

# The Yield Curve

January 31, 2008

## The U.S. Federal Reserve takes the bull by the horns, but more rate cuts will be needed

### Highlights

- U.S. Federal Reserve: Monetary easing continues apace.
- Bank of Canada: Heading for bigger rate cuts in Canada.
- European Central Bank: Inflation pressure has the ECB's hands tied.
- Bank of England: Inflation risks could limit rate cuts.
- Bank of Japan: No increases expected before mid-2008.
- Risk reappraisal continues to benefit safe haven assets.
- The yield curve's slope should steepen further.

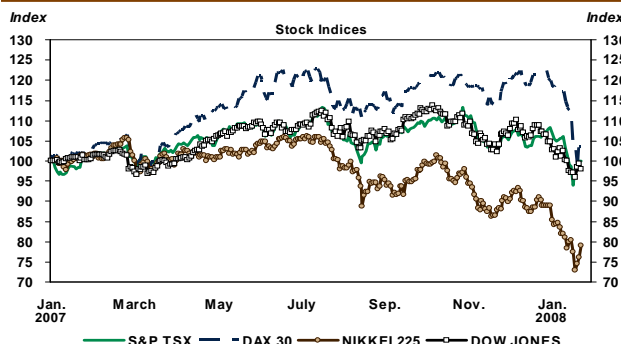
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### Summary

In the financial markets, the last few weeks have been tumultuous (Graph 1). Fears of a generalized economic slowdown have been magnified lately by pessimism from the rating agencies (such as Fitch's downgrading of Ambac from AAA to AA) about bond insurers (monolines) and an unusual volume of liquidation transactions in Europe's stock markets due to the historic US\$7.1B fraud at Société Générale. Close to panic, the market fled to safe-haven assets, pushing rates on two-year U.S. federal bonds to a cyclical low of less than 1.90%, the lowest they have been since April 2004. Even the surprise 75 basis point cut from the U.S. Federal Reserve (Fed) left the market stunned.

Graph 1 – Stock indices have dropped everywhere on the planet



Sources: Datastream and Desjardins, Economic Studies

And then the sky started to clear. The expectation of further cuts to federal funds, the potential US\$15B plan to bail out the monolines (Graph 2) and the Bush administration's agreement in principal regarding a US\$145B package to help U.S. business and households have finally breathed some hope into the markets, pushing U.S. bond interest rates up by nearly 30 basis points over the whole curve.

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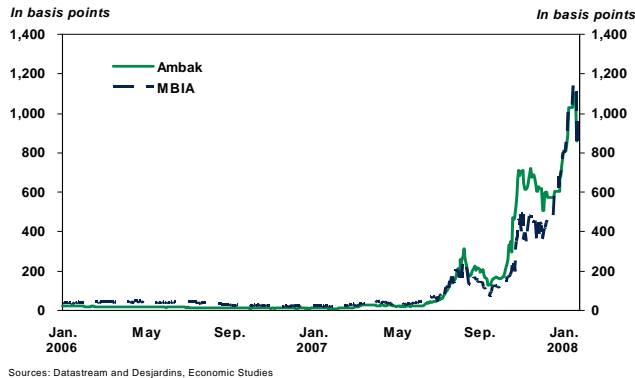
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**NOTE TO READERS:** The letters **k**, **M** and **B** are used in texts and tables to refer to thousands, millions and billions respectively.

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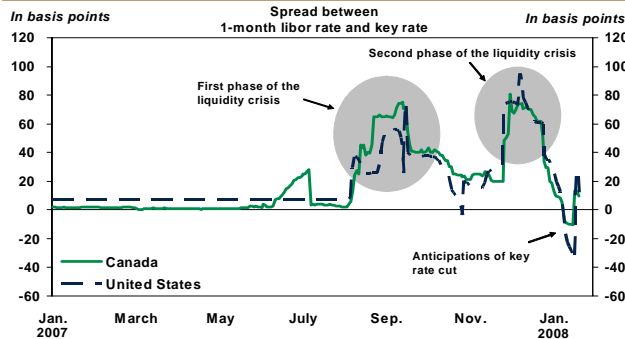
**Graph 2 – Bond insurers (monolines) are on credit watch**



Sources: Datastream and Desjardins, Economic Studies

For now, we think that further rate cuts are on the way. Strains on the money market eased somewhat with the arrival of the new year (Graph 3), but there are still many credit risks, especially among financial firms (Graph 4).

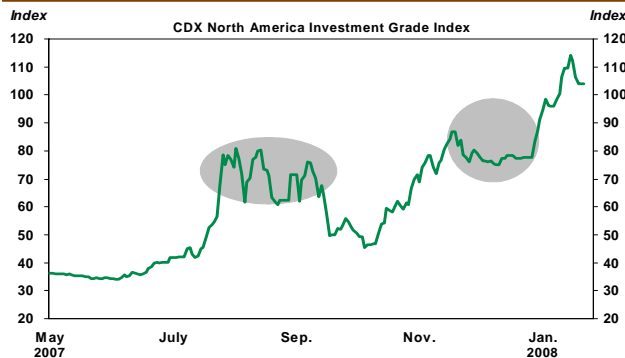
**Graph 3 – Liquidity constraints were reduced...**



Note: The Libor (London interbank offered rate) is an average rate that important London banks offer each other for interbank deposit.

Sources: Datastream and Desjardins, Economic Studies

**Graph 4 – ... but credit risks remain elevated**

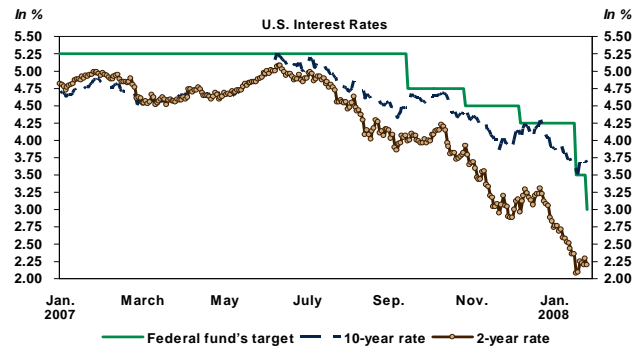


Sources: Bloomberg and Desjardins, Economic Studies

Under these circumstances, the yield curve's slope should steepen further to let the financials become profitable again.

However, after ordering 125 basis points in cuts to federal funds in one week, the Fed is now less out of step with the market's expectations (Graph 5); it will certainly want to slow the pace of monetary easing to hang onto some manoeuvring room to conduct its monetary policy in the event the economic situation deteriorates even more sharply, or deflation fears build up. That, especially since no concrete sign of a recession has emerged (beyond the housing market) and, to date, no net job losses have been recorded.

**Graph 5 – The Fed dropped its key rate aggressively**



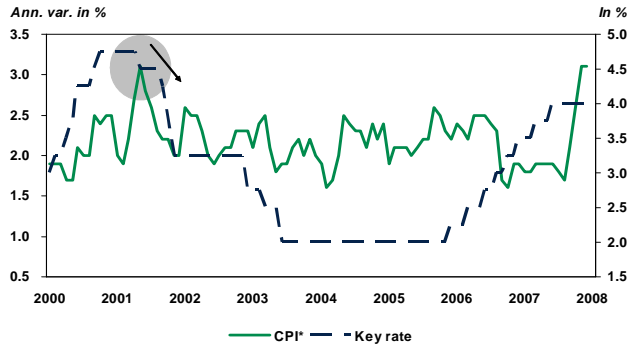
Sources: Datastream and Desjardins, Economic Studies

In our opinion, a recession is not the most likely scenario for the U.S. economy, but a sharp slowdown now seems inevitable. Under these circumstances, the other industrialized economies are widely expected to keep pace with the Fed and begin or move ahead with their monetary easing cycle. The fact is that, while industrialized countries and emerging economies have not been much hurt by the U.S. real estate market correction (not very import intensive), the impact of second-wave effects from the loss of wealth and expected increase in savings on consumer spending (very import intensive) could well have an impact on the rest of the world.

