The Yield Curve

Desjardins Economic Studies
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The U.S. Federal Reserve is torn between inflation risks and the slowing economy

Highlights

- After cutting rates by 325 basis points since the end of August 2007, the U.S. Federal Reserve has sent a clear signal that it does not intend to continue with monetary easing unless there is substantial deterioration in the economic and financial situation. In our view, the risks are still tilted to the downside, but, against the backdrop of inflation fears, the most likely option promises to be a lengthy status quo.
- Although inflation accelerated in April, the Bank of Canada has the leeway it needs to cut its key rate by 25 basis points to 2.75% at its June meeting.
- Runaway inflation in the United Kingdom is keeping the Bank of England's hands tied. Do not expect any rate decreases in the near future.
- The European Central Bank will maintain a hawkish tone at its next few meetings. It might even discuss the possibility of rate increases.

Contents

Summary

North American bond markets have remained volatile in recent weeks. However, after the rapid increase in bond rates that occurred from mid-March to the end of April, the upward trend is not as clear at this stage. The context is marked by the U.S. economic slowdown, but oil's runaway surge to over US$135/barrel in May has brought inflation fears back to the forefront.

That's all it took to bring central bank hawks back out of the woodwork. The European Central Bank's (ECB) stance has been focused on the inflation risks for several months, and the minutes of the Bank of England (BoE) and U.S. Federal Reserve (Fed) meetings revealed that their respective ongoing monetary easing cycles would be put off for now.

In the United Kingdom, with inflation already at the 3.0% upper limit, the monetary policy committee sent a clear message to wage and price setters to the effect that this period of high inflation will be temporary and that the BoE was committed to returning inflation back to the 2.0% target.

In the United States, the decision to drop the target for federal funds by 25 basis points to 2.0% at the end of April proved to be a close call. For several members, the rise in oil prices combined with the rapid surge in food and import prices would put upward pressure on inflation over the next few quarters. Under the circumstances, the committee clearly indicated that no further rate cuts were to be expected in the near future:

> "…several members noted that it was unlikely to be appropriate to ease policy in response to information suggesting that the economy was slowing further or even contracting slightly in the near term, unless economic and financial developments indicated a significant weakening of the economic outlook".

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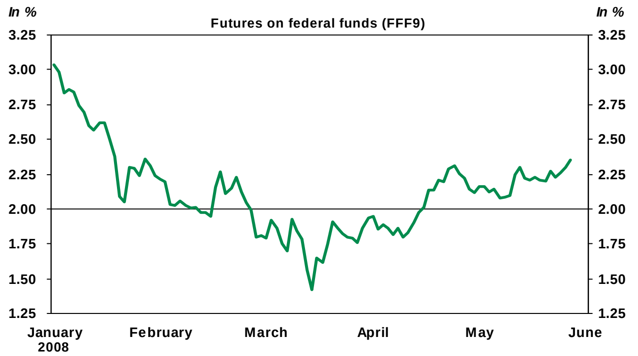
NOTE TO READERS: The letters **k**, **M** and **B** are used in texts and tables to refer to thousands, millions and billions respectively.

Still, we are puzzled by the interest rate increases the market is pricing in (Graph 1). The inflation situation is a concern, but we still think that second-round effects stemming from crude oil price increases will be limited.

Graph 1 – The market expects about one-and-a-half increases by year's end

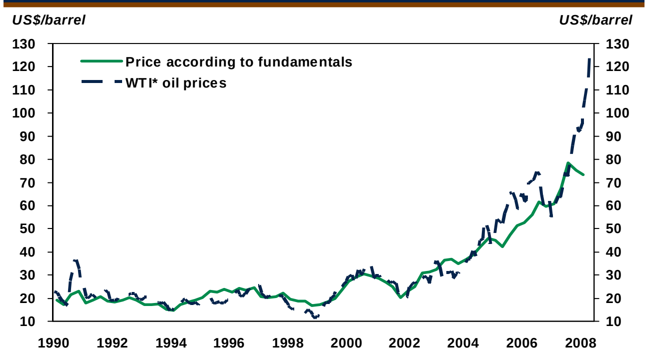


Sources: Bloomberg and Desjardins, Economic Studies

In a study[1] released earlier this week, we showed that the situation will be more deflationary than inflationary. We will not look at the study's conclusions in depth here, but the highlights are as follows:

