

Stagflation?

Risks to growth predominate over inflationary risks: Interest rate cuts will continue

Highlights

- U.S. Federal Reserve: Despite resistant inflation, the focus is on economic risks.
- Bank of Canada: Will Governor Carney dare a 50 basis point cut?
- European Central Bank: Inflation still takes priority, but the tone has softened.
- Bank of England: How far will interest rates drop?
- Bank of Japan: The status quo will continue.
- It is too soon to count on the end of the U.S. Federal Reserve's monetary easing cycle.
- Negative economic news and weaker inflationary pressures pushed Canadian 10-year rates slightly below U.S. rates.

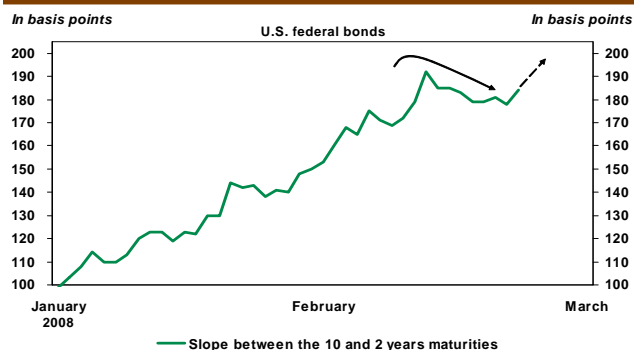
CONTENTS

| | |
|-----------------------------|-------|
| Summary | 1 |
| Monetary Policy | |
| U.S. Federal Reserve | 5 |
| Bank of Canada | 6 |
| European Central Bank | 7 |
| Bank of England | 8 |
| Bank of Japan | 9 |
| Tables | 10 |
| Fixed Income Market | |
| United States | 11 |
| Canada | 12 |
| Provinces | 13 |
| Tables | 13-14 |

Summary

Volatility kept a relentless grip on the financial markets in recent days, while fears of stagflation, that is, weak economic growth combined with high inflation, began to haunt investors. With the increase in 10-year rates, the slope of the yield curve steepened further in February, reaching as much as 190 basis points compared to the 2-year rates, and then retreated somewhat due to profit-taking and new doubts in investors' minds about the extent of future monetary easing, given the growing risks of inflation (Graph 1).

Graph 1 – The recent flattening of the slope does not reflect economic fundamentals



Sources: Datastream and Desjardins, Economic Studies

In fact, inflation remains a concern in just about all of the world's major economies. In the United States, the Consumer Price Index (CPI) rose by 0.4% in January, pushing the annual variation to 4.3%. The minutes of the Federal Open Market Committee's (FOMC) last meeting show that the U.S. Federal Reserve (Fed) has revised its inflation scenario for 2008, upwards (Graph 2). In Euroland, inflation has reached its highest level since 1993 (3.2%), and the latest forecasts by the European Central Bank pushed annual inflation up by

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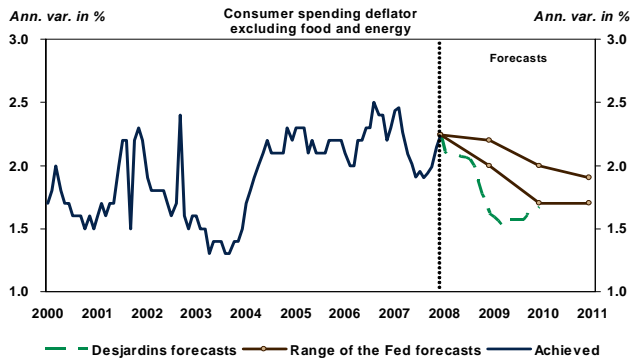
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NOTE TO READERS: The letters **k**, **M** and **B** are used in texts and tables to refer to thousands, millions and billions respectively.

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Graph 2 – The Fed has revised its inflation scenario upwards

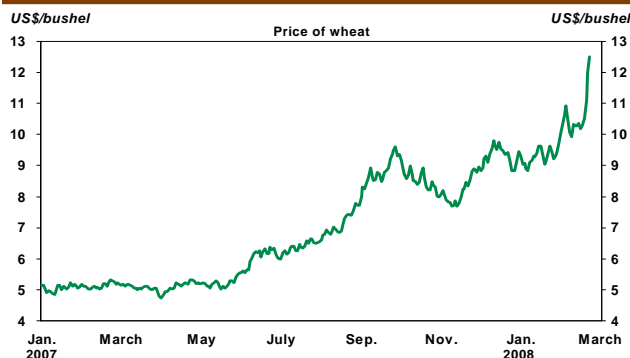


Sources: Bureau of Economic Analysis, Federal Reserve Board and Desjardins, Economic Studies

half a percentage point, from 2.1% to 2.6%, for 2008. As for China, it will have to intensify its efforts to reign in inflation, now standing above 7.0%.

At the same time, commodity prices are continuing to defy gravity. Despite the slowdown in the United States, the price of oil briefly cracked the US\$100 a barrel barrier in February; gold set a new benchmark, at over US\$950 per ounce; and the price of wheat has more than doubled from what it was last year, setting a record of US\$11.50 per bushel (Graph 3).

Graph 3 – The price of wheat has more than doubled in the past year

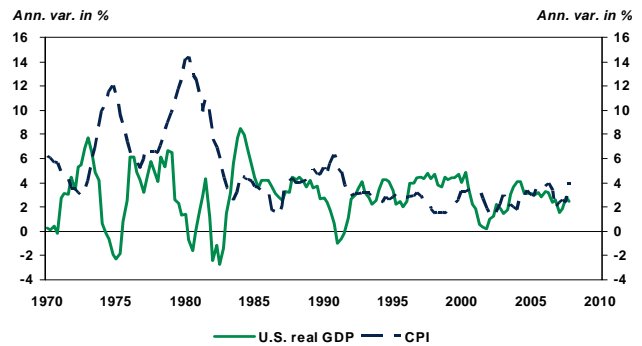


Sources: Datastream and Desjardins, Economic Studies

With a strong probability of a recession in the United States, the situation does give rise to concern, but in our opinion there is no reason to panic. Certainly, the very word “stagflation” brings to mind a difficult period for the world economy. However, it would be surprising to see a repeat performance of the 1970s. At that time, a sharp increase in oil prices pushed annual U.S. inflation well above 10% and triggered an acute contraction in economic activity (Graph 4).

Nowadays, market globalization and greater credibility of the central banks with respect to inflation control have provided better inflation anchors and a gradual lessening of volatility

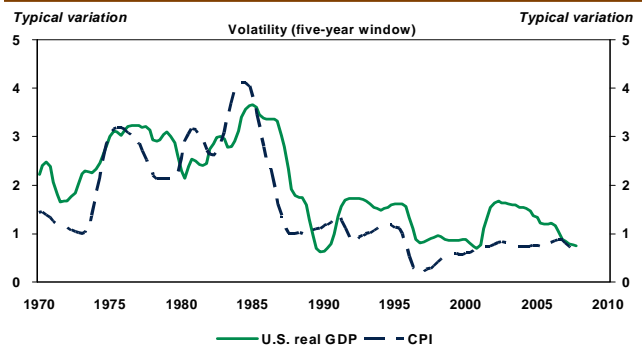
Graph 4 – We are very far from the stagflation of the past



Sources: Datastream and Desjardins, Economic Studies

in economic growth and inflation since the 1980s (Graph 5). Consequently, there is now little likelihood of experiencing a severe contraction in economic activity combined with high inflation.