For now, with inflation over one percentage point above its upper target, only the European Central Bank (ECB) is reluctant to lower its interest rates. However, recent misunderstandings on the Governing Council suggest that the ECB could be induced to change its stance if there are concrete signs of a slowdown. Two points are noteworthy here. First, inflation is a lagging indicator of the economic cycle: with several early signs of a slowdown in the euro zone, inflation should slow in the coming months. Second, inflation's elevated level is not the be all and end all: although inflation was at 2.7% in May of 2007, the ECB did not hesitate to cut its key rate by 25 basis points to limit the risks of the U.S. slowdown spreading to Euroland's economy (Graph 6).

The United Kingdom initiated a monetary easing cycle in December with a 25 basis point cut, to 5.50%. Due to the

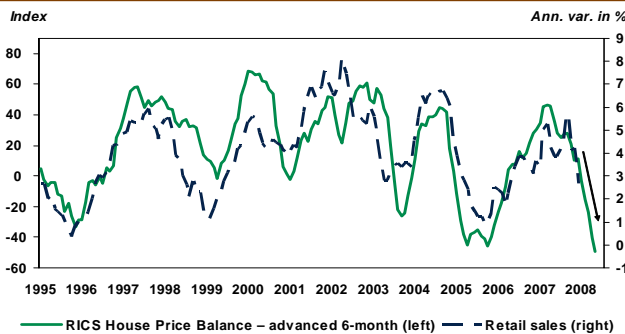
**Graph 6 – High inflation won't be a problem when signs of economic slowdown will be evident**



\* Consumer Price Index. Sources: Datastream and Desjardins, Economic Studies

committee's fears about a surge by inflation, the market is now pricing in slightly fewer rate cuts from the Bank of England (BoE). However, the real estate sector seems to be substantially overvalued, and the ongoing correction will surely have an impact on Britain's economic growth (Graph 7). Under these circumstances, further cuts to the bank rate will be needed by mid-2008.

**Graph 7 – UK real estate market's correction should bring a marked slowdown in consumption**



Sources: Royal Institution of Chartered Surveyors, Office of National Statistics and Desjardins, Economic Studies

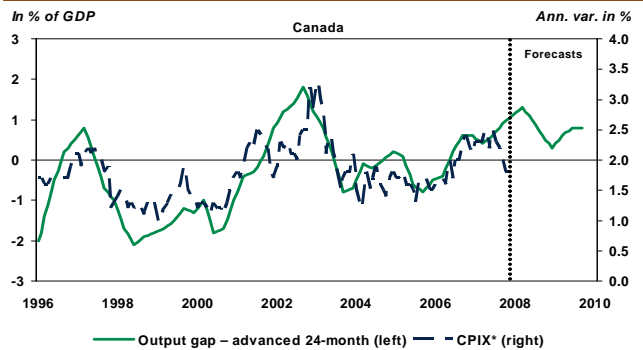
In Canada, the 25 basis point key rate cut ordered on January 22, less than one hour after the surprise 75 basis point cut to the federal funds rate in the United States, indicates that the Fed's decision was made in haste, and that the Fed certainly had not deemed it opportune (or necessary) to warn the Bank of Canada (BoC). Governor David Dodge vaguely asserted that they were in touch in times of crisis, but everything suggests that the Fed meeting was held without his knowledge. In any event, as the Fed meeting took place in the evening, over the phone, the BoC would not have had time to change its statement.

Nonetheless, the tone of the press release accompanying the decision had changed somewhat with the *Monetary Policy Report Update*. The short-term economic projections

now suggest that the pace of monetary easing will accelerate in the next few months. Clearly, the Fed's rate cuts, totalling 125 basis points in just over a week, will have a big influence on the BoC's future decisions.

For now, nothing is stopping the BoC from proceeding with bigger rate cuts. Some inflation pressures do remain, of course: the economy is still operating above production potential (Graph 8), labour market conditions remain tight, and real wages are rising.

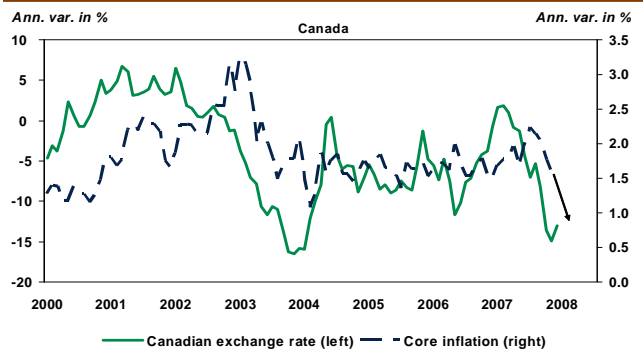
**Graph 8 – Inflationary pressure underlying from strong domestic demand...**



\* Consumer Price Index excluding eight of the most volatile components. Sources: Datastream and Desjardins, Economic Studies

Yet the downward revisions to growth should lead to a slight excess in supply as of the second quarter of 2008. What's more, intensifying competitive pressure associated with the strong loonie should offset the inflation risks stemming from the domestic economy's solid performance (Graph 9).

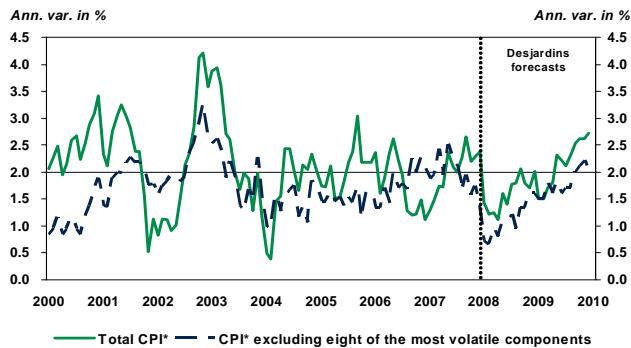
**Graph 9 – ... should be offset by increased competitive pressure stemming from the vitality of the loonie**



Sources: Statistics Canada and Desjardins, Economic Studies

As a result, core inflation is likely to close in on the lower end of BoC's target range (1.0%) in the next few months, giving the BoC the leeway it needs to further lower interest rates to limit the risks of a steeper slowdown (Graph 10).

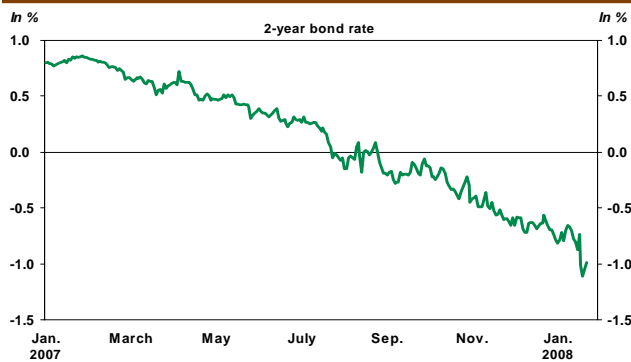
**Graph 10 – Tame inflation is giving the BoC the necessary leeway to cut its key rate**



\* Consumer Price Index.  
Sources: Datastream and Desjardins, Economic Studies

Nevertheless, the lag created by the smaller drop in the rates on Canadian government bonds vs. their U.S. counterparts will not be reversed in the near term. Under these circumstances, it is too early to bet on a flattening of the CAN/US 2-year slope (Graph 11).