1) Oil is substantially overvalued. The structural changes underway since the decade began, in terms of growing demand from Asia and gradual disinvestment in exploration, are enough to explain the rising trend that has been in place since 2003. However, supply and demand conditions have not crumbled to the point of driving crude oil prices up 25% in just two months. Our equilibrium model shows that a premium of about US$35, mainly associated with market speculation, is currently factored into prices (Graph 2).

Graph 2 – Oil is well overvalued compared with the evolution of fundamentals

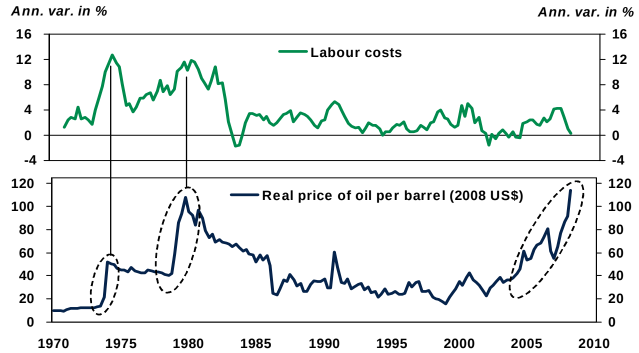


* West Texas Intermediate.
Sources: Datastream and Desjardins, Economic Studies

2) The important thing is the change in price fluctuation. After climbing 57% in 2007, it is unlikely that crude prices will maintain this hot a pace indefinitely (that would put prices at more than US$150 by the end of 2008, at US$237 by the end of 2009, and at US$371 by the end of 2010). As a result, if oil prices crest or, even better, correct, their impact on all-items CPI would be reversed after a year.

3) No pass-through effects are in sight. On a historical basis, non-financial business margins are relatively large, which should allow firms to absorb much of the increase in energy costs. The main difference, however, reflects the labour unions' loss of bargaining power. Unlike the 70s, when the increase in oil prices rippled through to wages, global competition and the productivity gains made since this decade began mean that increases in unit labour costs have remained small (Graph 3).

Graph 3 – Contrary to previous oil shocks, the increase in energy prices has not impacted wages



Sources: Datastream and Desjardins, Economic Studies

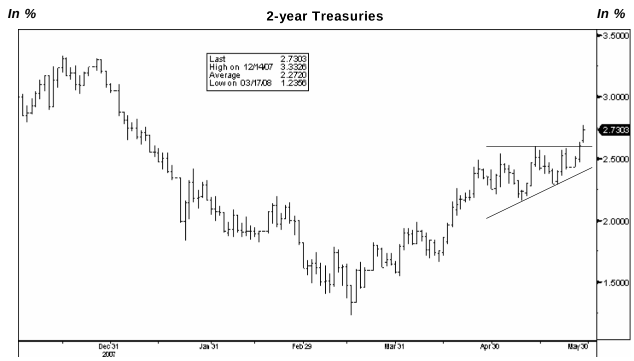
We think oil prices are ripe for a correction. We may not have reached a breaking point, where prices would have a more evident impact on demand, but any additional increase in crude oil prices could only trigger a sharper price correction. A number of Asian countries have dropped price controls, which could also help oil prices to go down.

As a result, the rise in the short end of the curve seems overdone. Technically, the breakout above 2.60% means 2-year rates could remain elevated for a while (Graph 4). We believe, however, that pressure on bond rates is still tilted more to the downside than the upside.