Graph 5 – Economic and inflation cycles have been much less volatile since the 1990s

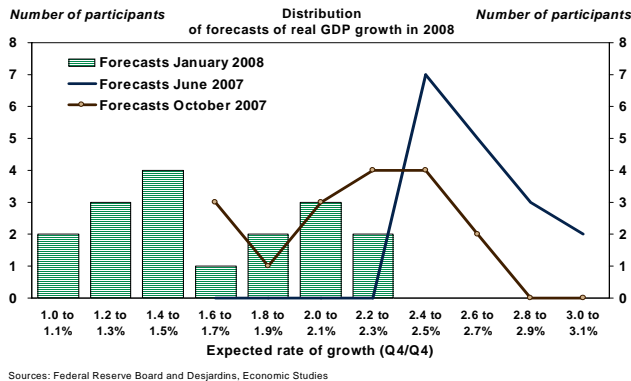


Sources: Datastream and Desjardins, Economic Studies

In our view, since risks to growth are predominating, the current level of inflation should not constitute an obstacle to the Fed’s activities. Inflation is a lagged indicator of the economic cycle, and we should therefore expect further rate cuts in the months to come. The signs of slowdown are unmistakable, to the point where the Fed has revised its annual growth forecasts downwards for the end of 2008, between 1.3% and 2.0%. In fact, all of the FOMC members now endorse lower growth expectations than those supported by the most pessimistic member six months ago (Graph 6).

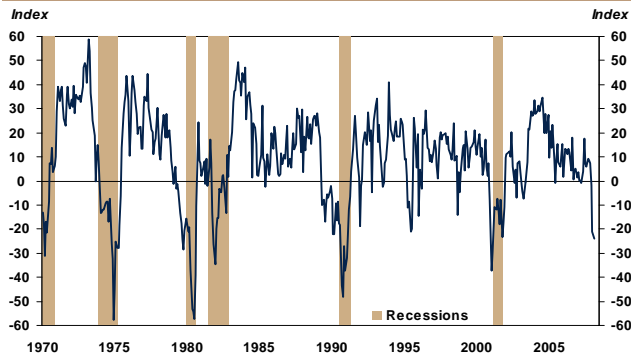
As far as businesses are concerned, after the abrupt drop in the non-manufacturing ISM index in January, the decline in the Philadelphia Fed index is now compatible with a recession in the manufacturing sector (Graph 7).

Graph 6 – The Fed's forecasts of economic growth have again been revised downwards for 2008



Sources: Federal Reserve Board and Desjardins, Economic Studies

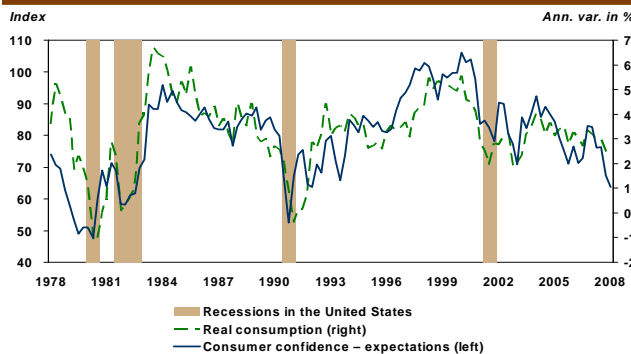
Graph 7 – The Philadelphia Fed index continued its decline in February and is now compatible with a recession



Sources: Federal Reserve of Philadelphia and Desjardins, Economic Studies

As for consumers, confidence indexes plunged in January, indicating that a marked deceleration of consumer spending is on the horizon (Graph 8).

Graph 8 – Lower consumer confidence points towards a slowdown in consumer spending

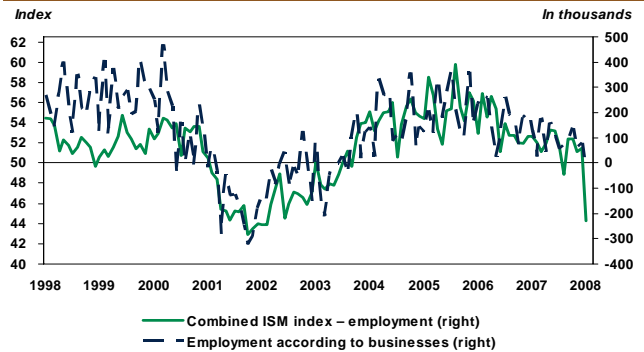


Sources: Bureau of Economic Analysis, University of Michigan and Desjardins, Economic Studies

This will certainly not be helped by the employment situation, which declined for the first time since August 2003. The loss of 17,000 jobs in January does not qualify as dramatic, but the “employment” component of the combined

(manufacturing and non-manufacturing) ISM index suggests that job losses may accelerate suddenly (Graph 9).

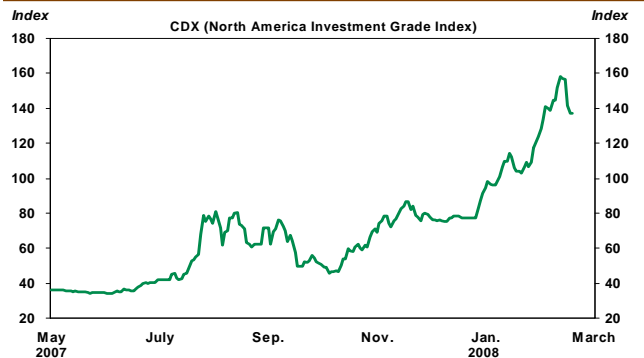
Graph 9 – The “employment” component of the combined ISM index points towards significant deterioration in the job market



Sources: Bureau of Labor Statistics, Institute for Supply Management and Desjardins, Economic Studies

Furthermore, despite restructuring efforts and plans to bail out bond insurers (*monolines*), the tension in the credit market is still palpable. The fact that Standard & Poor’s maintained the AAA rating for *monolines* Ambac and MBIA has given the markets some reassurance but, in general, risks of credit default are still abnormally high (Graph 10).

Graph 10 – Credit risks have abated, but remain high



Sources: Bloomberg and Desjardins, Economic Studies

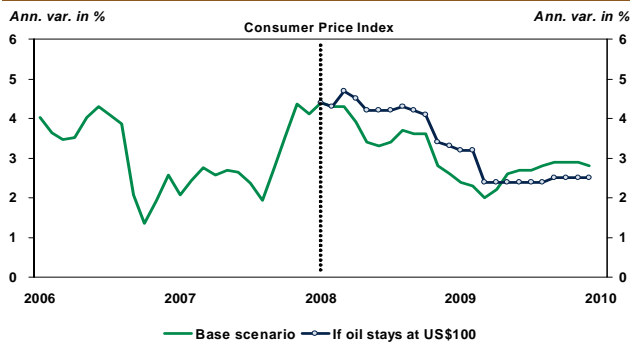
Therefore, despite high oil prices, we maintain that the economic slowdown, the liquidity crisis and the tightening of credit conditions should cause inflationary pressures to subside between now and the second half of the year. This is consistent with the Fed’s scenario:

“[...] many (members) believe that the slow growth in economic activity anticipated in the first half of this year and the associated slack in resource utilization would contribute to an easing of price pressures. [...]”

If oil prices remain stable at around US\$100 per barrel, we estimate that the CPI annual inflation rate will increase by

0.4% in 2008 (Graph 11). However, this record level of oil prices strikes us as unjustified, and we believe that lower global demand, combined with rising inventories in the United States, should trigger a gradual decline in crude prices towards US\$90 by the summer, which should allow the CPI to return to around 2.5%.

