

The Yield Curve

May 2, 2008

Has the U.S. Federal Reserve really finished with monetary easing?

HIGHLIGHTS

- Financial markets are too complacent: the situation calls for more rate cuts.
- U.S. Federal Reserve: Monetary authorities are still facing a dilemma.
- Bank of Canada: Monetary easing will continue over the next few months.
- European Central Bank: The status quo will hold for several months.
- Bank of England: Fears of an economic slowdown are winning out for now.
- Bank of Japan: Although inflation is up, tightening the monetary policy will have to wait.
- The short-end of the U.S. curve is becoming interesting: favor a steepening of the slope.

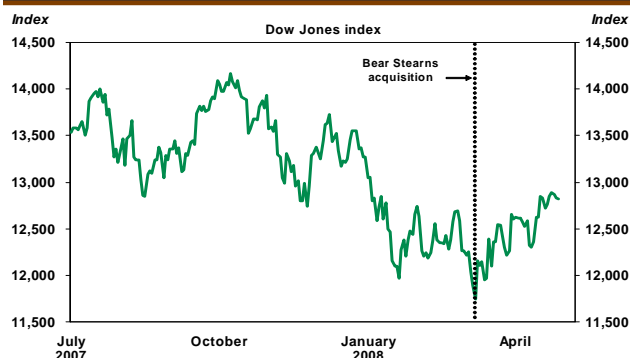
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Summary

The U.S. bond market is making a U-turn. Although, at the beginning of March, investors' pessimism seemed exaggerated, the renewed optimism since the Bear Stearns bailout organized by the U.S. Federal Reserve (Fed) and J.P. Morgan is just as inflated. Of course, the Fed's direct involvement as a last resort lender (and borrower) has been a turning point in the crisis, but the markets' enthusiasm since March 17, which has been characterized by an almost 10% rebound by the New York Stock Exchange, a significant drop in the costs of insurance on default risk, and an almost 120 basis point surge by federal 2-year bond rates is puzzling (Graphs 1, 2 and 3).

Graph 1 – The stock markets have rallied substantially since the Bear Stearns acquisition...



Sources: Bloomberg and Desjardins, Economic Studies

TOO MUCH COMPLACENCY IN THE FINANCIAL MARKETS

Now that the bulk of banking write-downs associated with losses on subprime loans has been well anticipated, the calm generated by less "negative" economic statistics seems to have triggered a shift in demand from safe haven securities (federal bonds) toward riskier securities (such as corporate equity), leading to substantial narrowing by spreads (Graph 4).

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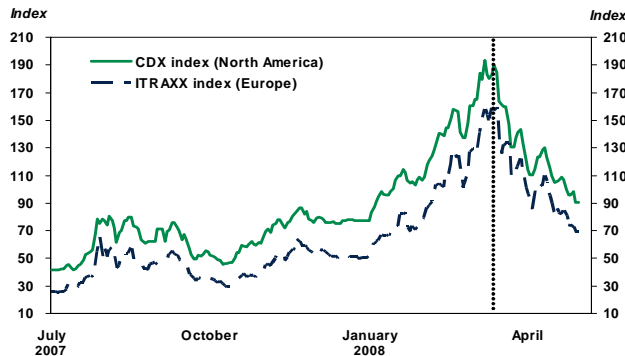
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NOTE TO READERS: The letters **k**, **M** and **B** are used in texts and tables to refer to thousands, millions and billions respectively.

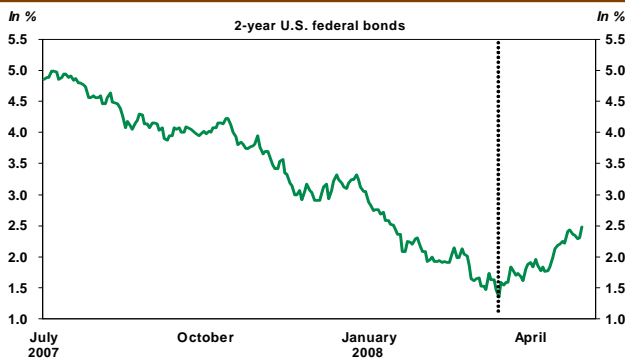
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Graph 2 – ... the cost of insurance on default risk has come down substantially...



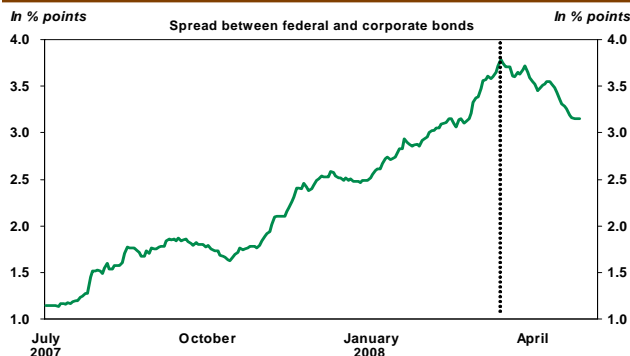
Sources: Bloomberg and Desjardins, Economic Studies

Graph 3 – ... and interest rates have started to climb



Sources: Bloomberg and Desjardins, Economic Studies

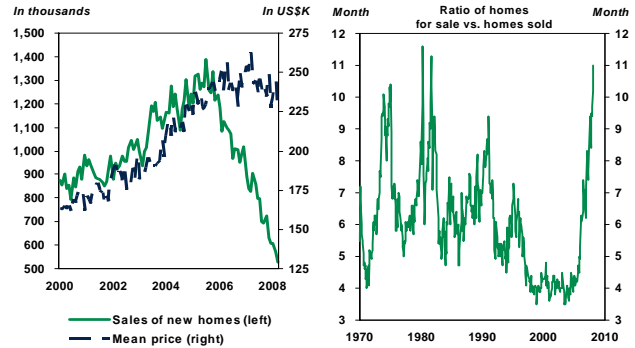
Graph 4 – Withdrawal from safe-haven securities was good for corporate rate spreads



Sources: Bloomberg and Desjardins, Economic Studies

Yet the economic news is nothing to write home about. Home sales are freefalling (Graph 5) and we think it will take another 10% to 15% drop in house prices to stabilize the real estate market. The problem is that the situation has been exacerbated by a vicious circle in which the correction by home prices is prodding more and more struggling owners to hand over their keys, increasing the inventory of houses and putting more downward pressure on the value of homes.

Graph 5 – The drop in prices is not enough to be able to hope for any immediate stabilization in the new home market



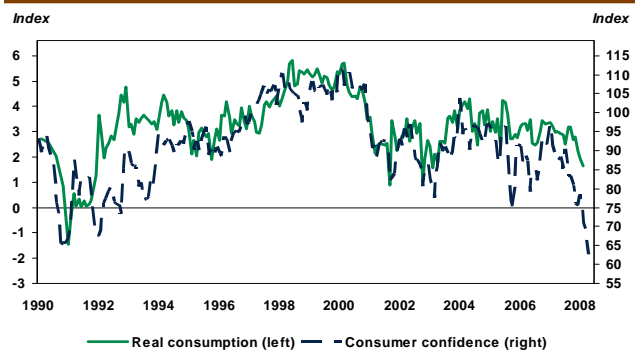
Sources: Census Bureau and Desjardins, Economic Studies

Moreover, while the slight 0.6% annualized real GDP growth in the first quarter of 2008 may have reassured more than a few that a technical recession (two straight quarters of contraction) can still be avoided, a number of pockets of softness clearly signal that the U.S. economy is in difficulties. Consumer spending only went up 1.0% during the winter, the worst performance in thirteen years. Non-residential investment (-2.5%) recorded its worst pullback in the last four years. Residential investment (-26.7%) saw its worst tumble since 1981. Together, these factors contributed to a 0.4% drop in final domestic demand, the first time it has contracted since 1991.

