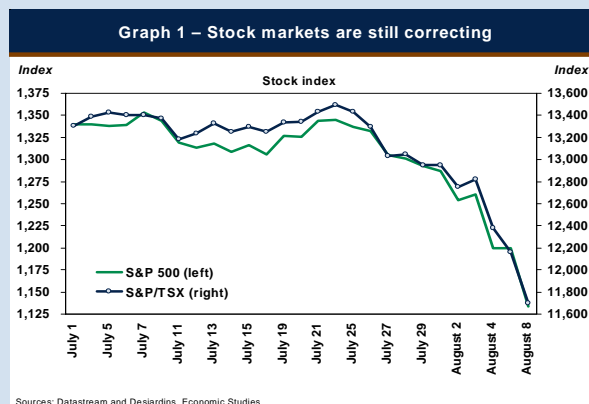


August 8, 2011

The downgraded U.S. rating is fuelling market losses

Financial markets have suffered major jolts in the last weeks and the world's major stock exchanges have tumbled sharply. In the United States and Canada, the S&P 500 and S&P/TSX indexes have shed close to 15% of their value since July 21 (graph 1). The downgrade of the U.S. debt by Standard & Poor's after the markets closed on Friday added oil to the fire at the start of the week. Bond yields have declined significantly and most currencies fell against the U.S. dollar. This Economic Viewpoint will summarize the current situation and shed some light on what could come next.



Stock markets have been in the midst of a major correction since the end of July. Several factors are behind this steep decline. First, the U.S. economic statistics released are fuelling fears of another recession in the United States. The last-minute deal reached to raise the debt ceiling in the United States also did little to reassure the financial markets. While the budget cuts announced will extend over the next few years, these alone are not enough to stabilize the debt to GDP ratio of the United States over the long term, thus explaining Standard & Poor's decision to downgrade the credit rating of the United States. Lastly, the U.S. government appears to have run out of means to support the economy should the need arise. On the other side of the Atlantic, concerns about sovereign debt are still swirling, despite the recent agreement reached on Greece's public finances.

STOCK MARKETS

Market investors are increasingly worried about the United States slipping into a recession and they are especially concerned about a scenario in which the government would be unable to support growth, as it had done in 2008

and 2009. If this scenario materializes, the recovery will be drawn out over a long period and curtail growth outlooks for corporate profits.

The short-term future is very uncertain. If U.S. statistics maintain their recent trend, this correction could continue. On the other hand, we cannot exclude the possibility that central banks will adopt measures to calm the financial markets. On Tuesday, the Federal Reserve (Fed) will release a statement on monetary policy and it might be open to adopting certain measures. Under these circumstances, stocks could pare losses, much like last summer.

BOND MARKET

One of the more striking aspects of recent events is the reaction of the bond market. Whereas a downgrade should, in principle, prop up bond yields, what is actually happening is the reverse (graph 2 on page 2). There are two conclusions we can draw from this. First, even though doubt has been cast on the quality of U.S. debt, the bond market is far from losing its safe-haven status. Second, economic outlooks and

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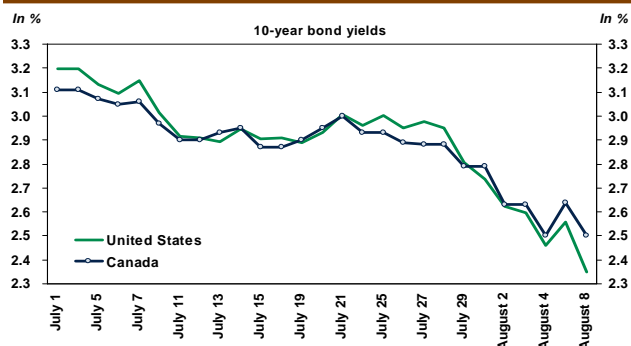
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Graph 2 – Bond yields continue to fall, even in the United States



Sources: Datastream and Desjardins, Economic Studies

central bank interest rate forecasts remain the fundamental pillars of bond yields, especially for short maturities.

In any event, the decline in bond yields observed in recent weeks may not last much longer. The future of bond yields depends on many factors. In a scenario where the economic and financial situation were to deteriorate further, the likely intervention by monetary authorities would restore some degree of confidence to the markets, sending yields back up. It is also possible that the economic climate improves on its own in weeks ahead.

CURRENCY MARKET

Risks in both the United States and Europe are tending to limit fluctuations in the EUR/USD pair. Initially, investors sought alternatives to the greenback and to the euro, benefiting many currencies including the loonie. However, concerns are becoming more widespread in the financial markets, while resource prices are undergoing corrections; these factors are now weighing heavily on the Canadian dollar, which could soon slip below parity with the greenback. Growing fears of a new, global recession could intensify this downward movement of the loonie.

THE AUTHORITIES WILL NOT STAY IDLE

Investors are likely to be kept on tenterhooks for a while to come. In the current climate, it will be difficult for business and consumer confidence to improve. Moreover, the austerity measures announced by some governments to reassure the markets about their borrowing quality will have a dampening effect on the economy in the short term. Meanwhile, any negative economic news will generate plenty of volatility in the markets.

We should expect government and monetary authorities to shortly announce measures designed to prevent the situation from deteriorating further. The G20 countries have already made a collective pledge to assure financial stability and increase liquidities in the money market as necessary.

The European Central Bank has recently begun purchasing Spanish and Italian government debt obligations. The Fed will hold a monetary policy meeting tomorrow and may announce new measures. Should the U.S. economy see a more pronounced slump, along with new disinflationary or even deflationary pressures, the Fed could soon go ahead with a third round of quantitative easing.

As for the Bank of Canada, it will probably have to just be patient. Even though Canada's economy seems to be doing fairly well and its public finances are in better shape, the current deterioration in the world economy is no longer conducive to interest rate hikes in this country.

THE CLIMATE WILL REMAIN UNCERTAIN

In conclusion, stock markets are currently attempting to reflect, as best they can, the increased risk of recession in the United States. It is difficult to predict exactly when the situation will stabilize. However, we should expect the reassuring words of monetary and government authorities, together with their upcoming actions, which have clearly been disclosed, to calm the markets in the days ahead. Nevertheless, volatility is still high and will remain so for some time to come. We must however remind investors to focus on their long-term objectives.