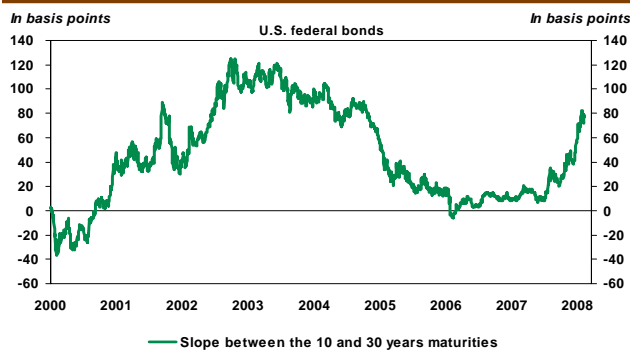
Graph 11 – Inflation in the United States should moderate during 2008



Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

Although inflation is not a problem in the short term, it is likely that the aggressive rate cuts by the Fed will lead to renewed inflation starting in 2009. In those conditions, upward pressure will remain on long-term rates. The spread has already grown considerably on the long portion of the curve, with the slope between the 10 and 30 years maturities widening to nearly 75 basis points in recent days, whereas the spread was around 40 basis points at the beginning of the year (Graph 12).

Graph 12 – Will inflation fears push the long portion of the curve up sharply?

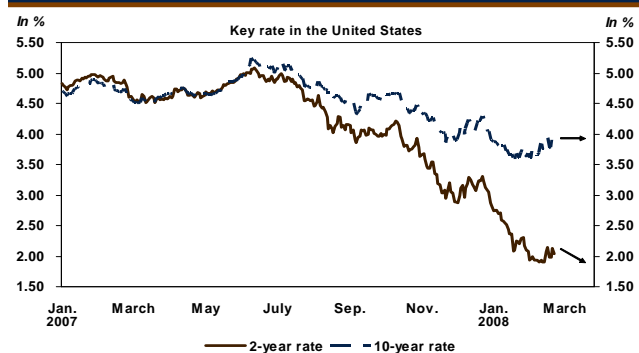


Sources: Datastream and Desjardins, Economic Studies

The two-year rates have risen somewhat in recent days, since the market is anticipating that the Fed may not cut its key rates as much as previously thought, due to fears of inflation. However, given the amount of bad news that is likely to arrive in the next few weeks (both economic and financial), the pressure on the two-year rates will probably remain

downwards until the Fed indicates that the easing cycle is nearing its end. With downside risks predominating over inflationary risks, the low of 1.82% recorded on February 15 may be tested as the bad news arrives. Therefore, we recommend giving preference to the short portion of the curve and continuing to favour a steepening of the slope between the two and ten years maturities (Graph 13).

Graph 13 – It is too soon to count on an end to interest rate cuts



Sources: Datastream and Desjardins, Economic Studies

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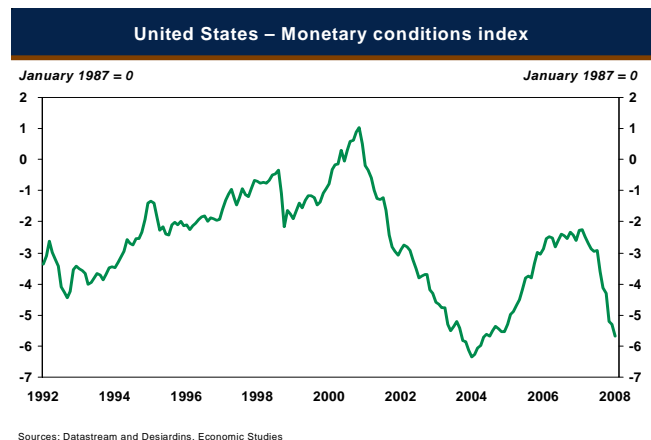
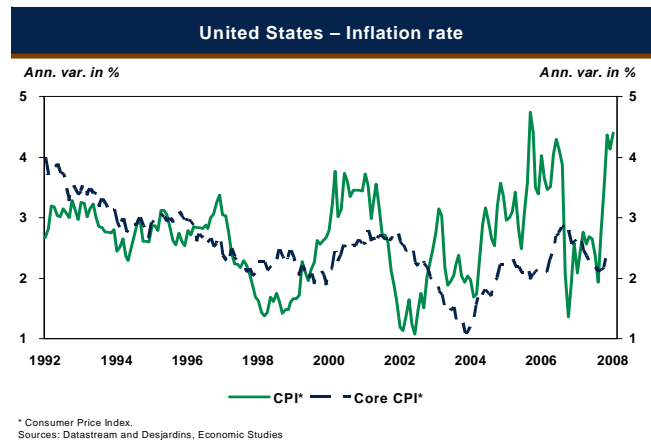
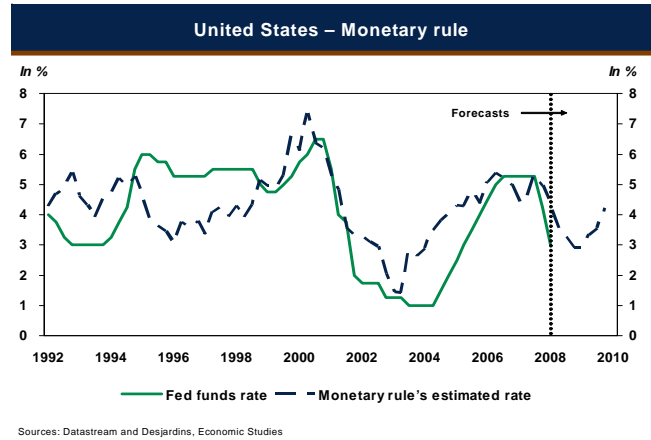
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MONETARY POLICY

U.S. Federal Reserve (Fed): Despite resistant inflation, the focus is on economic risks

- The minutes of the latest meeting of the Fed's monetary policy committee (FOMC) show that the cuts to key interest rates carried out at the end of January were intended to demonstrate the Fed's resolve to act energetically to counteract the deterioration in economic conditions.
- Despite those massive rate cuts, the Fed's leaders believe that the risks threatening economic growth are still high. On the one hand, the Fed is concerned by the fact that stock market declines, combined with lower house values, are leading households to limit their spending. On the other hand, the Fed notes a drop in confidence indexes and business activity indicators. It also mentions that tighter credit conditions are increasingly having an impact on investment projects, especially in commercial real estate.
- The Fed has revised its forecasts of economic growth, downwards. The forecast range for year-end calls for real GDP growth of between 1.3% and 2.0%. Our own forecasts call for real U.S. GDP growth of just 1.3% in 2008 (0.8% in terms of annual variation in the last quarter). In the next few months we should see a decline in economic activity, and real GDP could descend into negative territory. The fiscal stimulus plan should shorten the duration of the economic downturn by generating a sharp increase in disposable income and, therefore, spending.
- Inflation is still a concern, however. The recent increase in the price of oil revives that source of risk. The total Consumer Price Index is up by 4.3% compared with a year ago, and core inflation edged up from 2.4% to 2.5% in July. Those rates are above the comfort zone (below 2%) of many members of the FOMC. The economic slowdown should enable inflation to gradually abate over the next few quarters.
- Having fallen by 225 basis points since last fall, U.S. key interest rates are now at a level compatible with the monetary rule. However, this does not take into account the pessimism that is still perceptible in the financial markets, or the Fed's determination to counteract tightening credit conditions and market instability.