MORE BAD NEWS IS ON THE WAY

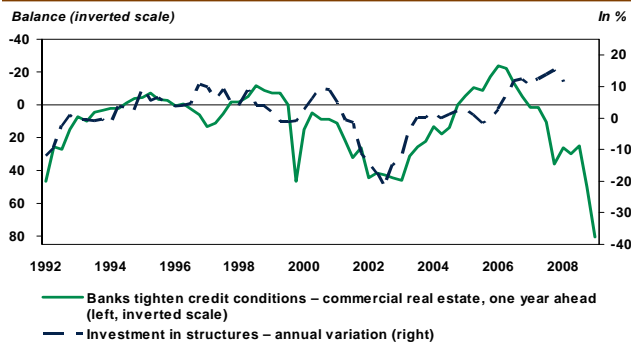
There is nothing to indicate that the situation is about to improve. With gas prices at record highs and household wealth being affected by tumbling home prices and the stock market correction, consumer confidence is at its lowest point since March of 1982. Corporate balance sheets are still relatively sound, but banks' tightening of credit conditions does not augur well for non-residential investment over the next few quarters (Graphs 6 and 7).

Graph 6 – Drop in confidence is a clear signal of a decline by households' real consumption



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

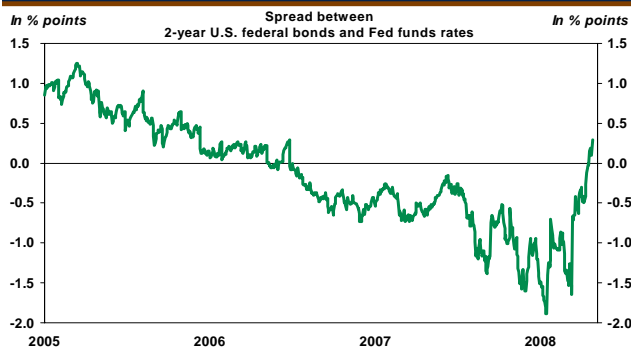
Graph 7 – Tight credit conditions should lead to a drop in non-residential investment



Sources: Federal Reserve Board, U.S. Census Bureau and Desjardins, Economic Studies

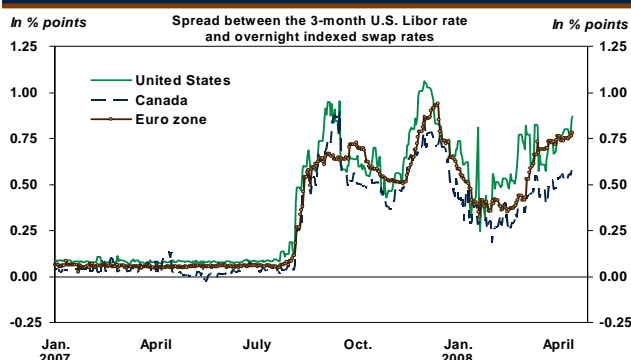
With 2-year bond yields more than 25 basis points above federal funds, the market seems to be saying that the Fed’s monetary stimulus cycle is over (Graph 8). After cutting its key rates by 325 basis points in just seven months, the Fed is surely relieved to be seeing the possibility of taking a break. The removal of the remark that “downside risks to growth remain” from the statement that accompanied the latest FOMC decision tends to point in that direction. In our opinion, however, it is still too early to bank on an end to rate cuts.

Graph 8 – The market shows that the Fed has done enough



Sources: Datastream and Desjardins, Economic Studies

Graph 9 – The stress on the money market is still high



Sources: Bloomberg and Desjardins, Economic Studies

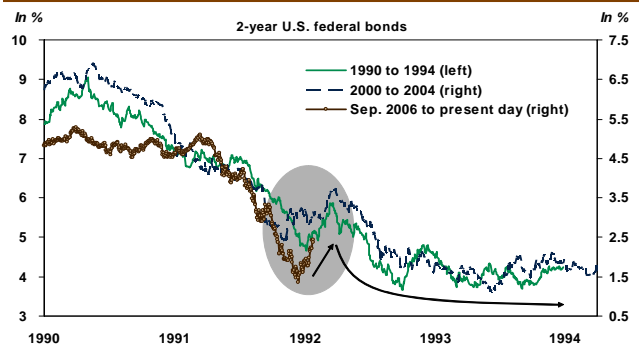
While they may have succeeded in limiting the damage and stabilizing financial markets, the Fed’s cuts have had little impact on the money market (Graph 9) and banks’ credit conditions.

THE SHORT PART OF THE CURVE IS ATTRACTIVE

Just over a month ago, in our view, the U.S. bond market did not represent a lot of value, and we were recommending shortening the duration of bond portfolios. But today, however, now that 2-year federal bond rates have come up by almost 120 basis points, the short part of the curve has some attractive potential.

In fact, a review of the last two recessions shows that the market tends to overestimate events to both the upside and downside during periods of monetary easing. Of course, persistent high energy prices are a big challenge for monetary authorities. As a result, bond markets could continue to be influenced to the upside in the short term. However, the overall context is deflationary (economic slowdown, increase in production capacities, job losses) and the priority will continue to be economic recovery. Similar to the 1991 and 2001 recessions, therefore, the market should, following a period of pessimism due to inflation fears, push interest rates back down (Graph 10).

Graph 10 – The market seems to be expecting an overly early end to the Fed’s monetary easing



Sources: Datastream and Desjardins, Economic Studies

In our opinion, the Fed could have to cut the target for federal funds again by the end of the summer to allow commercial banks to relax credit conditions. Under the circumstances, we still favour a steepening of the yield curve slope over the medium term.

EURO ZONE: TOO EARLY TO BANK ON A RATE CUT

Euroland’s inflation was at 3.6% in March (the non-detailed flash indicator puts inflation at 3.3% in April), so the European Central Bank’s (ECB) main concern remains inflation risks. However, we have begun to think that Euroland monetary authorities’ hawkish stance is the source of their problems.

Maintaining a firm stand on inflation meant the markets started to anticipate that the ECB's next change of direction would be a rate increase (Graph 11).

Graph 11 – Euro zone: Is the ECB's hawkish tone inflationary?

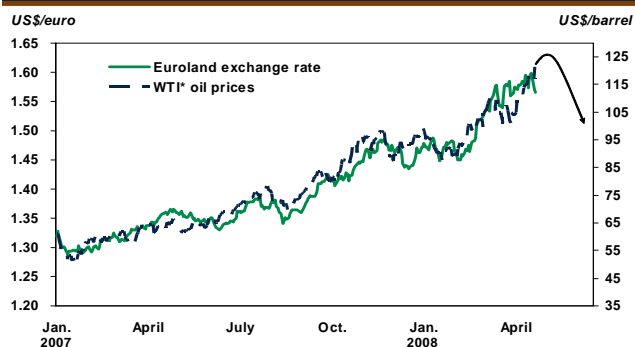


Sources: Datastream and Desjardins, Economic Studies

The ECB's attitude is only maintaining downward pressure on the greenback and, by ricochet, fanning commodities prices, with oil front and centre. As energy prices are at the core of the euro zone's current inflation, it would be to the ECB's advantage to calm things down. Usually, monetary policy has little effect on oil prices, which are set by the global market. But the current strains, which are characterized by intense speculation, would benefit from a change of course from the ECB.

In our opinion, a euro zone rate cut would have the advantage of killing two birds with one stone. With much of the Fed's monetary easing already behind us, ECB openness to rate cuts would on one hand trigger a correction by the euro, which would kick-start the euro zone's foreign trade. On the other, it would allow the greenback to bounce back and thus make oil prices come down (Graph 12).