Note that the economic picture remains grim. The Fed has trimmed its growth outlook for 2008, and is even expecting the economy to contract in the first half of the year (Graph 5). The stimulus provided by the Bush administration's fiscal plan (the cheques have started to go out) could be largely

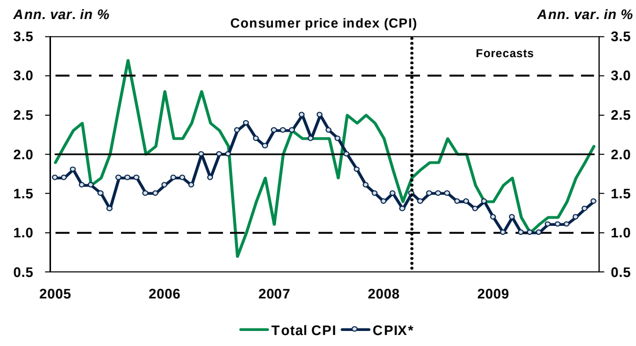
[1] See the *Economic Viewpoint* titled «Should the surge in oil and food prices prompt the U.S. Federal Reserve to target total inflation», May 27, 2008.

Graph 4 – Technically, the trend is still up



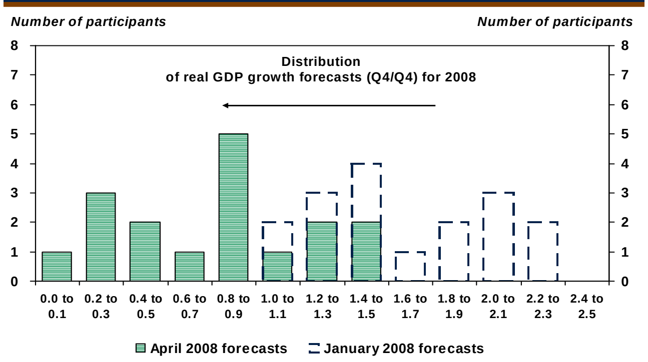
Sources: Bloomberg and Desjardins, Economic Studies

Graph 6 – Underlying inflation will stay contained in Canada



* Index that excludes the eight most volatile components and the effect of changes in indirect taxes.
Sources: Statistics Canada and Desjardins, Economic Studies

Graph 5 – The Fed trims its growth outlook for 2008 again



Sources: Federal Reserve Board and Desjardins, Economic Studies

offset by low consumer confidence and, in particular, the big jump in gas prices.

The housing market is still correcting and any interest rate increase would postpone its recovery. What's more, banks' credit conditions remain tight, and real interest rates will have to remain in negative territory for longer than expected so that financial institutions can regain profitable status.

CANADA IS IN BETTER POSITION… FOR HOW LONG?

In Canada, the inflation situation is much less of a concern. However, April's larger-than-expected increase in the consumer price index drove the year-over-year change from 1.4% to 1.7%, for the first rise in five months. It is likely that, with the latest increase in gas prices, the pressure from energy prices will still be with us in May. That said, we expect the Canadian dollar's strength to continue to offset much of the harm done by rising crude prices and keep inflation in the lower part of the Bank of Canada's (BoC) target range on average until the end of 2009 (Graph 6).

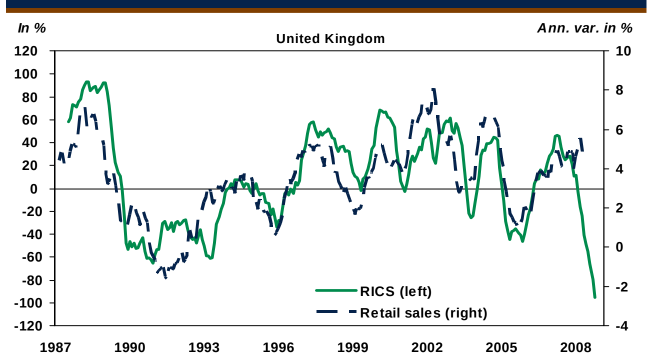
With the Fed unequivocally showing that it plans to stay on the sidelines for the next few months, the gap between expected interest rates in Canada and the United States should narrow. In our opinion, however, the BoC has the leeway it needs to bring its key rate down by another 25 basis points to 2.75% to limit the impact of the U.S. slowdown and tighter credit conditions on Canada's economy.