**Graph 11 – CAN/US slope**



Sources: Datastream and Desjardins, Economic Studies

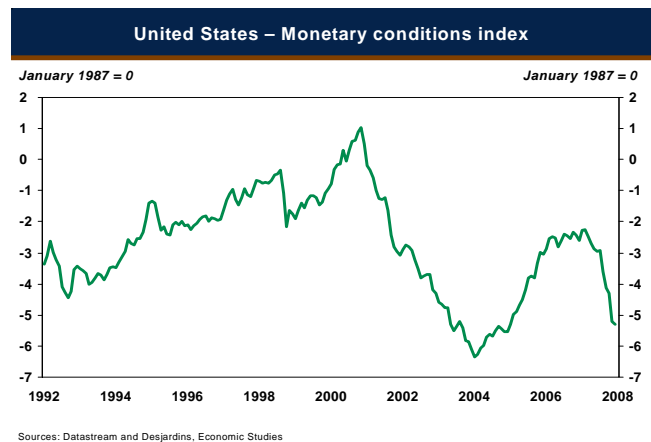
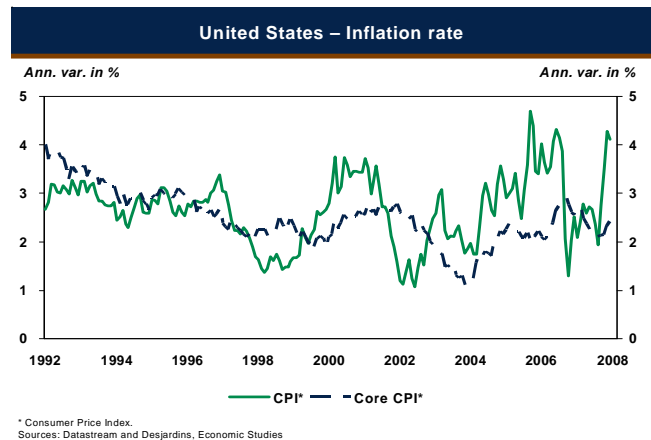
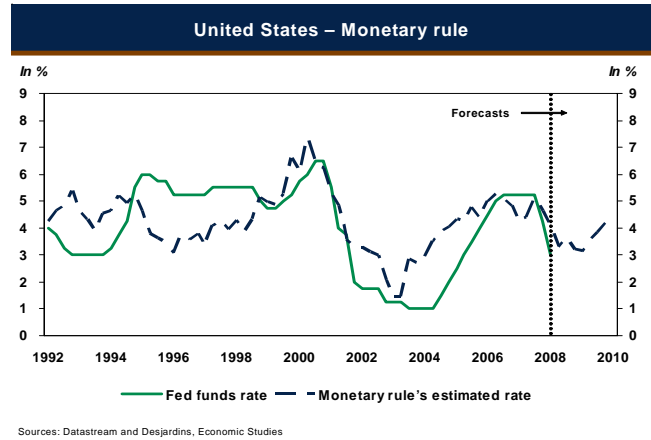
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# MONETARY POLICY

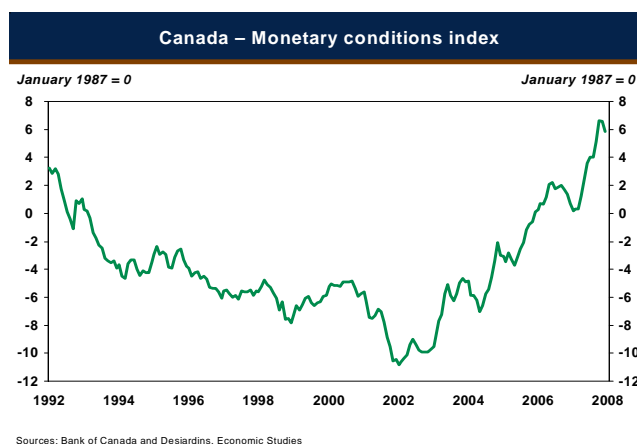
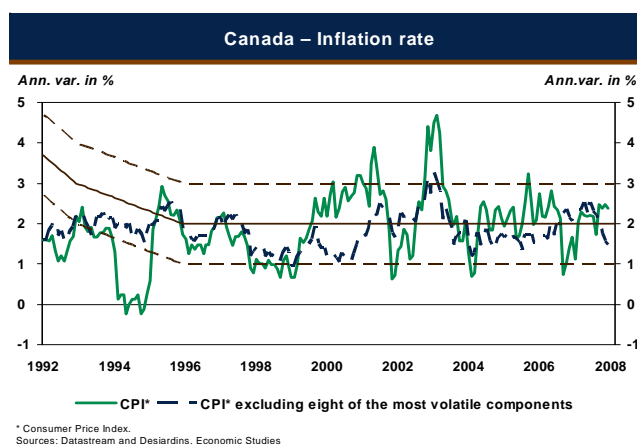
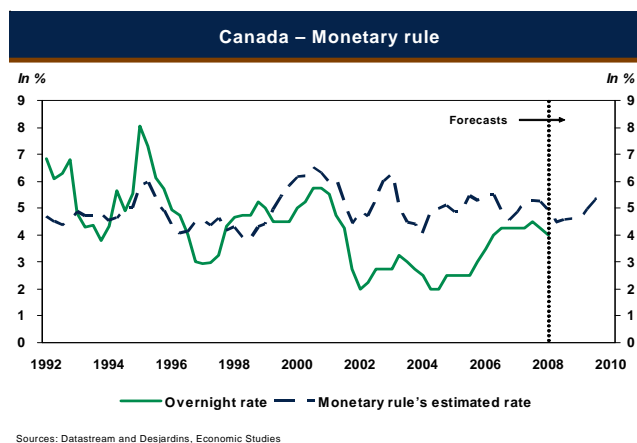
## U.S. Federal Reserve (Fed): Monetary easing continues apace

- The Fed surprised the markets with a 75 basis point cut on January 22, followed by another 50 basis point cut on January 30. This took the target for the federal funds rate from 4.25% to 3.00% in one week.
- The darkening economic outlook indicates that more rate cuts will be needed in the short term. According to the Fed, "The financial markets remain under considerable stress and credit has tightened further ... Moreover, recent information indicates a deepening of the housing contraction as well as some softening in labor markets. Downside risks to economic growth remain."
- The net slowdown by real GDP, from 4.9% in Q3 of 2007 to just 0.6% in Q4, on an annualized basis, was largely expected and did not have much impact on the financial markets. However, the ongoing real estate correction and financial institutions' troubles have induced the Fed to go one step further to keep the U.S. economy from sliding into a recession.
- It is now hard to accuse Ben Bernanke and his FOMC colleagues of anti-inflation dogmatism. The key rate cuts are occurring in a situation in which price increases are still above the comfort zones of a number of Fed leaders. In December, total inflation was 4.1% and core inflation was 2.4%. As a result, it is now very far from being a central bank that is only focused on its inflation target.
- High oil prices are still a concern, but this should be partially offset by ongoing disinflation in housing prices. These effects, combined with American economy's drop in pace, should help the annual change in core inflation to fall below 2% during 2008.
- **Forecasts:** The Fed has already made substantial interest rate cuts, but their work is not done. We expect monetary easing to continue, with the Fed striving to stave off a recession at all costs. The target rate for federal funds could reach 2.25% at mid-year.