Graph 12 – A euro correction would take oil prices back to a level more in line with fundamental determinants



* West Texas Intermediate.
Sources: Datastream and Desjardins, Economic Studies

It is still too early to look for rate cuts, but the signs of a slowing economy should gradually mount, allowing the ECB more leeway in developing its monetary policy. The decline by Germany's IFO index, an important barometer of economic activity in the euro zone, is one step in that direction. But rate cuts will certainly not see the light of day until there is some concrete deceleration by inflation. Here, the monthly decline by Germany's harmonized index of consumer prices, which took annual inflation down from 3.2% in March to 2.5% in April, is encouraging. We thus continue to expect rate cuts in the euro zone, but it seems increasingly clear that the ECB will not open the door before September.

Under these circumstances, patience is called for. Clearer opportunities for steepening by Euroland curves or narrowing of rate spreads between the euro zone and the United States should develop in the months to come.

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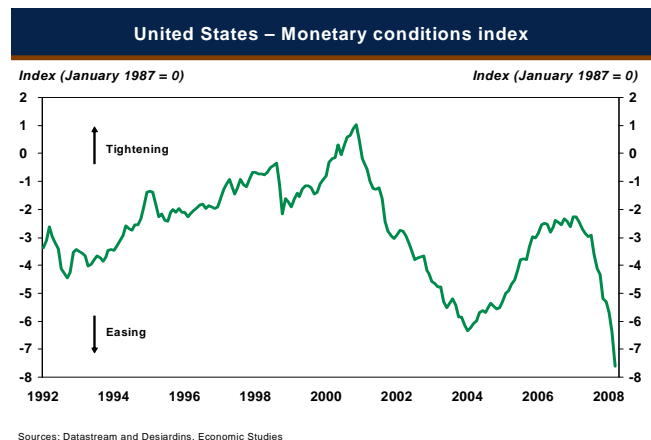
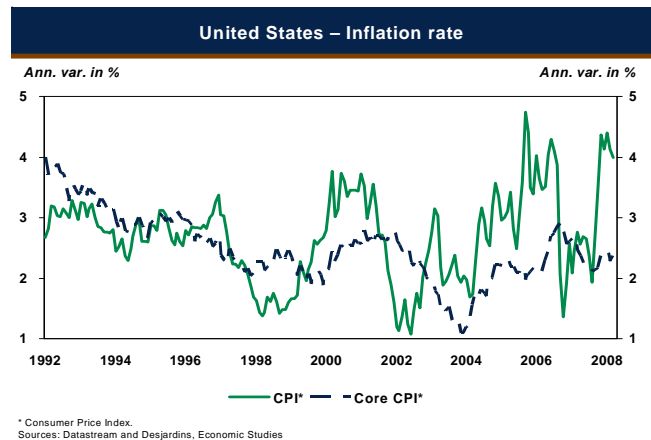
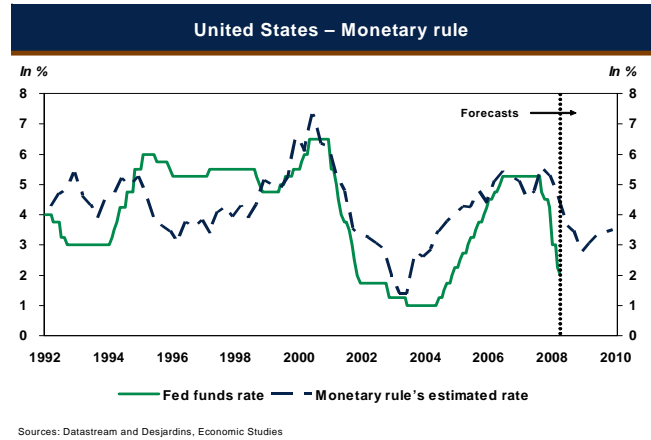
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MONETARY POLICY

U.S. Federal Reserve (Fed): Monetary authorities are still facing a dilemma

- The Fed met market expectations to the letter, lowering the target for federal funds by only 25 basis points at the meeting that ended on April 30. Stabilization by the stock and bond markets over the last month was largely offset by the feeling of urgency that had prevailed since the year opened. The Fed was thus able to temper its enthusiasm and the target interest rate for federal funds thus goes from 2.25% to 2.00%.
- In the statement accompanying the decision, the Fed said that core inflation is showing signs of improvement, but some indicators of inflation expectations have deteriorated. The Fed expects inflation to moderate in the coming quarters.
- Yet Uncertainty about the inflation outlook remains high and the latest results for consumer prices are fairly disappointing. After a lull in February, the consumer price index went up again in March. A monthly gain of 0.3% kept annual inflation at 4.0%. For its part, core inflation accelerated, going from 2.3% to 2.4%. The renewed surge by energy prices and concerns surrounding food prices still threaten the next inflation figures and the balance of inflation expectations. It is therefore clear that price evolution will continue to be a constraint on future monetary policy developments.
- The economic situation is also a sizeable challenge for the Fed. While GDP growth is not negative, it was anaemic in the first quarter of 2008, with an annualized gain of 0.6%. The increase primarily stems from restocking by businesses and positive foreign trade. U.S. final domestic demand fell 0.4% this winter, the first pullback since the 1991 recession. What's more, layoffs are mounting. 260,000 jobs have been lost since the year began and the job market should continue to erode.
- It is difficult to believe that the problems associated with credit are really over. The Fed's latest statement still mentions that the financial markets are under extensive stress. Despite the key rate cuts ordered since the financial crisis began and injections of liquidity for financial institutions, mortgage interest rates have not really come down.

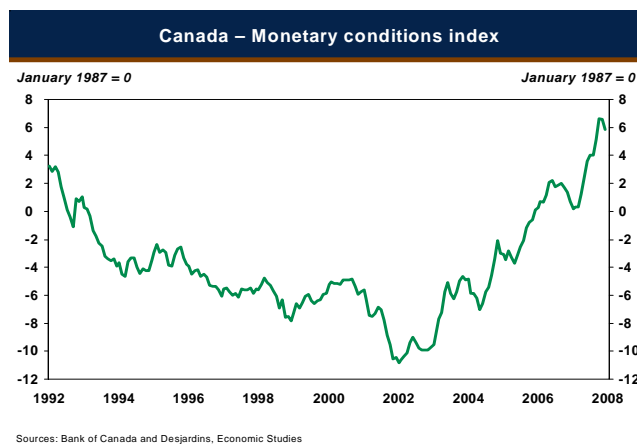
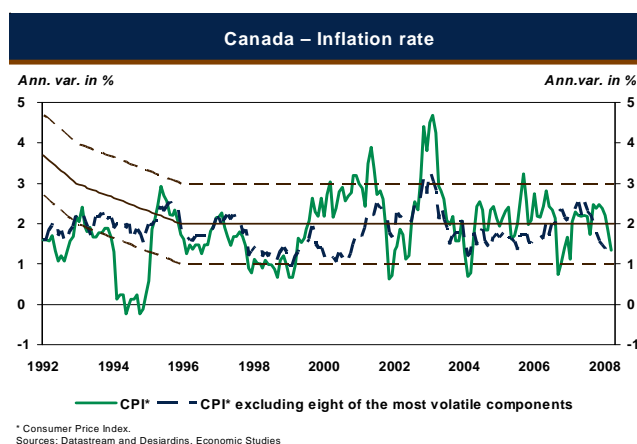
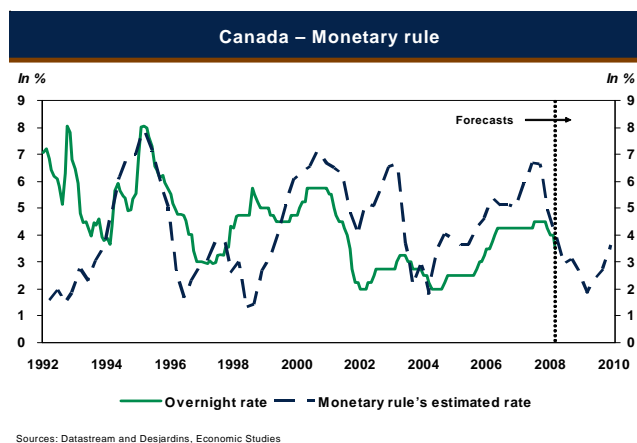
Forecasts: As more bad news is still to come and the Fed will continue to strive to counterbalance credit conditions, another key rate cut at future meetings is not out of the question. However, the inflation situation would have to permit it. We are expecting another 25 basis point cut to key rates at the June 24-25 meeting.