As a result, the Canadian bond market's solid performance is drawing to an end, but Canada's contained inflation still puts the Canadian market in a better position against the American and European markets. There is not much value in the current situation, which calls for prudence but, at 3.0%, the two-year rate seems too high. With 10-year rates fairly stable, this could mean the curve will steepen slightly in the next few weeks, particularly if oil prices correct.

THE BRITISH MARKET VS. THE EUROLAND MARKET?

The European context offers some great opportunities. At over 5%, 10-year GILTs clearly include a substantial inflation premium. In our view, however, the market has been too quick to discount the risks of a slowdown arising from the ongoing housing market correction. The signs of a slowdown are eloquent. Retail sales have started to decelerate, and the Royal Institute of Chartered Surveyors index, which shows that

Graph 7 – The economic slowdown should deepen



Sources: Royal Institute of Chartered Survey, Datastream and Desjardins, Economic Studies

95% of the market is expecting a housing correction, suggests that the worst is yet to come (Graph 7).

Prudence remains in order. The BoE expects annual inflation to go up more in the next few months. As a result, it should probably not open the door to rate cuts until fall. We still think that the economic slowdown will quickly outweigh inflation risks. The most prudent way to play the British bond market is to bet on it against Euroland's pillars. The ECB is in better relative standing and monetary authorities there are reluctant to lower rates.

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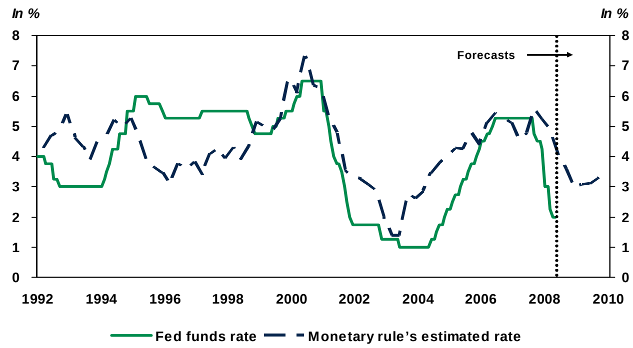
MONETARY POLICY

U.S. Federal Reserve (Fed): The Fed heads for a status quo on the resurgence of inflation expectations

- Although the U.S. economic situation is still very uncertain and the recession risk is far from gone, the Fed seems ready to keep its monetary policy steady, at least in the short run. The fact is, inflation risks are increasingly starting to worry Fed leaders and the financial markets.
- On an annual basis, the total consumer price index (CPI) was up 3.9% in April (the increase at the start of the year was 4.4%). Core inflation is 2.3%. Luckily, core inflation is showing signs of slowing; in April, the change over three months posted its lowest rate since December 2003.
- Fed leaders are in fact more disturbed by the deterioration of inflation expectations than about current inflation figures. Growth by food and energy prices is helping boost the inflation expectations of consumers and financial markets. The Fed sees the possibility of an increase in inflation expectations as a key risk.
- Still in the Fed's view, greater upside risks to inflation now balance the ongoing downside risks to economic growth. It does concede that the sharp tightening of credit conditions is largely offsetting the stimulus provided by its previous key rate cuts.
- According to the minutes of the last Fed meeting (April 29 and 30), the decision to cut key rates by 25 basis points can be characterized as a "close call". What's more, several members noted that "it was unlikely to be appropriate to ease policy in response to information suggesting that the economy was slowing further or even contracting slightly". At this point, therefore, it would take a big shock for the Fed to act again.
- Note, though, that the current inflation risks could dwindle over the next few months. The economy's slowdown, with a drop in pressure on wages and production capacity, should make core inflation decelerate further. However, total inflation will stay higher than initially forecast for 2008. The contrast in the situation will prompt the Fed to opt for a monetary policy status quo throughout 2008. The Fed will keep easing ongoing pressure on the markets by continuing to provide financial institutions with massive amounts of liquidity.

