pressure, China Shanshui Cement's stock rallied 73% YTD as of July 5, and its bonds are among the few Chinese industrial

companies that have been holding very well during the recent turmoil of Chinese companies. As part of our due diligence work, we met with the company's management, chatted with its largest institutional equity holders and checked its relationship with domestic lenders. The last part is actually a very critical step, as most troubled Chinese companies listed overseas don't have access to domestic/local lenders; that's part of the reason they go abroad. Hey, if local banks are not willing to lend money to a local company, why would you?