Bank of Canada (BoC): Monetary easing will continue over the next few months

- The BoC cut its key rate by 50 basis points at a second straight meeting in April, taking the overnight rate to 3.00%.
- The continued monetary easing and size of the cut ordered were not a surprise. Although domestic demand is doing well, the Canadian economy's overall growth outlook has dimmed more than anticipated. Canada is still showing signs of decoupling from the United States, especially in the area of employment, wages and consumption. However, the ongoing financial problems, tightening credit conditions and the combined impact on Canada's foreign trade of a strong dollar and the U.S. slowdown mean that economic activity will be lacklustre in the coming quarters.
- In April's *Monetary Policy Report*, the BoC intimates that U.S. recession risks will have negative repercussions for Canada's economy. The BoC therefore trimmed its growth outlook for Canada to 1.4% in 2008 and 2.0% for 2009.
- In our opinion, although the BoC clearly indicates that the timing of any further rate cuts will depend on the evolution of the global and Canadian economies, the situation is still conducive to further monetary easing.
- Low inflation gives the BoC all the leeway it needs. Although skyrocketing oil and grain prices are making the headlines worldwide, this seems to be having a limited impact on overall consumer prices in Canada. The effects of the goods and services (GST) tax cut, combined with the competitive pressures associated with the strong loonie, have brought on substantial deceleration by total inflation, to 1.4% in March. In the short term, the increase in gas prices will continue to be felt in the total index, but the economic slowdown should support the development of excess supply by the end of the year, which will keep inflation in the lower end of the BoC's target range.

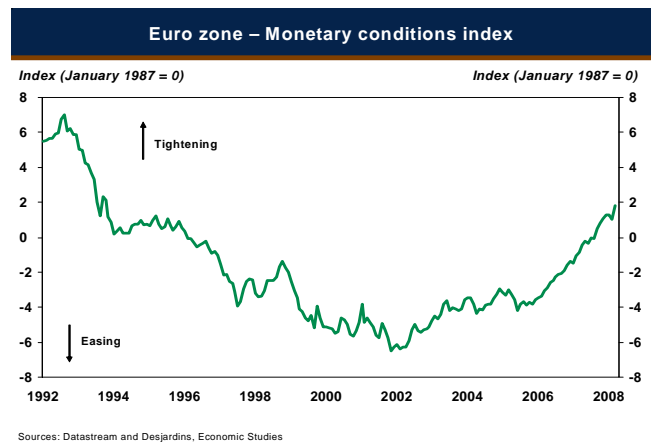
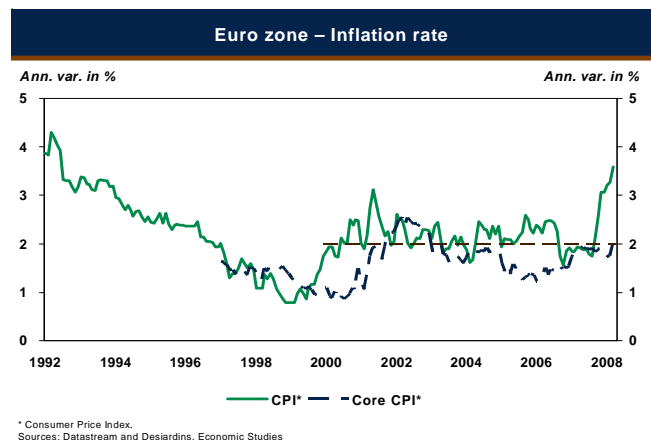
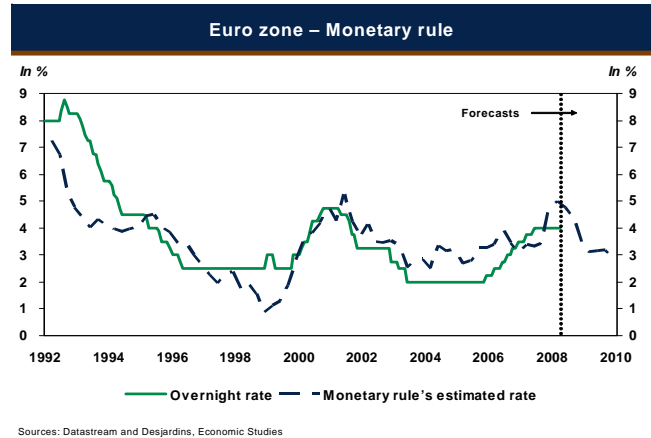
Forecasts: With the U.S. Federal Reserve signalling a break in its monetary easing cycle, the need to aggressively ease Canada's monetary policy has vanished. In our opinion, the situation still favours an additional 25 basis point cut at the June 10 meeting.



European Central Bank (ECB): The status quo will hold for several months

- As expected, the ECB kept its key rate at 4.00% in April for the eleventh straight month. Far from softening its stance, the ECB strenuously reaffirmed that its only goal was price stability. Some leaders even declared that the ECB could not permit itself to lower its key rate in 2008, given overly high inflation. This convinced the financial markets that the ECB would keep its monetary policy unchanged until year's end.
- The stubbornness of Euroland's monetary authorities arises from the fact that inflation, which reached a record 3.6% in March, should stay well above the 2% target for several months. The European Commission's latest forecasts anticipate that euro zone inflation will reach an average of 3.2% in 2008 before slowing to 2.2%. Like the ECB, the Commission deems that the inflation risks are still to the upside.
- However, the rapid rise by consumer prices is primarily a reflection of the surge by energy prices and some foods, and should therefore be temporary. For now, pass-through effects seem to be limited and inflation will already have slowed a little to 3.3% in April, according to the preliminary estimate.
- The economic outlook continues to deteriorate and the European Commission had to slash its growth forecast for the euro zone. Real GDP should only increase 1.7% in 2008 and 1.5% in 2009. The risks to this scenario are to the downside, and the International Monetary Fund's projections are even slightly more pessimistic. The global economic slowdown and strong euro will hurt Euroland exporters, but the domestic economy will also be hard hit by the housing sector slowdown and decline by consumer and business confidence.
- The economic slowdown and the euro's sharp appreciation have led many participants, including the French and Italian governments, to ask the ECB to show a little more flexibility. While ECB President Jean-Claude Trichet is demonstrably concerned about the potential impacts of big currency fluctuations on economic and financial stability, on April 28, he once again said that: "[...] It's crucial that the Governing Council sets the appropriate monetary policy stance on the basis of no other considerations than the delivery of price stability in the medium term [...]."