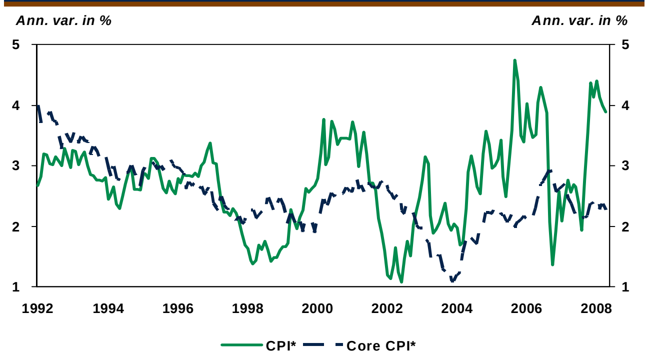
Forecasts: The target for the federal funds rate should stay at 2.00% in 2008. The main alternative is still tilted towards further monetary easing if the economic situation deteriorates more than forecast.

United States – Monetary rule



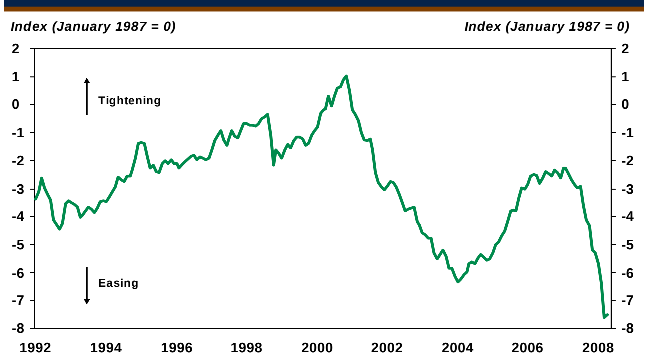
Sources: Datastream and Desjardins, Economic Studies

United States – Inflation rate



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

United States – Monetary conditions index



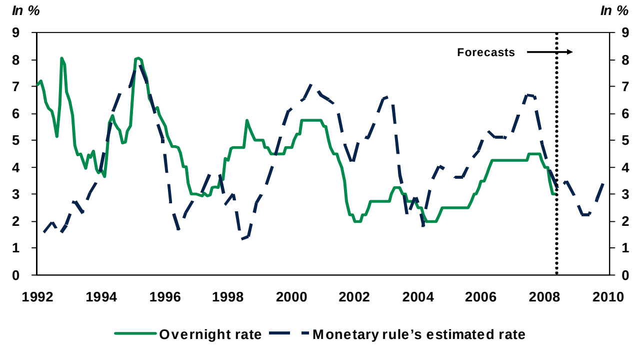
Sources: Datastream and Desjardins, Economic Studies

Bank of Canada (BoC): There is still room for one more rate cut

- The conditions are still there for the BoC to proceed with further monetary easing at its June meeting. After the 50 basis point key rate cut ordered in April, however, the BoC is likely to opt for a smaller decrease.
- The financial situation has improved somewhat with the surge in stock market prices, on one hand, and, on the other, the ebbing of tension in Canada's money market. The risks are still tilted to the downside and it is hard to assess how the banks' tightening of credit conditions will impact consumer spending. According to Bank of Canada Governor Mark Carney, "The market turbulence that began last summer has eased in recent weeks. That progress […] has prompted some to muse about whether we are in the seventh, eighth, or ninth inning. […] I would note that baseball games frequently go into extra innings."
- The economic outlook also remains grim. The U.S. slowdown and lively loonie are still reining in growth by exports. Consumer spending is still ascending but at a much slower pace than at the end of 2007. Consequently, real GDP growth contracted by 0.3% in the first quarter. Moreover, the jump in gas prices could slowdown growth by other goods and services until the summer.
- The main difference between Canada and the other industrialized economies is that the Canadian inflation situation is giving the BoC all the leeway it needs to cut its key rate to limit the downside risks to growth. All-items inflation picked up in April but, at 1.7%, it is still in the lower part of the BoC's target range. In the short run, rising oil prices should keep upward pressure on the all-items index, but the damage will largely be offset by competitive pressures stemming from the strong loonie.