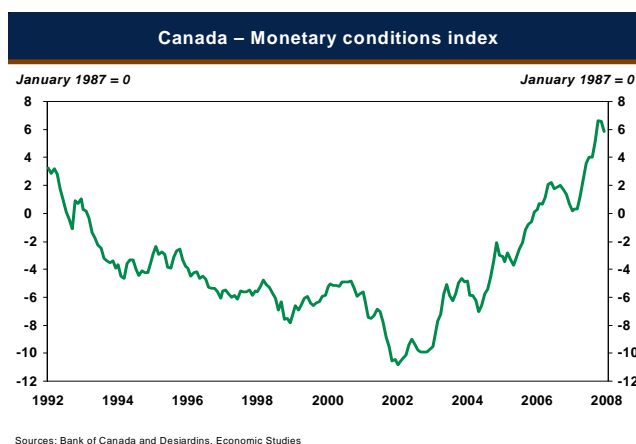
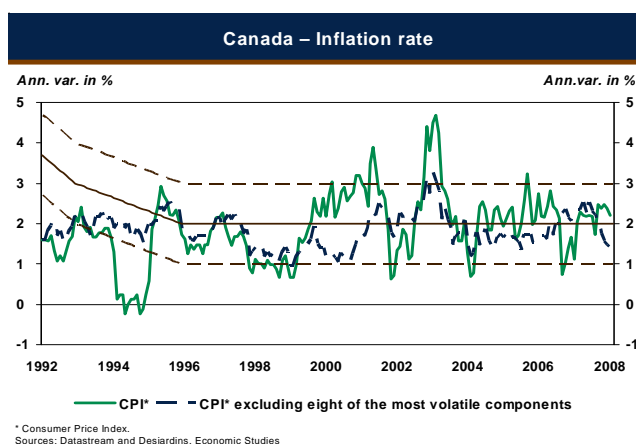
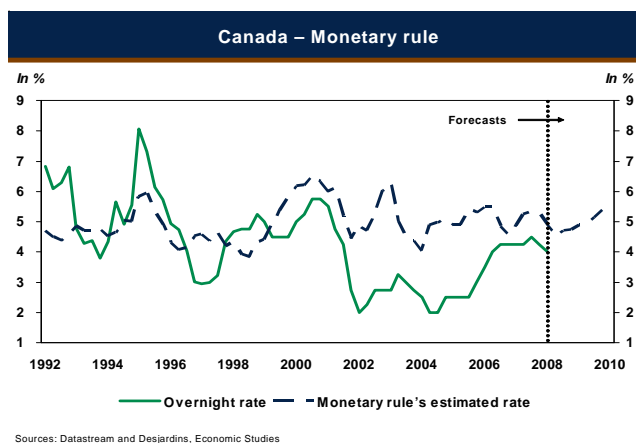
Forecasts: Monetary easing will continue in the United States. The Fed should cut the target rate for federal funds by 50 basis points at its March meeting. Further cuts, although more moderate, should follow. The target rate should reach 2.00% by mid-year. However, the Fed may raise rates quickly once economic growth strengthens.



Bank of Canada (BoC) : Will Governor Carney dare a 50 basis point cut?

- In Canada, after the 25 basis-point cut to 4.00% decreed in January, the deterioration of economic conditions in the United States and its impact on the Canadian economy will probably lead the BoC to cut its key interest rates faster and to a lower level than we had so far anticipated.
- Generally speaking, the indicators released in recent weeks show that economic growth in Canada moderated to a significant degree at the end of 2007. Furthermore, due to the combined effect of the vitality of the loonie and the U.S. downturn, net merchandise exports plunged in December, bringing the trade balance to -15.6B 2002 dollars for the fourth quarter of 2007. This could subtract a little over 2% from real GDP growth, which we have revised to 1.4% for the last three months of 2007.
- Certainly, some inflationary pressures are persisting: the economy is still running above its production potential, conditions in the job market remain tight, real wages are up and oil prices are at record levels. However, the intensification of competitive pressures linked to the strength of the loonie should offset the inflationary risks resulting from the strong performance of the domestic economy and the high prices of certain raw materials.
- Accordingly, total and core inflation should both retreat to the bottom of the target range (1%) by mid-2008, giving the BoC the leeway it needs to cut interest rates further in order to reduce the risks of a more pronounced slowdown.
- The BoC already believes that further rate cuts will be necessary to keep inflation in line with the Bank's target in the medium term: "[...] monetary stimulus is likely to be required in the near term to keep aggregate supply and demand in balance, and to return inflation to target over the medium term. The timing and degree of that stimulus will be determined at future fixed announcement dates [...]."
- With the U.S. Federal Reserve aggressively pursuing monetary easing, the BoC needs to be careful not to let the spread between Canadian and U.S. short-term interest rates widen further, in order to limit upward pressure on the loonie.

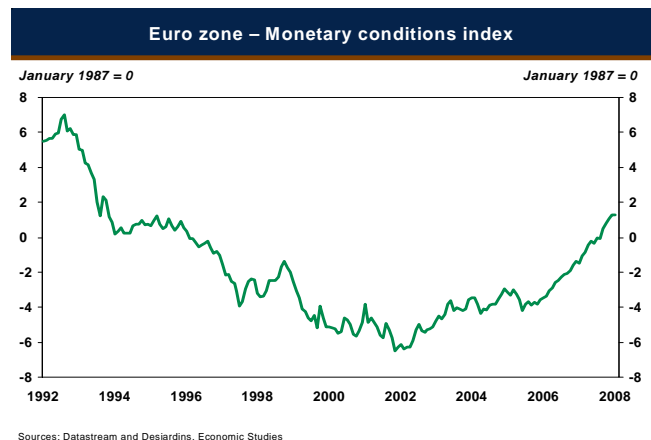
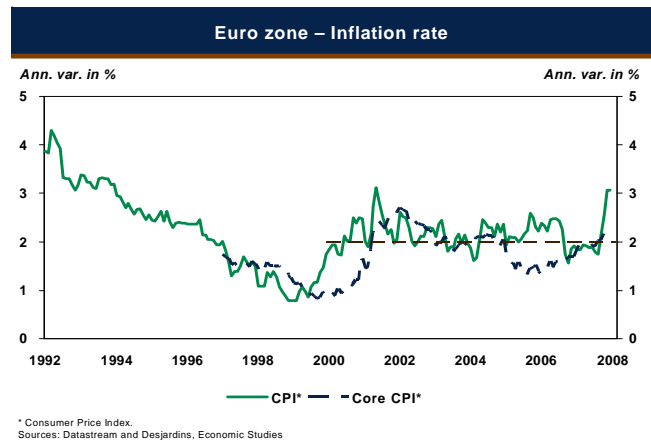
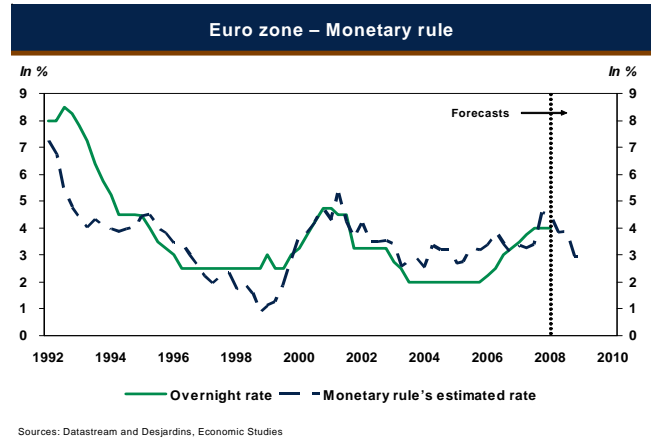
Forecasts: The rapid deterioration of Canadian economic conditions should lead the BoC to cut its key interest rate by 50 basis points at its March 4 meeting. Two more rate cuts will follow in order to counteract risks of a slowdown in Canada, bringing the key rate close to 3.0% by the spring.