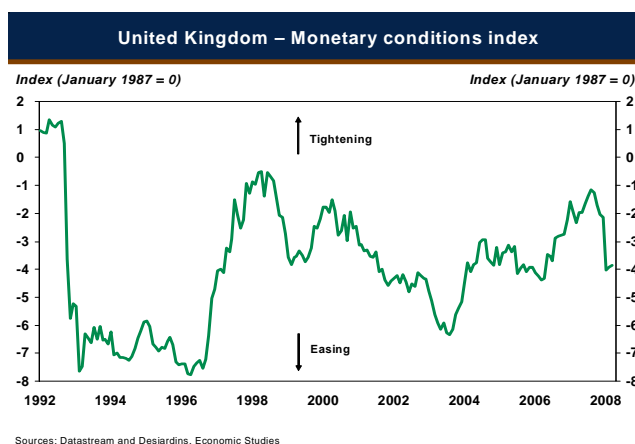
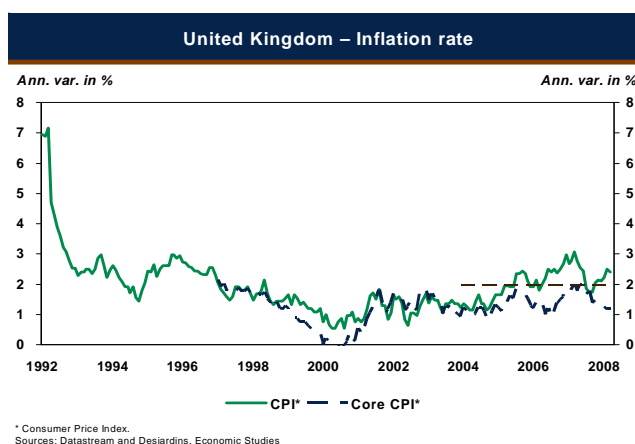
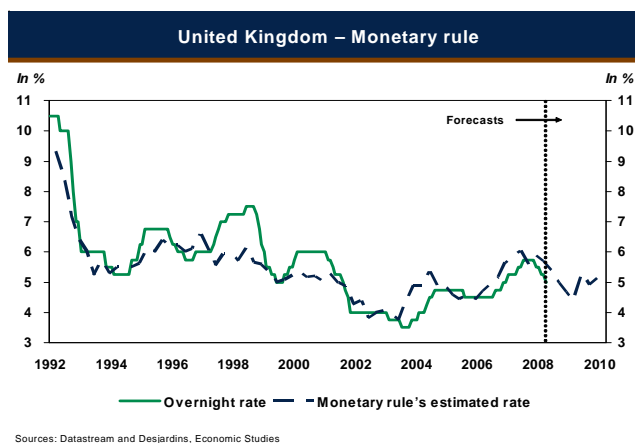
Forecasts: Pressure on the ECB will continue to mount over the next few months, while the risks of deep economic slowdowns should grow and inflation should start to moderate. However, the monetary authorities will not want to lose face, and will wait at least until the fall before proceeding within an initial rate cut.



Bank of England (BoE): Fears of an economic slowdown are winning out for now

- The BoE moved forward with monetary easing, cutting its key rate by 25 basis points in April. Since last December, the BoE has lowered this rate by 75 basis points to 5.00%. The minutes of April's meeting showed that only six of the nine members of the committee that sets the monetary policy voted in favour of the BoE decision. One member would have opted for an immediate cut of 50 points, while two other members would have preferred the status quo, although they acknowledged that the key rate would probably have to be lowered in the upcoming months. The extensive uncertainty surrounding the inflation outlook is the reason for the lack of BoE consensus.
- On one hand, inflation pressure stemming from the rise in global prices for energy and food is affecting the United Kingdom, and should keep inflation well over the 2% target in the near future. The inflation rate was stable at 2.5% in March and should reach 3% or higher within the next few months. Core inflation at only 1.2% confirms, however, that the price increase is coming from very specific external factors and has not had much impact on consumer goods as a whole.
- On the other hand, the UK economy is slowing, which could take inflation below the target over the medium term. Britain's real GDP growth was only 0.4% in the final quarter of 2007, the weakest result in three years; the International Monetary Fund is now projecting annual growth of just 1.6% in 2008.
- The real estate sector is especially worrisome. A number of price indexes are already signalling a decline in the value of British property, and a correction similar to the one happening in the U.S. housing market cannot be ruled out. David Blanchflower, the BoE committee member who was in favour of a 50 basis point cut in April, does not hesitate to say that he is worried about a UK recession as fallout from the real estate problems: "[...] More bad news is on the way. I think it is very plausible that falling house prices will lead to a sharp drop in consumer spending growth. Developments in the UK are starting to look eerily similar to those in the U.S. six months or so ago [...]"

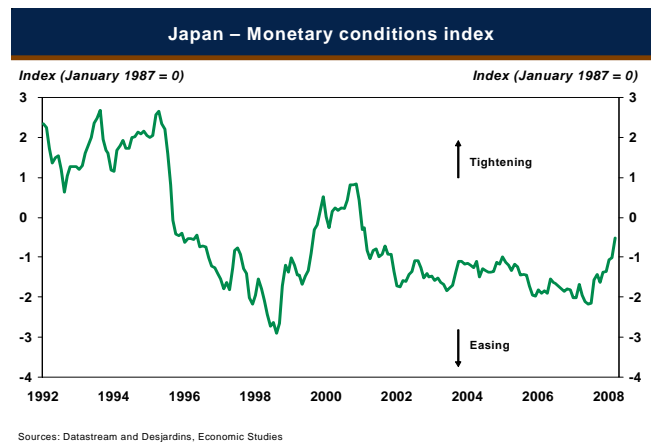
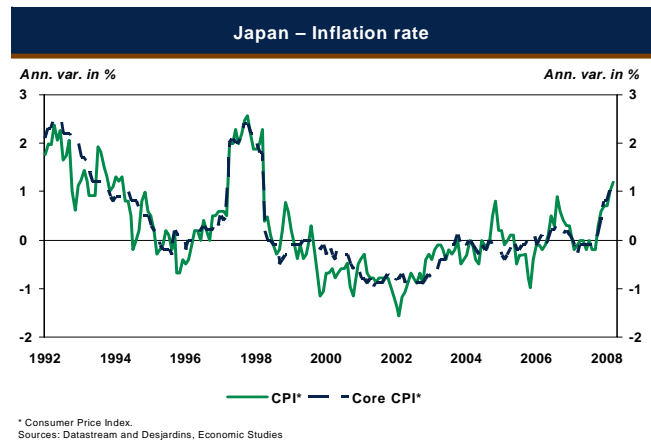
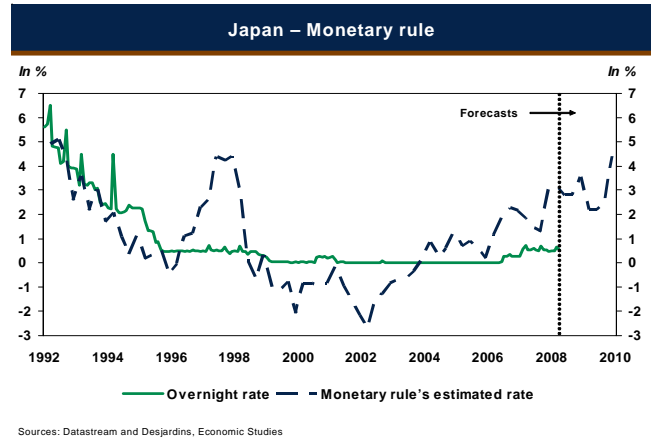
Forecasts: As usual, the BoE, after lowering rates in April, will probably pause in May. But the deterioration of the economy suggest that monetary easing will be pursued in June. The *Inflation Report*, to be published May 14, will provide a better idea of the BoE's vision.