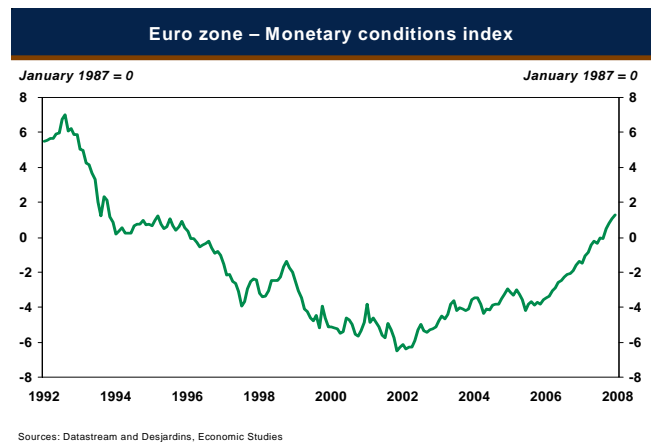
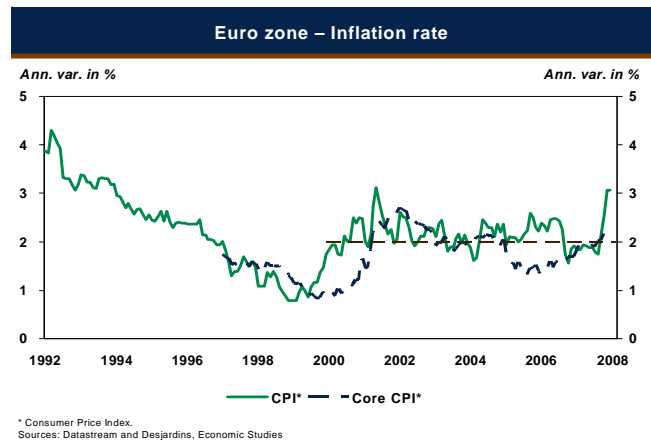
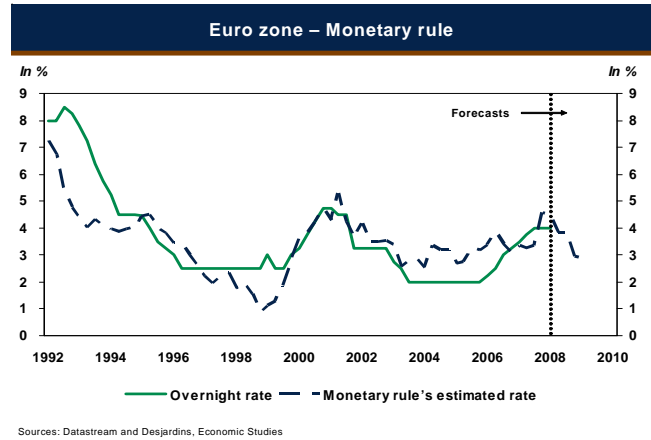
## Bank of Canada (BoC) : Heading for bigger rate cuts in Canada

- The BoC showed reserve with the 25 basis point cut to its key rate in January, taking it to 4.00%. However, its short-term economic projections suggest that the pace of monetary easing will accelerate in the next few months.
- The U.S. Federal Reserve's (Fed) surprise 75 basis point cut last Tuesday, and another 50 point cut yesterday, will have a big influence on the BoC's future decisions.
- The preponderance of downside risks will prod the BoC to take its key rates down faster and to a lower level than we had preciously anticipated. In particular, the U.S. housing market's pullback is more pronounced and should last longer than expected, which could result in greater weakening by U.S. domestic demand. Combined with the strong dollar, this softness will of course have a major impact on Canada's foreign trade. The problems with Canadian exports could therefore be greater than initially thought.
- Despite tightening credit conditions, we are still optimistic that Canada's domestic demand will remain robust. We still expect final domestic demand to grow at a faster pace than Canadian economic potential. However, the dimming outlook for foreign trade requires our scenario for real GDP to be downgraded to about 2.0% for 2008.
- For now, nothing is stopping the BoC from proceeding with rate cuts with more bite. Some inflation pressures do remain, of course: the economy is still operating above production potential, labour market conditions remain tight, and real wages are rising. However, downward changes to growth should lead to a slight oversupply as of the second quarter of 2008.
- Intensified competitive pressure stemming from the loonie's strength should also help offset the inflation risks arising from the domestic economy's solid performance. With the loonie at parity on average since October, retailers are likely to move to reduce their profit margins soon, allowing the downward adjustments to goods prices to continue. As a result, total and core inflation will drop to close to 1.5% by mid-2008, giving the BoC the leeway it needs to lower its interest rates further to limit the risks of a sharper slowdown.
- **Forecasts:** With the Fed in aggressive monetary stimulus mode, the BoC is likely to lower its key rate by 50 basis points at its March 4 meeting. Two further rate cuts will follow to combat the risks of a slowdown in Canada, taking the key rate to close to 3.0% this spring.



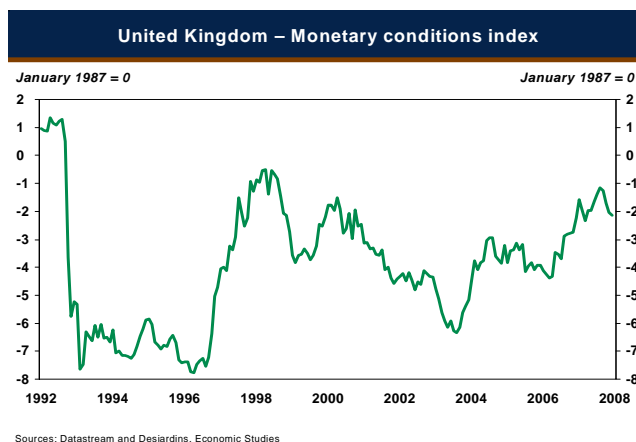
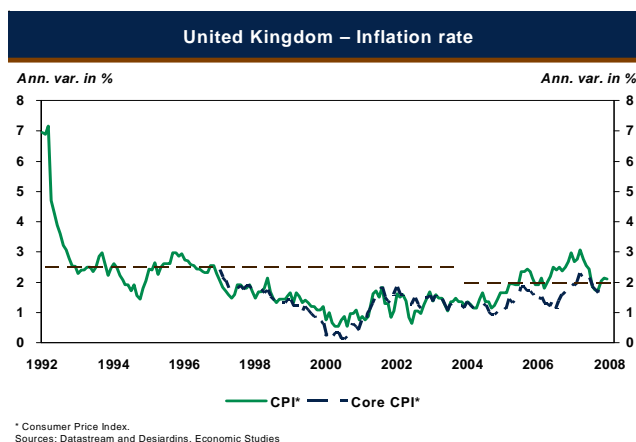
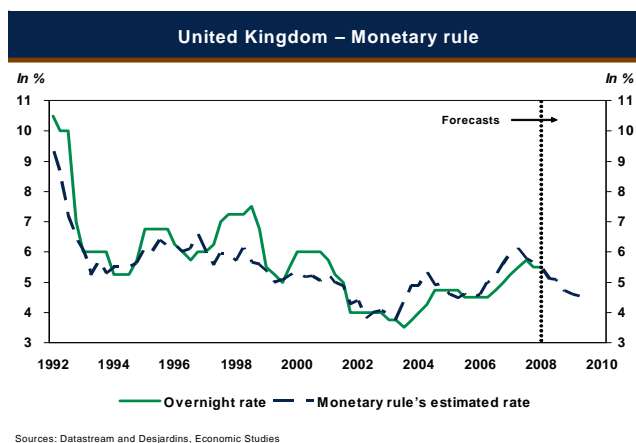
## European Central Bank (ECB) : Inflation pressure has the ECB's hands tied