European Central Bank (ECB) : Inflation still takes priority, but the tone has softened

- To no one's surprise, the ECB left its key interest rate unchanged at 4.00% at its meeting of February 7, since the board of governors still feels that risks to price stability are increasing. However, the ECB softened its tone slightly, taking into account the growing risk of an economic slowdown. The ECB's stance now appears to be more neutral, and it is significant that, contrary to previous meetings, the possibility of raising key interest rates was not considered in February.
- Economic growth in the euro zone was cut in half in the last quarter of 2007, to 0.4% at a quarterly, non-annualized rate. The downturn in consumption should continue in the beginning of 2008, since household confidence is still declining and financial institutions are tightening credit conditions. Trends in the balance of trade, which dropped into negative territory for the first time in 16 months in December, are also likely to curb growth, while the strength of the euro and the global slowdown will limit demand for European exports.
- Consequently, the European Commission recently revised its forecast for economic growth in the euro zone in 2008 downwards, from 2.2% to 1.8%. Nevertheless, some governors of the ECB are still hoping that the eurozone economy will manage to resist the U.S. downturn. Christian Noyer, Governor of the Bank of France, recently declared that "with regard to the euro zone, we have autonomous growth factors which encourage a degree of optimism..."
- The most recent developments on the inflation front do not point to any imminent cut in the key interest rate in the euro zone. A quick estimate of annual inflation puts it at 3.2% in February, which is the worst result since 1993. It is the high prices of oil and of food that have pushed inflation above 3% in recent months. Oil's return to above US\$100 per barrel in mid-February, and new increases in grain prices, do not indicate any slowdown in inflationary pressures in the near term. Moreover, the ECB's fears that high inflation will generate wage increases were certainly aggravated by the announcement that Germany's largest trade union, IG Metall, had won wage increases of 5.2% over 14 months for 85,000 of its members.

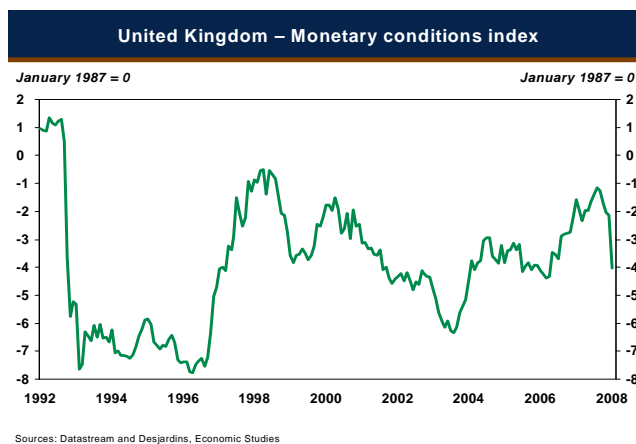
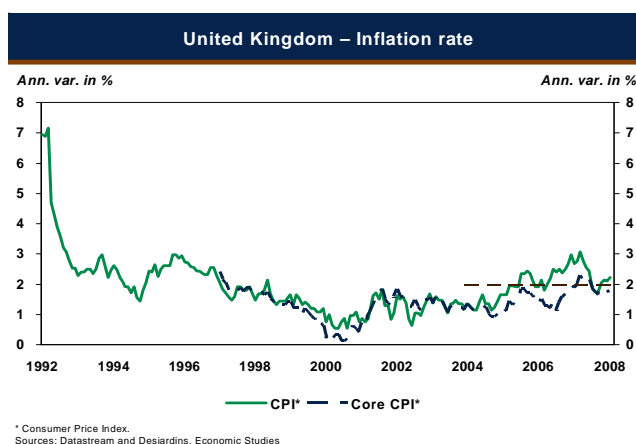
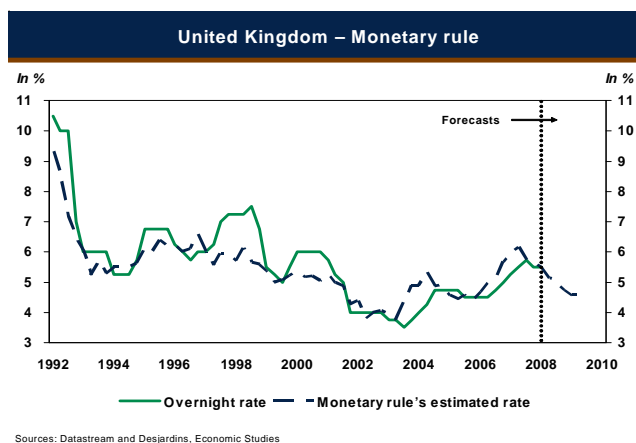
Forecasts: The ECB will maintain the status quo until signs of an economic downturn in Europe become more evident and upward pressures on inflation begin to dissipate. The economic slowdown should convince the ECB to reduce its key interest rate by around mid-year.



Bank of England (BoE) : How far will interest rates drop?

- As expected, the BoE continued its monetary easing, initiated last December, announcing a second 0.25% cut to its key rate on February 7. At 5.25%, that rate is still high compared to what may be observed in the world's other major economies. The minutes of the meeting show eight governors in favour of the decision, with one opposed. One of the governors, David Blanchflower, would have preferred an immediate cut of 50 basis points given the risk of a severe economic downturn in the United Kingdom.
- February's inflation report shows how complicated the situation has become for the BoE in recent months. On the one hand, the expected slowdown of the British economy should be more severe and longer lasting than the BoE was forecasting in November. This is mainly due to domestic demand, as the more acute slowdown of the global economy should be partly offset by the depreciation of the pound sterling. Tighter credit conditions, trouble in the real estate market and downward pressures on real income should dampen spending and investment in the next few months in the United Kingdom. The rally in retail sales in January may seem surprising in these circumstances, but it is mainly due to large price cuts and to seasonal factors linked to the fact that Easter falls very early this year.
- On the other hand, and despite less favourable economic prospects, the BoE has had to revise its inflation scenario upwards. Annual growth in consumer prices rose slightly to 2.2% in January, but is still close to the target of 2%. The weakness of the pound combined with very high prices for energy and food should drive the inflation rate up sharply in the coming months. In theory, that increase would be temporary, but the recent rise in inflation expectations to relatively high levels is a concern for the BoE governors.
- The BoE's new inflation scenario will force it to remain prudent and rule out any aggressive monetary easing for the time being. However, the current level of the key rate still seems overly restrictive, given the fragility of the British economy. Monetary easing should therefore continue gradually in the months ahead. The evolving credit crisis and the effects of tighter lending conditions on the British economy will determine, to a large extent, just how far down rates will go.