Bank of Japan (BoJ): Although inflation is up, tightening the monetary policy will have to wait

- As forecast, the BoJ once again stayed on the sidelines at its April 29 monetary policy meeting. Japan's key rate has been steady at 0.50% for more than a year now, and few factors justify a change in the coming months. The BoJ also changed its stance in favour of a status quo in its semi-annual publication on the Outlook for the Economic Activity and Prices. Although the inflation rate is up, a number of factors call for prudence, including the U.S. slowdown, the still very present financial risks, the yen's appreciation, and now skyrocketing prices for oil and other commodities.
- In March, total inflation and inflation excluding fresh food both reached an annual 1.2%. If we exclude energy prices as well, however, the inflation rate was only 0.1%, which is still the biggest change seen since August of 1998. This encouraging news for Japan's central bank still does not justify moving ahead with monetary firming, however. Much of inflation stems from supply (costs for energy and raw materials), and a number of factors are overshadowing the short-term economic outlook.
- The slowdown in the United States and the yen's appreciation intimate that Japan could potentially get hurt by means of its foreign trade sector. Thankfully, demand from Asia's emerging nations remains lively, for now. For the other economic components, the news is still mixed. Japanese consumer confidence is at historically low levels. The residential construction sector is still disappointing. The Tankan index, often associated with investment in capital and machinery, is down, and industrial production plummeted in March after the rebound noted in February.
- The Monetary Conditions Index tightened again in March due to the yen's appreciation, one more argument to not precipitate rate hikes. Nonetheless, the index should show a little more flexibility soon, given the decline recorded for Japan's currency, making room for potential monetary tightening.
- After a little turmoil in Japan's parliament, Masaaki Shirakawa was finally named the BoJ's governor on April 7. This appointment should not make the central bank deviate from its objectives, despite a stance that is now more neutral.

Forecasts: Japan's economy could be hurt by the U.S. slowdown and the yen's appreciation. The rise by oil and commodities prices is also a source of concern. Cost-push inflation is not the ideal scenario, and the BoJ should stay on the sidelines until the end of 2008.



**Table 1
Key interest rates**

End of period in %	2007				2008				2009			
	Q1	Q2	Q3	Q4	Q1	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
United States												
Federal funds	5.25	5.25	4.75	4.25	2.25	1.75	1.75	1.50	1.50	2.00	2.75	3.50
Canada												
Overnight funds	4.25	4.25	4.50	4.25	3.50	2.75	2.50	2.50	2.75	3.25	3.50	4.00
Euro zone												
Refinancing rate	3.75	4.00	4.00	4.00	4.00	4.00	4.00	3.50	3.25	3.25	3.50	3.75
United Kingdom												
Base rate	5.25	5.50	5.75	5.50	5.25	4.75	4.50	4.50	5.00	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
February 2007			
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
March 2007			
3	Reserve Bank of Australia	+25 b.p.	7.25
4	Bank of Canada	-50 b.p.	3.50
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	s.q.	5.25
6	Bank of Japan	s.q.	0.50
13	Bank of Norway	s.q.	5.25
13	Swiss National Bank	s.q.	2.75
14	Bank of Mexico	s.q.	7.50
18	U.S. Federal Reserve	-75 b.p.	2.25
10	Reserve Bank of Australia	s.q.	7.25
April 2008			
8	Bank of Japan	s.q.	0.50
10	European Central Bank	s.q.	4.00
10	Bank of England	-25 b.p.	5.00
16	Bank of Brazil	+50 b.p.	11.75
18	Bank of Mexico	s.q.	7.50
22	Bank of Canada	-50 b.p.	3.00
23	Bank of Norway	+25 b.p.	5.50
23	Reserve Bank of New Zealand	s.q.	8.25
23	Bank of Sweden	s.q.	4.25
29	Bank of Japan	s.q.	0.50
30	U.S. Federal Reserve	-25 b.p.	2.00

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

Source: Desjardins, Economic Studies

**Table 3
Coming soon**

Date	Central Bank
May 2008	
6	Reserve Bank of Australia
8	European Central Bank
8	Bank of England
16	Bank of Mexico
19	Bank of Japan
28	Bank of Norway
June 2008	
3	Reserve Bank of Australia
4	Reserve Bank of New Zealand
4	Bank of Brazil
5	European Central Bank
5	Bank of England
10	Bank of Canada
12	Bank of Japan
19	Swiss National Bank
20	Bank of Mexico
25	Bank of Norway
25	U.S. Federal Reserve
July 2008	
1	Reserve Bank of Australia
3	European Central Bank
3	Bank of Sweden
10	Bank of England
14	Bank of Japan
15	Bank of Canada
18	Bank of Mexico
23	Reserve Bank of New Zealand
23	Bank of Brazil
August 2008	
5	Reserve Bank of Australia

Source: Desjardins, Economic Studies

TECHNICAL ANALYSIS

UST 10-YEAR: (3.70%)

The U.S. 10-year rate emerged from its downward corridor around 3.70%. A break above 3.90% would confirm a quick ascent toward 4.25%, characterized by a steepening of the U.S. yield curve.



CRB INDEX: (409)

The CRB (Commodity Research Bureau) index graph shows that we will see a consolidation phase for demand for raw materials. Supports at 400 and 380 are expected. Only a break above 422 would confirm that it is starting to move up again.



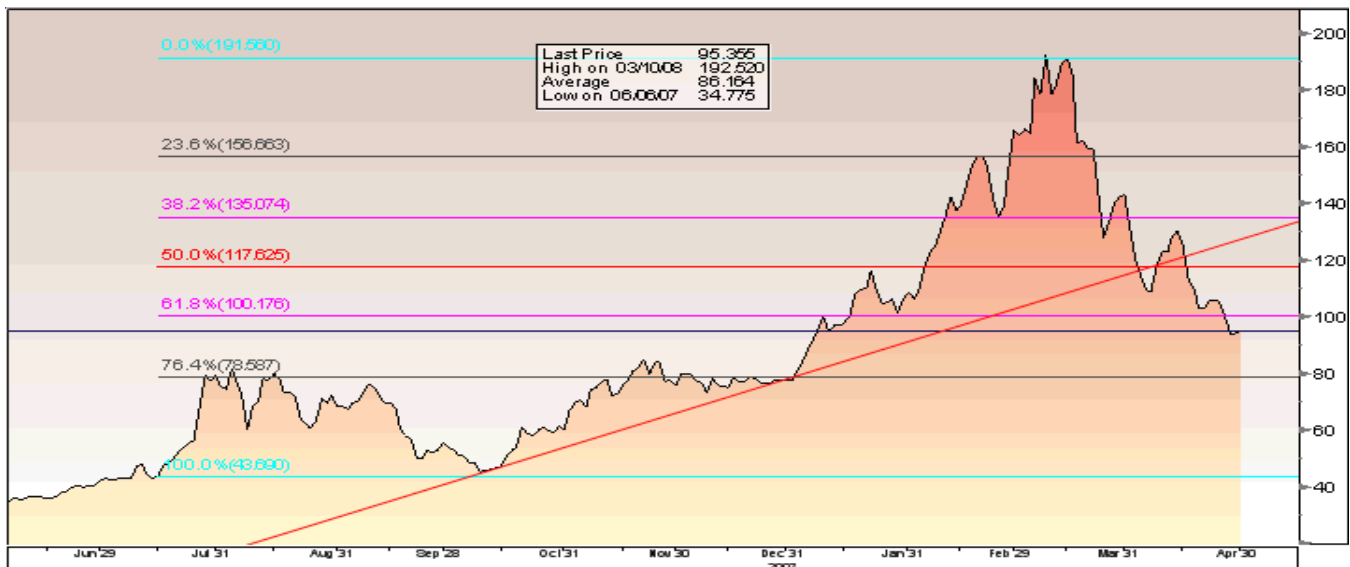
MERR US: (49.80)

A good indicator for knowing whether the stock market is anticipating and validating the end of the financial crisis, at least in the short term, is watching whether the price of a Merrill Lynch share in the United States is able to trade and close above \$50. This would confirm that the downward trend line has given way, and we should then see a surge toward \$59.



CDX: (95.3)

As we can see, the negative trend for credit that started when the crisis began in July gave way close to 120. There was some resistance around 100, which was also shattered last week. We can expect the CDX index to reach 80 points in the fairly near future. In the short term, therefore, credit should continue to do well.