- The ECB kept its key rate steady at 4.00% at its last meeting on January 10. It is still showing a lot of concern about inflation, and maintaining a restrictive bias, only considering two options, a key interest rate increase and the status quo. According to the ECB: "A cross-check of the outcome of the economic analysis with that of the monetary analysis fully confirms the assessment that there are upside risks to price stability over the medium term."
- The euro zone's inflation rate was stable at 3.2% in January, more than 1% above the ECB's target. Inflation's strength is mainly coming from the surge by oil and food prices. These factors also caused producer prices to accelerate. The ECB is very concerned about inflation's acceleration, and asserts that it will not hesitate to raise its key rates if it perceives second round effects, through wage negotiations, for example. Even if raw materials prices moderate and there are no second round effects, inflation should stay well above 2% in the next few months, and will only come down gradually after that, according to the ECB.
- The ECB's refusal to consider a rate cut is partly based on an optimistic economic scenario: "Our main scenario remains that of real GDP growth broadly in line with trend potential. The fundamentals of the euro area economy are sound..." It acknowledges, however, that the risks are declining, as the negative impacts of the reappraisal of risk in the financial markets could be greater than expected. In our opinion, the euro zone's economy is already showing signs of flagging, and the ECB will eventually have to downgrade its economic outlook as the euro's strength and U.S. slowdown could bring on a marked slowdown by European growth.
- Following the U.S. Federal Reserve's surprise 75 basis point cut, the markets read some official comments from the ECB as the beginning of softening in the central bank's stance. However, ECB President Jean-Claude Trichet corrected this by saying that it was becoming even more important to anchor inflation expectations in the context of financial upheaval.
- **Forecasts:** The ECB will keep its monetary policy steady over the months to come, and wait for clear signs of an economic slowdown before it changes its stance. In spite of this, it will have to initiate monetary easing toward mid-year.



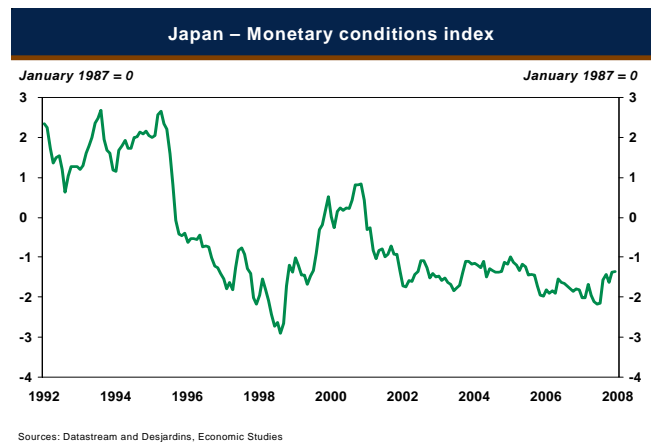
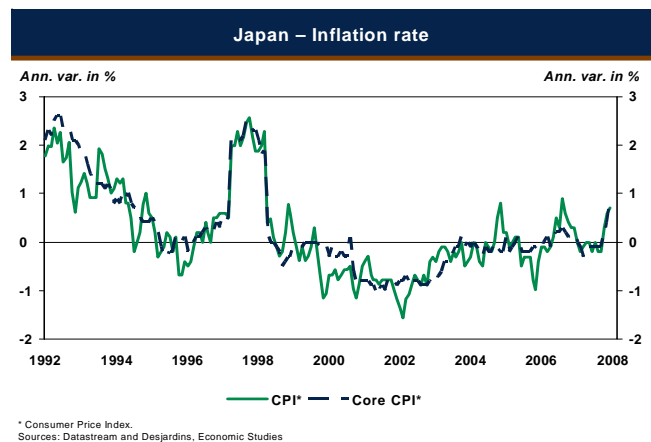
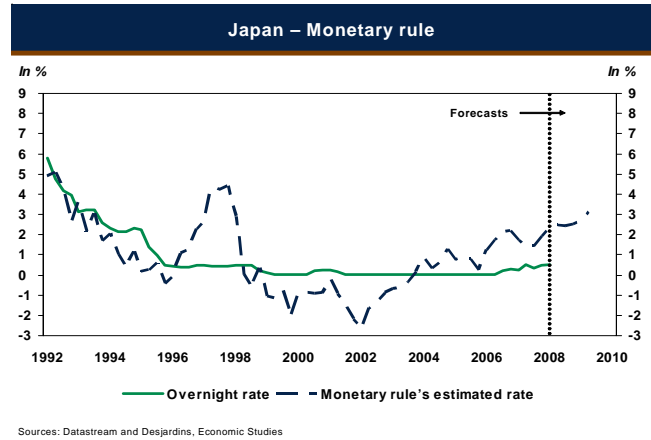
## Bank of England (BoE) : Inflation risks could limit rate cuts

- As expected, the BoE kept its key rate steady at 5.50% at its last meeting in early January, opting to wait for February's Inflation Report before moving ahead with the monetary stimulus it initiated last December. The minutes of the last BoE meeting, however, show that one committee member was in favour of cutting the key rate as early as January.
- To date, the British economy has remained fairly lively; annual real GDP growth of 2.4% in the fourth quarter allowed it to record 3.1% growth for 2007 as a whole. However, everything is pointing to a steep slowdown in 2008. The upheaval in financial markets has led to tighter credit conditions in the United Kingdom, which will only magnify the housing market's marked slowdown. Consumer confidence has already hit its lowest level since 1994 and, according to BoE Governor Mervyn King: "So in 2008 it is likely that a less buoyant housing market will go hand in hand with slower growth of consumer spending."
- At first glance, inflation in the United Kingdom seems to be perfectly under control: the consumer price index' annual change was 2.1% in December, compared with only 1.4% for core inflation. However, recent increases in oil and food prices, and the news of major increases in gas and electricity rates are making the BoE fear a major acceleration by inflation in the next few months. The pound's plummet at the start of the year could also have had an inflationary impact. However, the currency has since regained some altitude.
- The BoE's position seems to have become more problematic in the last few weeks, as upside risks to inflation intensified in tandem with downside risks to economic growth. In a recent speech, Mervyn King summed up the challenge facing the BoE in 2008 as follows: "To put it bluntly, this year we are probably facing a period of above target inflation and a market slowing in growth."
- Forecasts:** Despite the upside risks to inflation, the BoE will lower its key rate in February as, at its current level, it seems too restrictive for the context. However, the BoE should prove prudent subsequently to protect its credibility on the fight against inflation, but real estate difficulties could prompt it to lower rates more than what is expected.