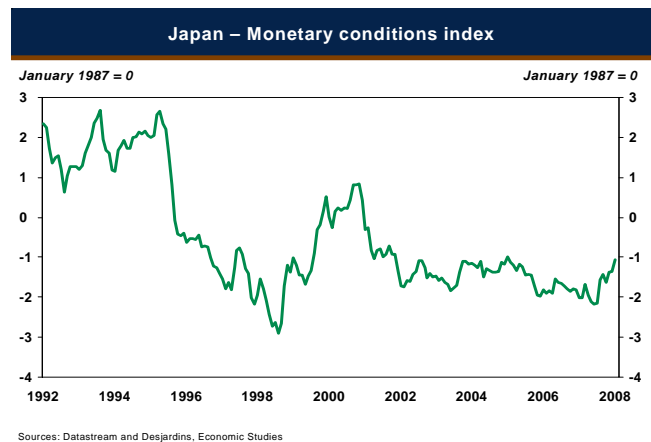
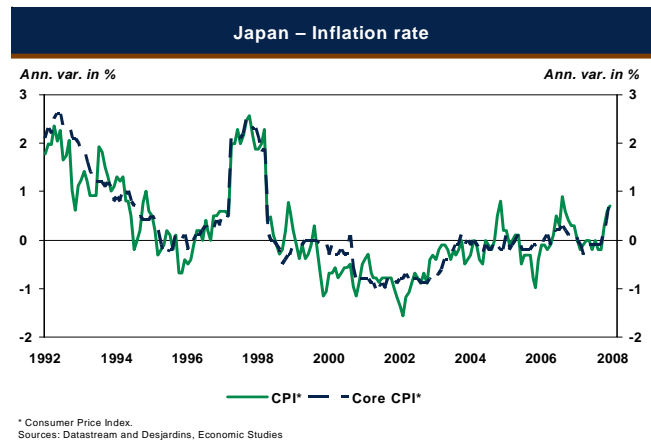
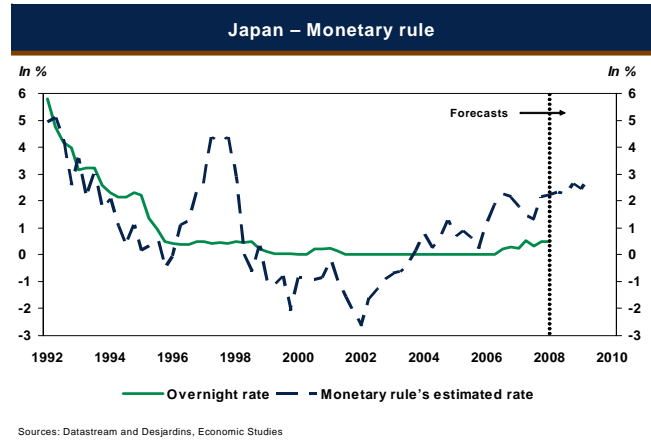
Forecasts: Prudence will remain the watchword for the BoE due to inflation expectations, but the deterioration of the real estate market and collateral damage in terms of consumer spending will induce it to implement further 0.25% cuts to its key rate between now and the summer.



Bank of Japan (BoJ) : The status quo will continue

- As expected, the BoJ maintained the status quo on February 15: the key rate remains unchanged at 0.50%. The slowdown in the U.S. economy, financial risks tied to assets backed by high-risk mortgage loans, the structural weakness of the Japanese economy and an annual inflation rate which, energy prices aside, is struggling to stay above zero, are all factors that encourage the BoJ to remain on the sidelines.
- Stimulated by capital investment, Japan's economic growth jumped by 3.7% year/year in the fourth quarter, whereas the consensus expectation was 1.7%. Apart from that bright spot, economic prospects remain gloomy for the coming months. Among other factors, a change in building standard regulations is leading to a marked drop in residential investment in Japan, and the weakness of the U.S. economy should result in lower Japanese exports. In fact, the Japanese government has revised downward its economic forecasts for the year. Even though the country's exports are less dependent on the U.S. market than in the past, the government expects the U.S. downturn to affect domestic demand in Asia sooner or later, which will indirectly affect the Japanese economy.
- Changes will soon be announced at the BoJ. The current Governor, Toshihiko Fukui, will complete his term on March 19. We don't know yet who his successor will be, but there is every reason to believe that the Deputy Governor, Toshiro Muto, will be chosen. In a situation in which the Japanese economy is liable to falter, some interpret this changing of the guard as opening the door to interest rate cuts in Japan. As far as we are concerned, this scenario seems highly unlikely, but future rate increases may be deferred to 2009.
- Recently, the appreciation of the yen has had a restrictive effect on monetary conditions in Japan, which provides a further argument against rushing into interest rate hikes. However, in the second half of the year, the expected increase in inflation and more robust economic growth will be compatible with a tightening of rates, as suggested by the estimate of our monetary rule.

Forecasts: In the short term, the U.S. economic slowdown and the appreciation of the yen will encourage the BoJ to remain on the sidelines. Sustained inflation above zero and signs of economic recovery could open the door to a rate hike towards the end of 2008.



**Table 1
Key interest rates**

| End of period in % | 2007 | | | | 2008 | | | | 2009 | | | |
|-----------------------|------|------|------|------|------|------|------|------|------|------|------|------|
| | Q1 | Q2 | Q3 | Q4 | Q1f | Q2f | Q3f | Q4f | Q1f | Q2f | Q3f | Q4f |
| United States | | | | | | | | | | | | |
| Federal funds | 5.25 | 5.25 | 4.75 | 4.25 | 2.50 | 2.00 | 2.00 | 2.00 | 2.50 | 3.00 | 3.00 | 3.50 |
| Canada | | | | | | | | | | | | |
| 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 |
| Euro zone | | | | | | | | | | | | |
| 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 |
| United Kingdom | | | | | | | | | | | | |
| 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 |
| Japan | | | | | | | | | | | | |
| Overnight funds | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.75 | 0.75 | 1.00 | 1.00 |

f: forecasts

Sources: Datastream and Desjardins, Economic Studies

**Table 2
Schedule and key rates**

| Date | Central Bank | Decision | Rate |
|----------------------|-----------------------------|----------|-------|
| November 2007 | | | |
| 12 | Bank of Japan | s.q. | 0.50 |
| 23 | Bank of Mexico | s.q. | 7.50 |
| December 2007 | | | |
| 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 |
| January 2008 | | | |
| 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 |
| February 2007 | | | |
| 4 | Reserve Bank of Australia | +25 b.p. | 7.00 |
| 7 | European Central Bank | s.q. | 4.00 |
| 7 | Bank of England | -25 b.p. | 5.25 |
| 13 | Bank of Sweden | +25 b.p. | 4.25 |
| 14 | Bank of Japan | s.q. | 0.50 |
| 15 | Bank of Mexico | s.q. | 7.50 |

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

Source: Desjardins, Economic Studies

**Table 3
Coming soon**

| Date | Central Bank |
|-------------------|-----------------------------|
| March 2008 | |
| 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 |
| April 2008 | |
| 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 |
| 30 | U.S. Federal Reserve |
| May 2008 | |
| 6 | Reserve Bank of Australia |
| 8 | European Central Bank |
| 8 | Bank of England |
| 16 | Bank of Mexico |
| 19 | Bank of Japan |

Source: Desjardins, Economic Studies

FIXED INCOME MARKET

United States: Federal bonds

U.S. FEDERAL BONDS

- Volatility has ruled the U.S. bond market in recent weeks. It all was rooted in fears of inflation, with the combination of higher inflation than expected in the United States, an upwards revision to the U.S. Federal Reserve's (Fed) annual inflation scenario and a spike in commodities prices casting doubt upon expectations of rate cuts in that country.
- The rate for two-year federal bonds shot up, moving from a low of 1.82% on February 15 to nearly 2.20% in the space of a few days. However, signs of a slowdown (first, the unexpected drop in the Philly Fed and the decline in the leading indicator on February 21, then the plunge in new orders on February 27) quickly took over, bringing the two-year rate back down to around 1.90%.
- The ten-year rate has continued the climb it started at the end of January, confirming that the low point (3.29%) was probably reached on January 23. In February, the ten-year rate rose to 3.95% on February 20 only to retreat to around 3.75% the next day in reaction to bad economic news.
- We believe that risks of inflation are being exaggerated, and this strikes us as a good time to replenish portfolios with two-year federal securities at any sign of weakness in the market. With a fair amount of more bad news expected in the weeks to come (on both the economic and financial fronts), the pressure on the two-year rates will probably remain downwards until the Fed indicates that the monetary easing cycle is drawing to a close. With downside risks predominating over inflationary risks, the low of February 15 should be tested as disappointing statistics are released over time.
- Although inflation is not a problem in the short term, it is likely that the Fed's aggressive interest rate cuts will generate a rebound in inflation starting in 2009. Under those conditions, upwards pressure will continue on rates in the long portion of the yield curve. In the short term, the ten-year rate will react to the ups and downs of the U.S. economy, but unless economic conditions worsen considerably, it should continue moving gradually upwards due to risks of inflation.