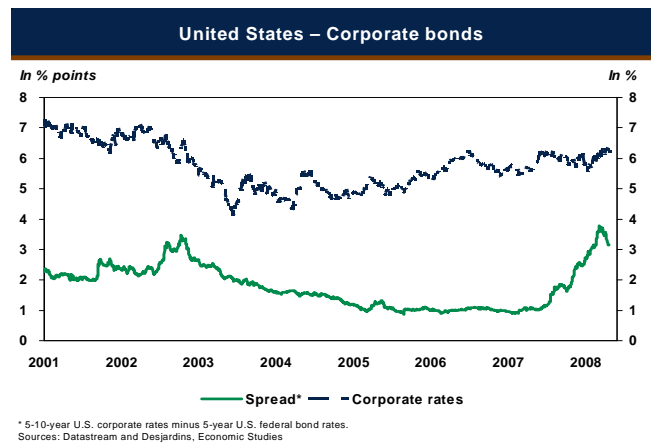
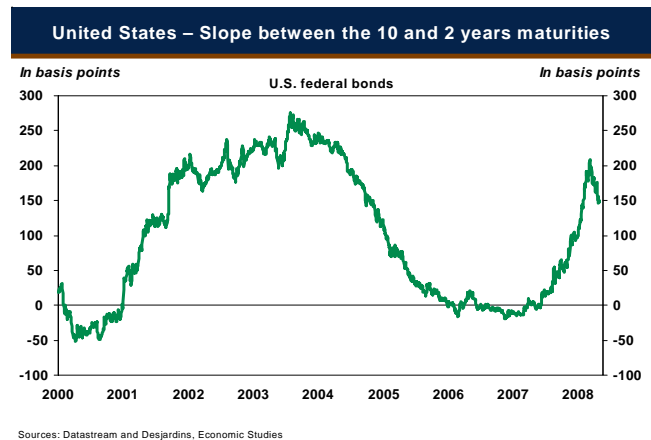
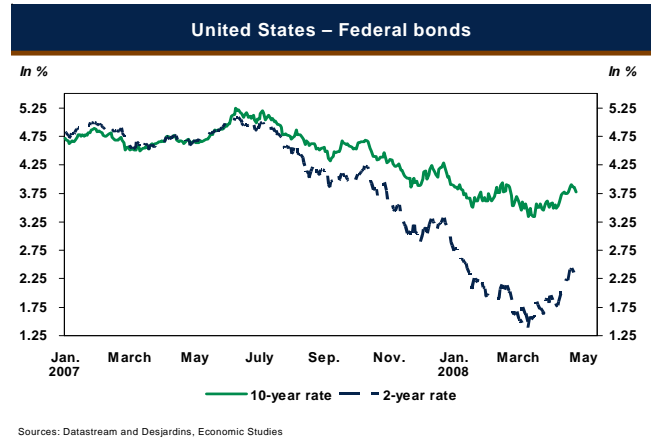
FIXED INCOME MARKET

United States: Federal bonds

U.S. FEDERAL BONDS

- The U.S. bond market has begun a clear U-turn. On one hand, in a context of high inflation, skyrocketing energy and grain prices are continuing to play on inflation fears. On the other, the buyout of Bear Stearns, the investment bank, allowed optimism to return to the financial centres, making the bond market anticipate an end to rate cuts from the U.S. Federal Reserve (Fed).
- Reflecting a shift toward safe-haven securities, rates on 2-year federal bonds shot up, going from a low of 1.26% on March 17 (date of the bailout of Bear Stearns by the Fed and J.P. Morgan) to a cyclical peak of 2.50% on April 25. Some bad news, including the tumble by consumer confidence, led to a slight correction but, better-than-expected employment results in April have pushed rates up by 120 basis points from mid-March.
- The 10-year rate continued the rise it began at the end of January, confirming that the low point of 3.29% was probably reached during trading on January 23. In the last few weeks, 10-year rates have continued to climb, reaching 3.90% on April 25.
- Inflation fears could continue to put upward pressure on bond rates over the short term. However, the situation promises to be temporary. With much bad news still expected in the next few weeks, the economic and financial situation remains deflationary, overall. In our opinion, a contraction by real GDP in the second quarter is likely, and job losses will continue until this fall.
- Under the circumstances, we think it is still too early to bank on an end to Fed rate cuts. During the last two recessions, the bond market was too quick in expecting an end to U.S. monetary easing, and it seems history is about to repeat itself.

Forecasts: Given the almost 110 basis point rise by 2-year rates, the short part of the curve is becoming attractive again. With the break in the downward trend seen over the last six months, 10-year rates are likely to remain over 3.50%. In the near term, we thus continue to lean toward steepening by the U.S. yield curve.

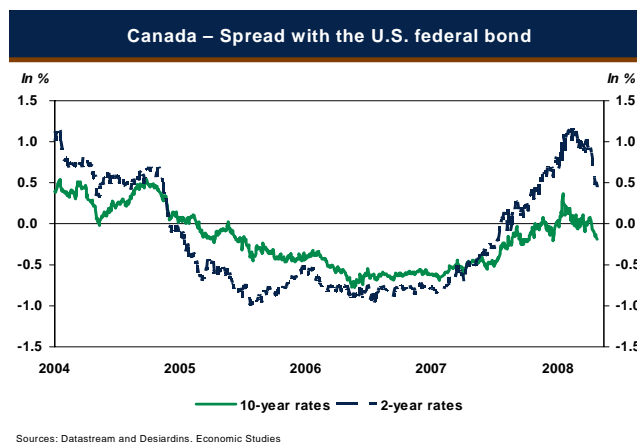
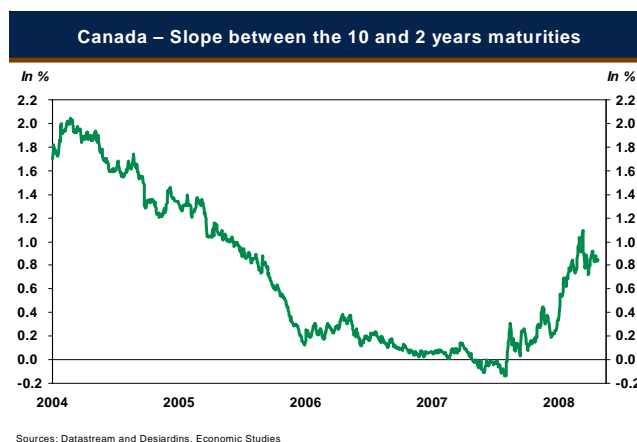
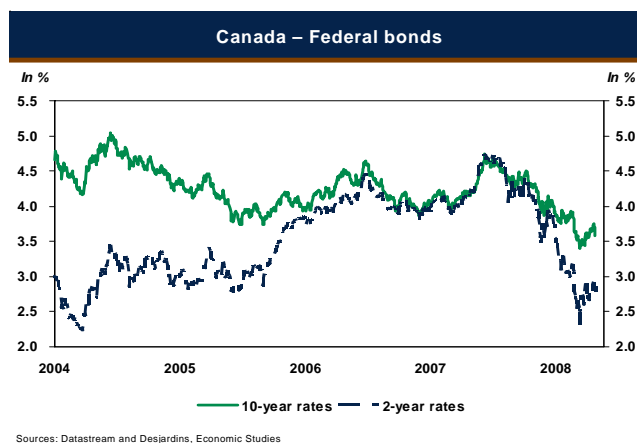


Canada: Federal and provincial bonds

FEDERAL BONDS

- The evolution of Canadian bond rates has been strongly influenced by the U.S. market over the last few weeks. After hitting a cyclical low in mid-March, rates on Canadian government securities came back up substantially on the renewed optimism of investors abandoning safe-haven securities. Global inflation fears stemming from the surge in energy and food prices also helped Canadian bond rates rise again. The Canadian 10-year/2-year slope, which had reached 110 basis points in mid-March, came down to about 85 points on the rapid climb by 2-year rates.
- The U.S. market's influence is especially clear in the short part of the curve. The Canadian 2-year rate has jumped about 50 basis points since mid-March, to around 2.80%, even though the Bank of Canada (BoC) continued with aggressive monetary easing. This surge is directly related to the even larger surge by 2-year U.S. rates, as the markets believe the U.S. Federal Reserve has finished with monetary easing. The spread between Canadian and 2-year U.S. rates thus went from over 100 basis points in March to less than 50 points.
- Canada's 10-year rate also went up less than the U.S. equivalent did in the last few weeks; it is now about 15 points under its counterpart. The deterioration by Canada's economic outlook and inflation pressure that is much weaker than it is south of the border (due to the strong loonie, among other things) justify slightly lower long-term rates in Canada.
- Unlike what has happened in the United States, the easing of strains on the financial markets has not yet benefited Canadian corporate bonds to any great extent. Rate spreads with federal securities have only come down by 10 basis points in the last few weeks, and remain very high. It seems that slightly weaker demand for safe-haven securities has done a lot more to boost the stock markets than riskier Canadian bonds.