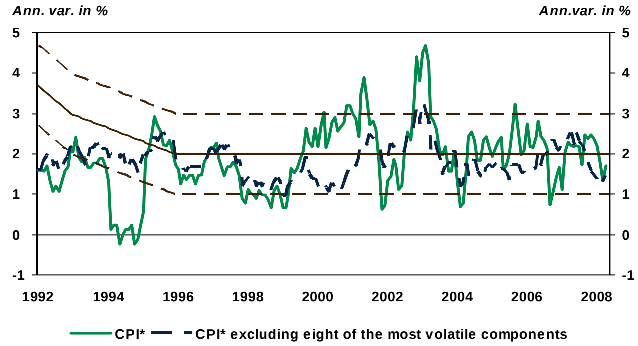
Forecasts: With the Fed signalling a pause in its monetary easing cycle, there is no more need for further aggressive cuts to Canada's monetary policy. In our view, the situation still favours another 25 basis point cut to 2.75% at the June 10 meeting. After that, the most likely avenue is an extended status quo.

Canada – Monetary rule



Sources: Datastream and Desjardins, Economic Studies

Canada – Inflation rate



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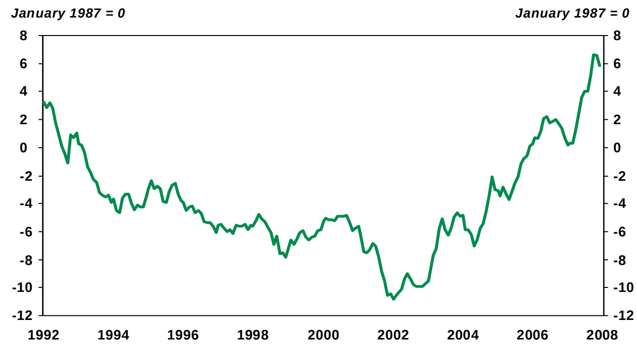
Canada – Monetary conditions index



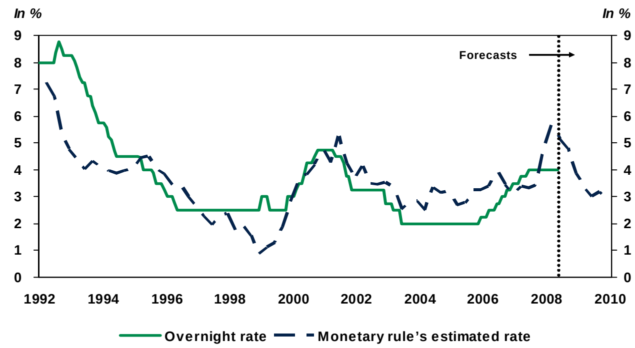
Sources: Bank of Canada and Desjardins, Economic Studies

European Central Bank (ECB): Inflation is still the main concern

- To no one's surprise, the ECB kept its key rate at 4.00% in May and did not open the door to monetary easing an inch. The most hawkish leaders, especially Bundesbank President Axel Weber, even seem to want to bring back the option of a rate increase to contain inflation pressure. However, most ECB Council members seem very comfortable with where the key rate is now.
- Although inflation moderated slightly, going from 3.6% in March to 3.3% in April, inflation pressure is still very strong in the euro zone. The surge by international food and energy prices should keep the inflation rate well above the ECB's 2% target in the coming months. Core inflation, which excludes, energy, food, alcohol and tobacco, is much more moderate, at 1.6% in April, but this does not provide much comfort to Euroland's monetary authorities. The rapid increase in producer prices is an additional source of anxiety for the ECB.
- Economic growth, which was stronger than forecast in Q1 of 2008, shored up the ECB's position that Euroland's economy is on a solid footing and should not undergo a sharp slowdown. The euro zone's real GDP advanced by a surprising 0.7% (not seasonally adjusted), on strong growth in Germany. The economic environment is, however, still much tougher in the rest of the zone, especially Spain, which is seeing a real estate market correction, and in Italy, where economic activity has been stagnating for several quarters.
- Overall, the economic outlook for the euro zone remains fairly dim, and the slowdown should become increasingly evident in the next few months. Europe's banks continue to tighten access to credit and consumer and business confidence is sliding. Moreover, activity indexes have been almost stagnant in both the services sector and manufacturing. The ECB acknowledges that the outlook for Euroland's economy is overshadowed by substantial uncertainty, with the risks of a bigger-than-forecast slowdown dominating.