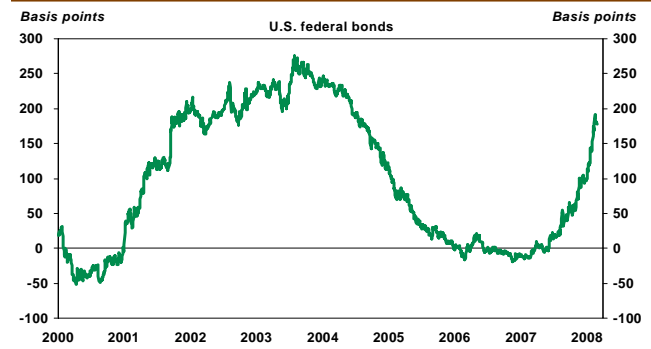
Forecasts: We recommend giving preference to the short portion of the curve and continuing to favour a steepening of the slope between the two and ten years maturities. The recent flattening did not reflect economic fundamentals, and a retreat of the slope below 180 basis points strikes us as a good point of entry.

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



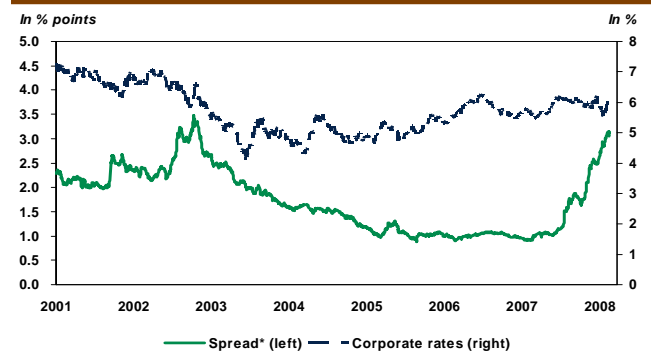
Sources: Datastream and Desjardins, Economic Studies

United States – 2/10 yield curve



Sources: Datastream and Desjardins, Economic Studies

United States – Risk appraisal is showing on corporate bonds spreads



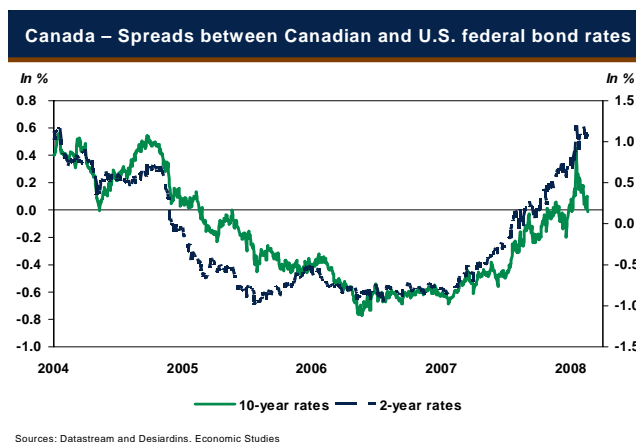
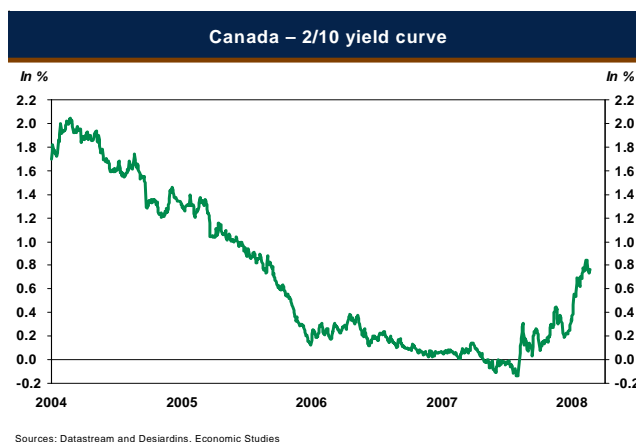
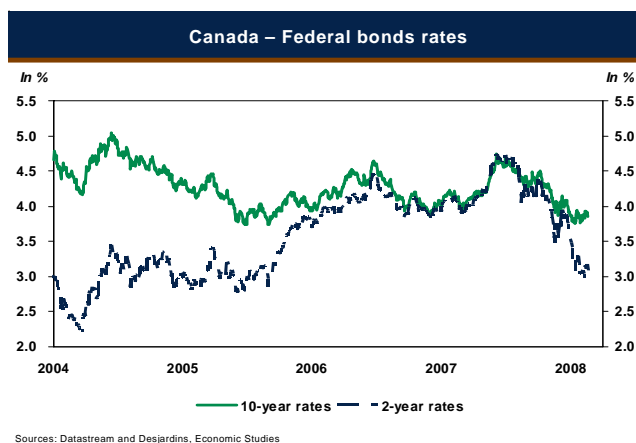
* 5-10-year U.S. corporate rates minus 5-year U.S. federal bond rates.
Sources: Datastream and Desjardins, Economic Studies

Canada: Federal and provincial bonds

FEDERAL BONDS

- After dropping sharply in the past few months, the rates for Canadian federal bonds have stabilized in recent weeks. The rate for the two-year term has been hovering between 3.0% and 3.2% since the beginning of the month, compared with a range of 3.80% to 3.95% for the ten-year rate.
- This recent stabilization reflects two contrary forces. On the one hand, credit problems have taken a disquieting turn internationally, and an economic slowdown is increasingly perceptible in this country. That will encourage the Bank of Canada to continue its monetary easing policy.
- On the other hand, the robustness of commodity prices, especially the record price of grains and the return of oil above US\$100 per barrel, has revived fears of accelerated inflation around the world. These inflationary pressures are limiting the retreat of bond rates and have even triggered an increase of approximately 20 basis points in the Canadian 30-year rate since mid-January.
- After reaching 84 basis points in mid-February, the highest level in two years, the 2/10 slope retreated by 10 basis points in recent days. The influence of U.S. rates and the markets' perception that inflationary pressures may limit monetary easing are responsible for this slight flattening of the slope.
- The spread between federal rates in Canada and the United States is still slightly more than 100 basis points for the two-year term, which mainly reflects the 125 basis point plunge of the U.S. key interest rate in January. The positive spread of 0.25% which existed between the Canadian and U.S. ten-year rates at the end of January is now slightly negative.
- Disappointing economic news in Canada in recent weeks and less worrisome inflationary pressures compared to the United States, account for this reversal of the spread.
- On February 26, the Harper government tabled a budget devoid of major surprises. The reduction in the supply of federal securities should continue over the next few years, but at a slower pace, since the planned repayment of the federal debt will, in theory, drop from \$10.2B for the 2007-2008 fiscal year to \$2.3B in 2008-2009. Still, Canada's budget situation remains enviable, despite the risks of economic slowdown.

Forecasts: More bad news relating to the credit crisis should bring Canadian rates down further over the next few months, especially in the short portion of the curve, which will be the first to benefit from cuts to key interest rates.