## Bank of Japan (BoJ) : No increases expected before mid-2008

- On January 22, the BoJ announced that it was keeping its key rate stable at 0.50%. Despite higher inflation, the economic slowdown and financial problems did not allow it to proceed with a rate increase.
- We do not expect its stance to change in the coming months. Against the backdrop of uncertainty in the United States, the Nikkei stock market index is down almost 10% from where it started the year. Of course, inflation ex-fresh food went from 0.4% in November to 0.8% in December, but Japan's disappointing economic context is delaying rate hikes. Investment was down in 2007, and the economy is showing worrisome signs of a recession. Despite Q3's moderate 1.5% rebound, GDP is below where it was at the beginning of 2007.
- On January 11, in his statement on the semi-annual report on the currency and monetary control, BoJ Governor Toshihiko Fukui reiterated that they will wait for the signs of economic recovery and stable inflation to emerge before they take action. "The pace of increase in interest rates should be determined in accordance with improvements in the economic and price situation without any predetermined view."
- Encouraging signs, the jobless rate fell to 3.8% in November, and net exports are up. Nonetheless, growth should only be 1% in the fourth quarter of 2007, and true signs of economic recovery may only emerge in the second half of 2008. The U.S. slowdown and the yen's appreciation could limit growth by net exports. However, fairly sustained global demand and appreciation by other currencies, such as the yuan, should, in the end, support Japan's export growth.
- Until very recently, the rate estimated by our monetary rule was down. However, the expected increase in inflation and stronger economic growth are compatible with an interest rate increase in the second half of 2008.
- Forecasts:** In the short term, no rate hike is expected in Japan. The effects of the U.S. slowdown, combined with the yen's appreciation, will keep the BoJ on the sidelines. By the end of 2008, inflation that is above zero and stable and signs of an economic recovery could give the BoJ the green light on rate hikes.



**Table 1  
Key interest rates**

End of period in %	2007				2008				2009			
	Q1	Q2	Q3	Q4	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
<b>United States</b>												
Federal funds	5.25	5.25	4.75	4.25	2.75	2.25	2.25	2.25	2.50	3.00	3.00	3.50
<b>Canada</b>												
Overnight funds	4.25	4.25	4.50	4.25	3.50	3.00	3.00	3.00	3.25	3.50	3.50	4.00
<b>Euro zone</b>												
Refinancing rate	3.75	4.00	4.00	4.00	4.00	3.75	3.50	3.25	3.25	3.25	3.50	3.75
<b>United Kingdom</b>												
Base rate	5.25	5.50	5.75	5.50	5.25	4.75	4.75	5.00	5.25	5.25	5.50	5.75
<b>Japan</b>												
Overnight funds	0.50	0.50	0.50	0.50	0.50	0.50	0.75	1.00	1.00	1.25	1.50	1.75

f: forecasts

Sources: Datastream and Desjardins, Economic Studies

**Table 2  
Schedule and key rates**

Date	Central Bank	Decision	Rate
<b>October 2007</b>			
31	Bank of Japan	s.q.	0.50
30	Bank of Norway	s.q.	5.00
31	U.S. Federal Reserve	-25 b.p.	4.50
<b>November 2007</b>			
6	Reserve Bank of Australia	+25 b.p.	6.75
8	European Central Bank	s.q.	4.00
8	Bank of England	s.q.	5.75
8	Bank of Japan	s.q.	0.50
23	Bank of Mexico	s.q.	7.50
<b>December 2007</b>			
4	Reserve Bank of Australia	s.q.	6.75
4	Bank of Canada	-25 b.p.	4.25
5	Reserve Bank of New Zealand	s.q.	8.25
5	Bank of Brazil	s.q.	11.25
6	European Central Bank	s.q.	4.00
6	Bank of England	-25 b.p.	5.50
7	Bank of Mexico	s.q.	7.50
11	U.S. Federal Reserve	-25 b.p.	4.25
<b>January 2008</b>			
10	European Central Bank	s.q.	4.00
10	Bank of England	s.q.	5.50
18	Bank of Mexico	s.q.	7.50
21	Bank of Japan	s.q.	0.50
22	Bank of Canada	-25 b.p.	4.00
22	U.S. Federal Reserve	-75 b.p.	3.50
17	Bank of Norway	s.q.	5.25
24	Reserve Bank of New Zealand	s.q.	8.25
30	Bank of Brazil	s.q.	11.25
30	U.S. Federal Reserve	-50 b.p.	3.00

s.q.: status quo; b.p. : basis points

Source: Desjardins, Economic Studies

**Table 3  
Coming soon**

Date	Central Bank
<b>February 2008</b>	
4	Reserve Bank of Australia
7	European Central Bank
7	Bank of England
13	Bank of Sweden
14	Bank of Japan
15	Bank of Mexico
<b>March 2008</b>	
3	Reserve Bank of Australia
4	Bank of Canada
5	Reserve Bank of New Zealand
5	Bank of Brazil
6	European Central Bank
6	Bank of England
6	Bank of Japan
13	Bank of Norway
13	Swiss National Bank
14	Bank of Mexico
18	U.S. Federal Reserve
<b>April 2008</b>	
1	Reserve Bank of Australia
8	Bank of Japan
10	European Central Bank
10	Bank of England
16	Bank of Brazil
18	Bank of Mexico
22	Bank of Canada
23	Bank of Norway
23	Reserve Bank of New Zealand
23	Bank of Sweden
29	Bank of Japan