Forecasts: Canadian rates' rapid rise over the last few weeks opens the door to a potential correction. The economic and financial context is still very uncertain, and it would only take some disappointing news to convince investors to start accumulating safe-haven securities. The short part of the curve should be preferred as it should also benefit from ongoing monetary easing by the BoC.

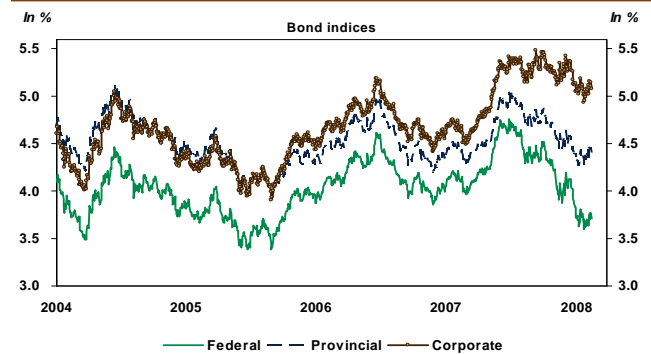


PROVINCIAL BONDS

- Like corporate securities, rates on provincial bonds have not benefited much to date from investors' renewed confidence. Instead, provincial securities have moved in tandem with federal bonds, and rate spreads have only narrowed by a few basis points. At 85 basis points, the spread between Québec and federal 10-year bonds is still close to the cyclical peak of 92 points set at the end of March.
- The economic situation of the provinces in central Canada is still worrisome. Despite lively domestic demand, growth promises to be very soft in Québec and Ontario this year as the strong loonie, flagging U.S. demand and foreign contribution will lead to further substantial deterioration in these two provinces' trade balance.
- Conversely, everything suggests that the western provinces have maintained economic growth that is above the national average since the year began. However, British Columbia's economy will not avoid some slowing as the decline by U.S. demand for forest products is intensifying BC's foreign trade problems.

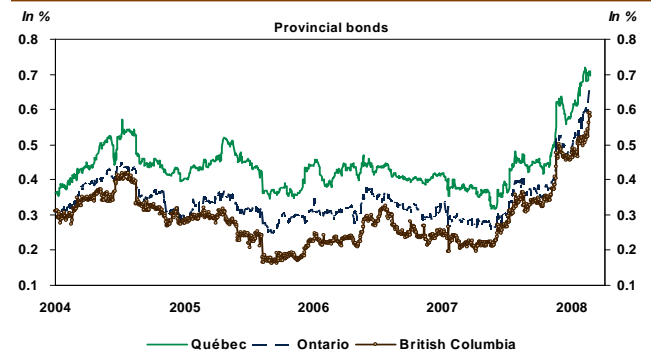
Forecasts: If the worst of the financial strain is really behind us, the premium demanded on provincial bonds should start to come down soon. Rate spreads could still go up a little in the very near future if bad news affects investors' still fragile optimism.

Evolution of the 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	10,200	0.7	34.9	AAA	Aaa
Newfoundland	154	882	3.0	35.0	A	Aa2
Prince Edward Island	24	-42	-0.9	37.6	A	Aa2
Nova Scotia	-336	-347	-1.0	34.4	A+	Aa2
New Brunswick	237	18	0.1	28.9	AA-	Aa1
Québec	1,993	1,695	0.6	55.3	A+	Aa2
Ontario	2,269	600	0.1	26.4	AA	Aa1
Manitoba	430	298	0.6	30.4	AA	Aa1
Saskatchewan	398	693	1.4	26.5	AA	Aa1
Alberta	8,510	3,988	1.5	0.0	AAA	Aaa
British Columbia	4,056	2,120	1.1	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	Q1	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Key rate												
Federal funds	5.25	5.25	4.75	4.25	2.25	1.75	1.75	1.50	1.50	2.00	2.75	3.50
Treasury bills												
3-month	5.04	4.82	3.82	3.36	1.38	1.40	1.50	1.40	1.80	2.15	2.90	3.60
Federal bonds												
2-year	4.58	4.87	3.96	3.07	1.62	2.00	2.40	2.10	2.90	3.30	3.80	4.20
5-year	4.54	4.93	4.23	3.46	2.47	3.00	3.10	2.90	3.50	3.80	4.10	4.60
10-year	4.65	5.03	4.58	4.03	3.43	3.80	3.95	3.75	4.10	4.20	4.40	4.70
30-year	4.85	5.13	4.83	4.45	4.30	4.50	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	1.09	1.60	1.60	1.50	1.70	1.65	1.20	1.00
10-year - 2-year	0.07	0.16	0.62	0.96	1.81	1.80	1.55	1.65	1.20	0.90	0.60	0.50
30-year - 3-month	-0.19	0.31	1.01	1.09	2.92	3.10	3.10	3.25	2.85	2.55	1.90	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	Q1	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Key rate												
Overnight funds	4.25	4.25	4.50	4.25	3.50	2.75	2.50	2.50	2.75	3.25	3.50	4.00
Treasury bills												
3-month	4.18	4.43	3.98	3.83	1.88	2.40	2.60	2.70	3.00	3.55	3.75	4.15
Federal bonds												
2-year	3.98	4.58	4.08	3.74	2.63	2.70	2.90	2.70	3.40	3.80	4.00	4.35
5-year	4.01	4.56	4.21	3.87	2.91	2.90	3.05	2.85	3.45	4.00	4.20	4.50
10-year	4.11	4.55	4.34	3.99	3.43	3.60	3.90	3.60	4.05	4.15	4.40	4.70
30-year	4.20	4.49	4.45	4.10	3.94	4.20	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	1.03	0.50	0.45	0.15	0.45	0.45	0.45	0.35
10-year - 2-year	0.13	-0.03	0.26	0.25	0.80	0.90	1.00	0.90	0.65	0.35	0.40	0.35
30-year - 3-month	0.02	0.06	0.47	0.27	2.06	1.80	1.75	1.70	1.45	1.00	0.90	0.65
Spreads (Canada - U.S.)												
3-month	-0.86	-0.39	0.16	0.47	0.50	1.00	1.10	1.30	1.20	1.40	0.85	0.55
2-year	-0.60	-0.29	0.12	0.67	1.01	0.70	0.50	0.60	0.50	0.50	0.20	0.15
5-year	-0.53	-0.37	-0.02	0.41	0.44	-0.10	-0.05	-0.05	-0.05	0.20	0.10	-0.10
10-year	-0.54	-0.48	-0.24	-0.04	0.00	-0.20	-0.05	-0.15	-0.05	-0.05	0.00	0.00
30-year	-0.65	-0.64	-0.38	-0.35	-0.36	-0.30	-0.25	-0.25	-0.20	-0.15	-0.15	-0.10

f: forecasts

Sources: Datastream and Desjardins, Economic Studies