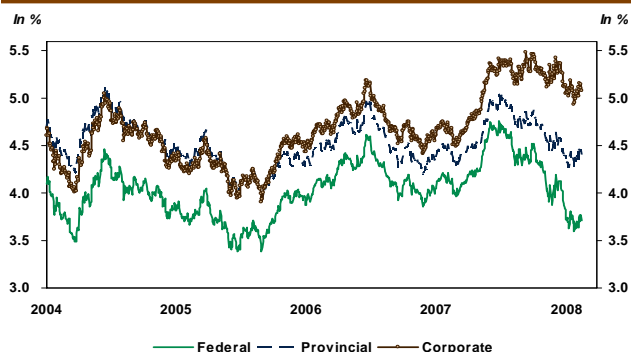


PROVINCIAL BONDS

- Provincial bonds have not been spared by the new widening of risk premiums. The rate spreads between provincial and federal bonds are now reaching peaks not seen since 2001 in the case of Québec bonds, and even longer ago for Ontario and British Columbia bonds.
- The turmoil in Canada's economy continues to be concentrated in Québec and Ontario, where the manufacturing sector is struggling to cope with the strength of the dollar and the slackening in U.S. demand. Those provinces' foreign trade has deteriorated sharply in recent months, and many jobs have been lost in the industrial sector. Recently, the news was especially bad in Ontario, where the automobile industry is suffering greatly. That contributed to a slight under-performance by Ontario bonds, compared to those of the other large provinces.
- In British Columbia, the vitality of the economy enabled the provincial government to table a surplus budget with an ecological bent on February 19. For the 2007-2008 fiscal year, B.C. is now calling for a budget surplus very close to \$2B, and the large reserves set aside in the budget plan should be sufficient to keep the province in a surplus position in the years to come.

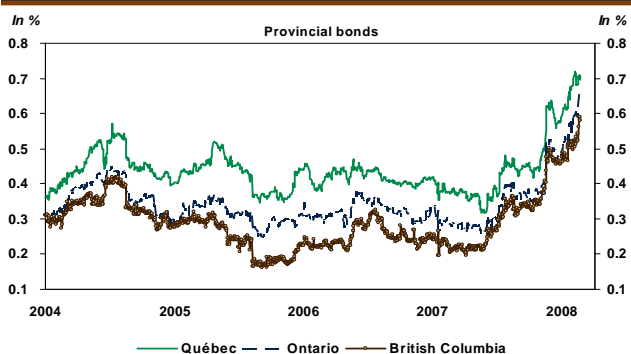
Forecasts: The rate spreads (historically very high) of provincial bonds make these securities attractive just now because the real risk of default by the provinces seems practically nil. However, given that financial turbulence will probably continue over the next few months, the rate spreads will probably widen a bit more in the short term, and then gradually lessen once the markets settle down.

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

| | Surplus (deficit) (1) in \$M | | Budget surplus (deficit) in % of GDP | Total debt (2) in % of GDP | Credit rating | |
|----------------------|---------------------------------|-------------|---|-------------------------------|---------------|---------|
| | 2006-2007 | 2007f-2008f | 2007f-2008f | 2007f-2008f | S&P | Moody's |
| Federal government | 13,752 | 10,200 | 0.7 | 29.9 | 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 | 1,970 | 1.0 | 19.0 | 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 |
| Key rate | | | | | | | | | | | | |
| Federal funds | 5.25 | 5.25 | 4.75 | 4.25 | 2.50 | 2.00 | 2.00 | 2.00 | 2.50 | 3.00 | 3.00 | 3.50 |
| Treasury bills | | | | | | | | | | | | |
| 3-month | 5.04 | 4.82 | 3.82 | 3.36 | 2.10 | 2.00 | 2.15 | 2.25 | 2.70 | 3.10 | 3.25 | 3.60 |
| Federal bonds | | | | | | | | | | | | |
| 2-year | 4.58 | 4.87 | 3.96 | 3.07 | 1.80 | 2.00 | 2.40 | 2.80 | 3.10 | 3.40 | 3.80 | 4.20 |
| 5-year | 4.54 | 4.93 | 4.23 | 3.46 | 2.90 | 3.10 | 3.30 | 3.40 | 3.50 | 3.70 | 4.10 | 4.50 |
| 10-year | 4.65 | 5.03 | 4.58 | 4.03 | 3.75 | 3.90 | 3.95 | 4.00 | 4.10 | 4.20 | 4.40 | 4.70 |
| 30-year | 4.85 | 5.13 | 4.83 | 4.45 | 4.50 | 4.55 | 4.60 | 4.65 | 4.65 | 4.70 | 4.80 | 4.90 |
| Yield curve | | | | | | | | | | | | |
| 5-year - 3-month | -0.50 | 0.11 | 0.41 | 0.10 | 0.80 | 1.10 | 1.15 | 1.15 | 0.80 | 0.60 | 0.85 | 0.90 |
| 10-year - 2-year | 0.07 | 0.16 | 0.62 | 0.96 | 1.95 | 1.90 | 1.55 | 1.20 | 1.00 | 0.80 | 0.60 | 0.50 |
| 30-year - 3-month | -0.19 | 0.31 | 1.01 | 1.09 | 2.40 | 2.55 | 2.45 | 2.40 | 1.95 | 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 |
| Key rate | | | | | | | | | | | | |
| 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 |
| Treasury bills | | | | | | | | | | | | |
| 3-month | 4.18 | 4.43 | 3.98 | 3.83 | 3.30 | 2.85 | 3.05 | 3.10 | 3.35 | 3.55 | 3.75 | 4.15 |
| Federal bonds | | | | | | | | | | | | |
| 2-year | 3.98 | 4.58 | 4.08 | 3.74 | 2.80 | 2.90 | 3.15 | 3.45 | 3.60 | 3.80 | 4.05 | 4.35 |
| 5-year | 4.01 | 4.56 | 4.21 | 3.87 | 3.50 | 3.65 | 3.75 | 3.80 | 3.85 | 4.00 | 4.20 | 4.50 |
| 10-year | 4.11 | 4.55 | 4.34 | 3.99 | 3.75 | 3.85 | 3.90 | 3.95 | 4.05 | 4.15 | 4.40 | 4.70 |
| 30-year | 4.20 | 4.49 | 4.45 | 4.10 | 4.20 | 4.25 | 4.35 | 4.40 | 4.45 | 4.55 | 4.65 | 4.80 |
| Yield curve | | | | | | | | | | | | |
| 5-year - 3-month | -0.17 | 0.13 | 0.23 | 0.04 | 0.20 | 0.80 | 0.70 | 0.70 | 0.50 | 0.45 | 0.45 | 0.35 |
| 10-year - 2-year | 0.13 | -0.03 | 0.26 | 0.25 | 0.95 | 0.95 | 0.75 | 0.50 | 0.45 | 0.35 | 0.35 | 0.35 |
| 30-year - 3-month | 0.02 | 0.06 | 0.47 | 0.27 | 0.90 | 1.40 | 1.30 | 1.30 | 1.10 | 1.00 | 0.90 | 0.65 |
| Spreads (Canada - U.S.) | | | | | | | | | | | | |
| 3-month | -0.86 | -0.39 | 0.16 | 0.47 | 1.20 | 0.85 | 0.90 | 0.85 | 0.65 | 0.45 | 0.50 | 0.55 |
| 2-year | -0.60 | -0.29 | 0.12 | 0.67 | 1.00 | 0.90 | 0.75 | 0.65 | 0.50 | 0.40 | 0.25 | 0.15 |
| 5-year | -0.53 | -0.37 | -0.02 | 0.41 | 0.60 | 0.55 | 0.45 | 0.40 | 0.35 | 0.30 | 0.10 | 0.00 |
| 10-year | -0.54 | -0.48 | -0.24 | -0.04 | 0.00 | -0.05 | -0.05 | -0.05 | -0.05 | -0.05 | 0.00 | 0.00 |
| 30-year | -0.65 | -0.64 | -0.38 | -0.35 | -0.30 | -0.30 | -0.25 | -0.25 | -0.20 | -0.15 | -0.15 | -0.10 |

f: forecasts

Sources: Datastream and Desjardins, Economic Studies