Source: Desjardins, Economic Studies

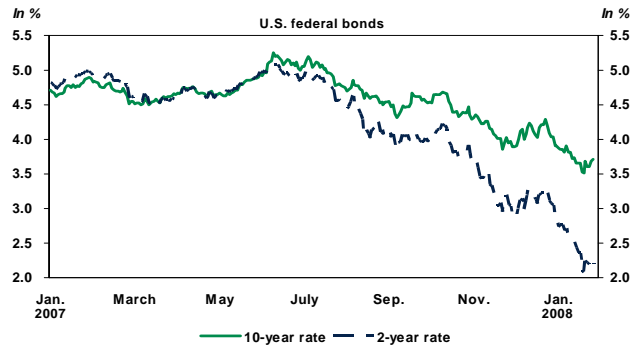
# FIXED INCOME MARKET

## United States: Federal bonds

### U.S. FEDERAL BONDS

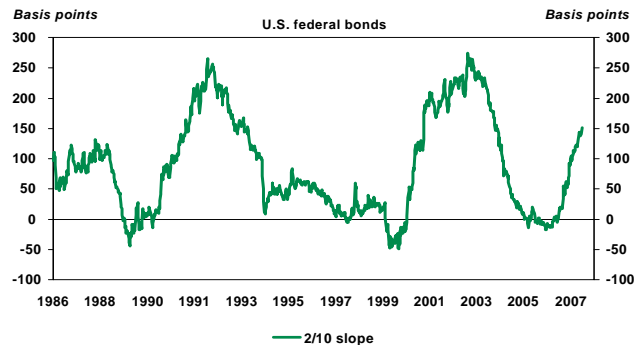
- Recent developments in the bond markets continue to reflect investors' greater pessimism. The year's end and recent concerted efforts by monetary authorities at the major central banks allowed the liquidity crunch to resolve partly. However, the credit risks are still substantial, due to rating agencies' pessimism about bond insurers (monolines). Combined with the stock market correction, this has triggered a major pullback (larger than we had anticipated) in the yield demanded on government securities.
- In the United States, the rate on 2-year federal bonds thus fell to a cyclical low of 1.84% on January 23. The 10-year rate kept pace, losing close to 100 basis points from where rates were at the end of 2007. The surprise cut to federal funds and potential monoline bailout plan gave the markets some hope, which made bond rates come back up by about 30 basis points on average over all maturities on the yield curve.
- In our view, further federal funds cuts are on the way. Making 125 basis points in cuts in just a week, the U.S. Federal Reserve (Fed) closed in on the market's expectations, but short-term rates indicate that the market is positioned for further cuts of 75 to 100 basis points by the spring. However, the Fed may want to try to limit upcoming action to hang onto some leeway to conduct its monetary policy in the event of steeper deterioration by the economic and financial context.
- Given the extreme volatility in the financial markets and predominance of downside risks to economic growth, it still seems premature to cut the duration of bond portfolios beyond the benchmarks. More bad news will certainly be hitting the headlines and federal bonds will continue to benefit from a generalized resurgence by risk. However, the curb's recent rise augurs that potential gains will be smaller.
- With the target for federal funds now at 3.0%, the low point for 10-year bonds seems to be behind us. The inflation risks stemming from rate cuts and high oil prices should lead to a gradual rise by 10-year rates in the coming months. Under these circumstances, we can expect the 2/10 slope to sharpen by mid-2008, potentially up to 200 basis points.

**United States – Investor's pessimism will continue to favour a flight to quality**



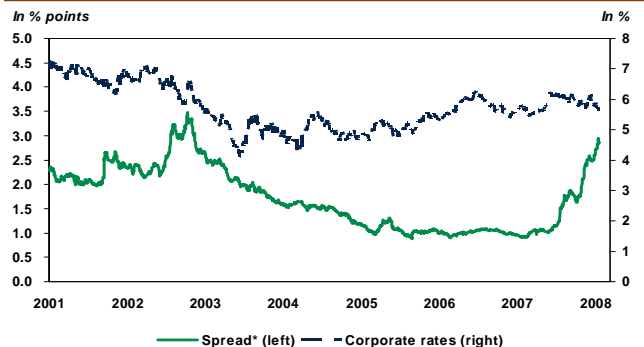
Sources: Datastream and Desjardins, Economic Studies

**United States – The slope of the yield curve will steepen further**



Sources: Datastream and Desjardins, Economic Studies

**United States – Risk appraisal is showing on corporate bonds spreads**

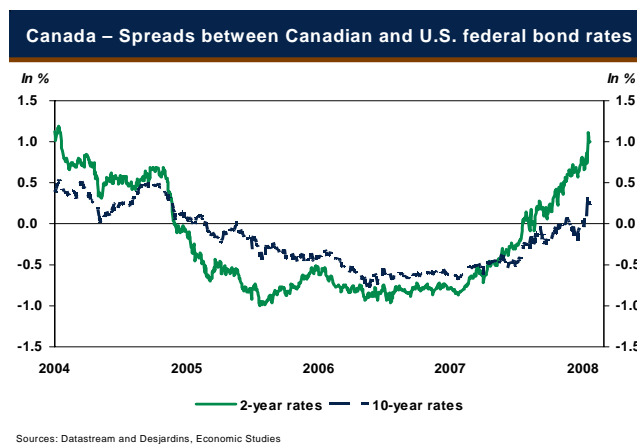
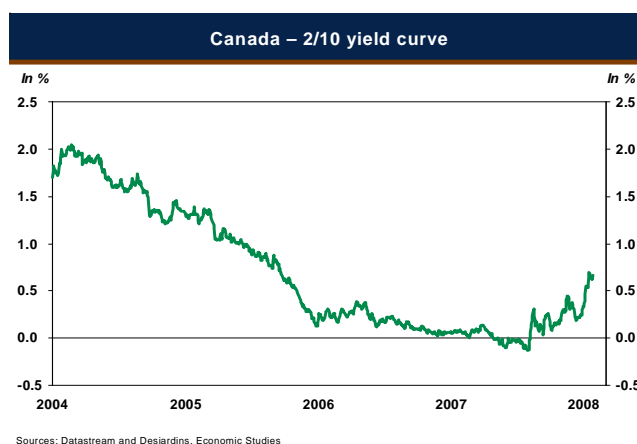
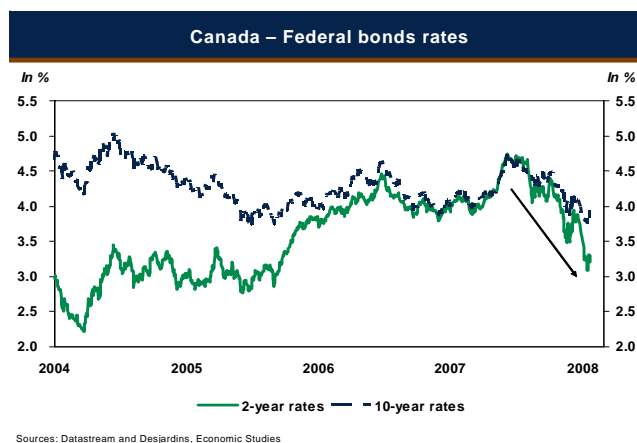


\* 5-10-year U.S. corporate rates minus 5-year U.S. federal bond rates.  
Sources: Datastream and Desjardins, Economic Studies

## Canada: Federal and provincial bonds

### FEDERAL BONDS

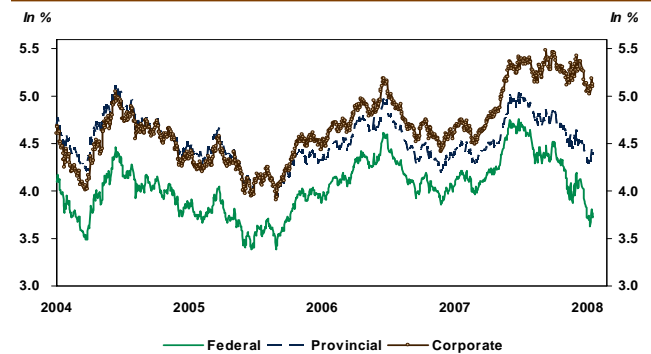
- Canadian bond rates continued to decline in the last few weeks, especially rates on federal securities, which benefited from investors' strong demand for safe haven assets.
- At the worst point in the stock market correction, on January 21, the rate on 2-year federal bonds went to 3.01%, while the ten-year rate fell below 3.70% for the first time.
- Following the U.S. Federal Reserve's decisive action, the markets' return to calm drove Canadian rates up by a little more than ten basis points in recent days, but current levels are still very low.
- The sharp drop by two-year rates reflects expectations of a larger than previously anticipated cut to Canadian key rates on the darkening of Canada's economic outlook. However, Canadian key rates should stay well above U.S. federal funds rates. Bigger than expected cuts to Canada's key rates could help stabilize the spread between Canadian and U.S. 2-year rates; the spread has recently widened substantially to about 1%.
- Canada's longer-term rates also went down less than in the United States, recently taking the Canadian 10-year rate above its U.S. counterpart. Despite very low inflation here, higher short-term rates and a much lower chance of a recession are behind the positive spread in favour of Canadian rates.
- For now, it appears to be too early to shorten the duration of a portfolio of Canadian government bonds. There is likely to be more bad news, and the tough economic and financial context should lead to another decrease by bond rates. Under the circumstances, we are still calling for the 2/10 slope to sharpen in the first half of 2008.



**PROVINCIAL BONDS**

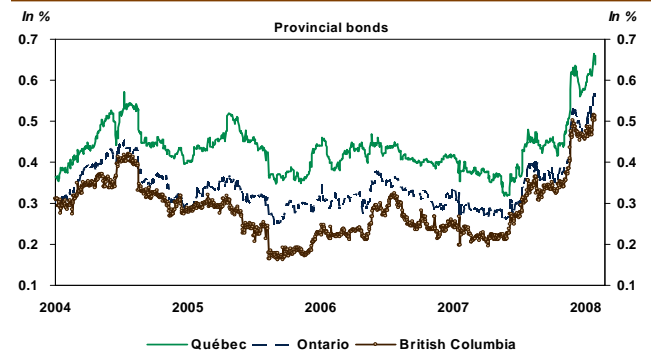
- Like federal securities, provincial bonds have benefited from the recent dimming of economic outlooks and tumble by stock market indexes. The rate on Ontario's 10-year bonds thus fell below 4.30% on January 21, but has since come back up to around 4.40%. Spreads between provincial and federal rates have grown slightly since the year began, but much less than is the case with corporate bonds.
- The economic problems in Québec and Ontario should continue in 2008. For both provinces, foreign trade is likely to deteriorate further under the impact of the U.S. economy's slowdown and the strong loonie. Buoyed by various government measures, strong domestic demand in Québec and Ontario should limit the economic slowdown, however, and help avoid a recession in central Canada.
- The western provinces will be less affected by the U.S. slowdown and continue to benefit from high raw materials prices. What's more, preparations for the 2010 Olympic Games will sustain growth in British Columbia. This better economic performance, combined with an enviable fiscal situation, could lead to a slight increase in the negative spread between rates on British Columbia's bonds, and rates on Québec and Ontario securities.
- Overall, rate spreads between provincial and federal bonds should gradually narrow in 2008, as strains in the financial markets ebb. It would, however, be surprising to see spreads as tight as those recorded in the first half of 2007 any time soon.

**Canadian bond indices**



Sources: Datastream and Desjardins, Economic Studies

**Spreads with Canadian federal bond rates**



Sources: Datastream and Desjardins, Economic Studies

**Table 4  
Canada: Public finance of the federal and provincial governments**

	<i>Surplus (deficit) (1) in \$M</i>		<i>Budget surplus (deficit) in % of GDP</i>	<i>Total debt (2) in % of GDP</i>	<i>Credit rating</i>	
	2006-2007	2007f-2008f	2007f-2008f	2007f-2008f	S&P	Moody's
Federal government	13,752	3,270	0.2	34.9	AAA	Aaa
Newfoundland	76	261	1.0	35.0	A	Aa2
Prince Edward Island	1	-42	-1.0	37.6	A	Aa2
Nova Scotia	-336	-383	-1.2	34.4	A+	Aa2
New Brunswick	237	37	0.1	28.9	AA-	Aa1
Québec	1,829	0	0.0	55.3	A+	Aa2
Ontario	2,269	750	0.1	26.4	AA	Aa1
Manitoba	1,430	175	0.4	30.4	AA	Aa1
Saskatchewan	398	-188	-0.4	26.5	AA	Aa1
Alberta	8,510	2,480	1.0	0.0	AAA	Aaa
British Columbia	4,056	2,150	1.2	17.0	AAA	Aaa

f: forecasts

(1) Include contingency reserves for some governments, (2) Adjusted based on the Dominion Bond Rating Service.

Sources: Budget of the federal government, ministère des Finances du Québec and Desjardins, Economic Studies

**Table 5**  
**United States: Fixed income market**

End of period in %	2007				2008				2009			
	Q1	Q2	Q3	Q4	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
<b>Key rate</b>												
Federal funds	5.25	5.25	4.75	4.25	2.75	2.25	2.25	2.25	2.50	3.00	3.00	3.50
<b>Treasury bills</b>												
3-month	5.04	4.82	3.82	3.36	2.00	2.10	2.25	2.35	2.70	3.10	3.25	3.60
<b>Federal bonds</b>												
2-year	4.58	4.87	3.96	3.07	1.80	1.70	2.40	2.60	3.00	3.40	3.90	4.30
5-year	4.54	4.93	4.23	3.46	2.45	2.50	2.90	3.10	3.40	3.70	4.10	4.50
10-year	4.65	5.03	4.58	4.03	3.30	3.40	3.65	3.80	3.90	4.20	4.40	4.70
30-year	4.85	5.13	4.83	4.45	4.05	4.15	4.35	4.50	4.60	4.70	4.80	4.90
<b>Yield curve</b>												
5-year - 3-month	-0.50	0.11	0.41	0.10	0.45	0.40	0.65	0.75	0.70	0.60	0.85	0.90
10-year - 2-year	0.07	0.16	0.62	0.96	1.50	1.70	1.25	1.20	0.90	0.80	0.50	0.40
30-year - 3-month	-0.19	0.31	1.01	1.09	2.05	2.05	2.10	2.15	1.90	1.60	1.55	1.30

f: forecasts

Sources: Datastream and Desjardins, Economic Studies

**Table 6**  
**Canada: Fixed income market**

End of period in %	2007				2008				2009			
	Q1	Q2	Q3	Q4	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
<b>Key rate</b>												
Overnight funds	4.25	4.25	4.50	4.25	3.50	3.00	3.00	3.00	3.25	3.50	3.50	4.00
<b>Treasury bills</b>												
3-month	4.18	4.43	3.98	3.83	3.25	2.85	3.05	3.10	3.35	3.55	3.75	4.15
<b>Federal bonds</b>												
2-year	3.98	4.58	4.08	3.74	2.90	2.60	3.15	3.30	3.60	3.90	4.30	4.60
5-year	4.01	4.56	4.21	3.87	3.20	3.20	3.40	3.55	3.80	4.10	4.40	4.70
10-year	4.11	4.55	4.34	3.99	3.60	3.65	3.85	4.00	4.10	4.40	4.55	4.80
30-year	4.20	4.49	4.45	4.10	3.95	4.05	4.25	4.40	4.55	4.65	4.80	4.90
<b>Yield curve</b>												
5-year - 3-month	-0.17	0.13	0.23	0.04	-0.05	0.35	0.35	0.45	0.45	0.55	0.65	0.55
10-year - 2-year	0.13	-0.03	0.26	0.25	0.70	1.05	0.70	0.70	0.50	0.50	0.25	0.20
30-year - 3-month	0.02	0.06	0.47	0.27	0.70	1.20	1.20	1.30	1.20	1.10	1.05	0.75
<b>Spreads (Canada - U.S.)</b>												
3-month	-0.86	-0.39	0.16	0.47	1.25	0.75	0.80	0.75	0.65	0.45	0.50	0.55
2-year	-0.60	-0.29	0.12	0.67	1.10	0.90	0.75	0.70	0.60	0.50	0.40	0.30
5-year	-0.53	-0.37	-0.02	0.41	0.75	0.70	0.50	0.45	0.40	0.40	0.30	0.20
10-year	-0.54	-0.48	-0.24	-0.04	0.30	0.25	0.20	0.20	0.20	0.20	0.15	0.10
30-year	-0.65	-0.64	-0.38	-0.35	-0.10	-0.10	-0.10	-0.10	-0.05	-0.05	0.00	0.00

f: forecasts

Sources: Datastream and Desjardins, Economic Studies