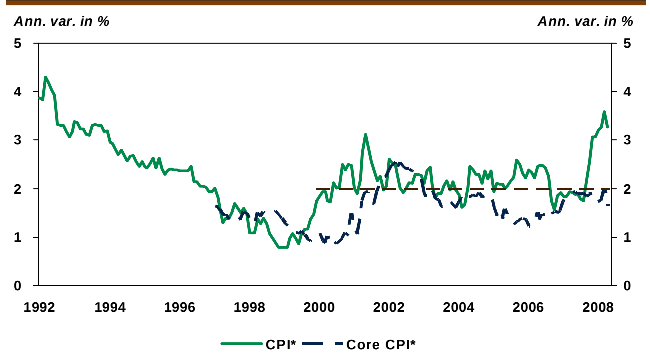
Forecasts: Given the persistence of inflation pressures and a tough economic environment, the key rate should stay at 4.00% in the euro zone for a few more months. The ECB will wait for concrete signs that inflation is moderating or that the economy is undergoing a substantial slowdown before it opens the door to monetary easing. In our opinion, the ECB could start to lower its key rate in Q4 of 2008, at the earliest.

Euro zone – Monetary rule



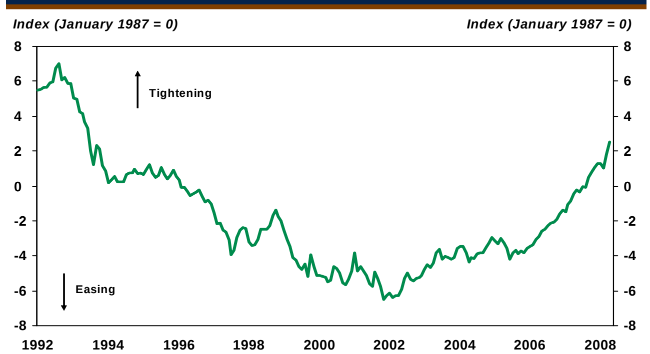
Sources: Datastream and Desjardins, Economic Studies

Euro zone – Inflation rate



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

Euro zone – Monetary conditions index



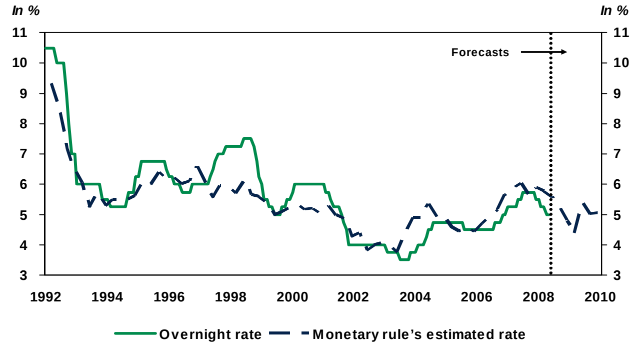
Sources: Datastream and Desjardins, Economic Studies

Bank of England (BoE): Inflation picks up speed, pushing rate cuts back

- After a 25 basis point cut in April (the third since December of 2007), the BoE kept its key rate steady at 5.00% in May. The pause was expected, but intensified inflation pressure could now keep BoE leaders' hands tied for several months.
- April's statistics on consumer prices showed that the annual inflation rate had jumped 0.5 percentage points to 3.0%. As in the rest of Europe, the surge by food and energy prices is what is mainly swelling British inflation, while the core index is showing moderate growth. Because of the increase, which is much faster than forecast, inflation is now 1% over the BoE's target, putting it at the threshold. Over that, BoE Governor Mervyn King must send a letter of explanation to Britain's Chancellor.
- May's Inflation Report also showed that British monetary authorities are now anticipating a much sharper, and more sustained increase in inflation by the end of 2008. Although the BoE only strives to control inflation over the medium range, it cannot ignore the risk that the current price surge will swell inflation expectations over the long run. The BoE notes that several indexes of inflation expectations have already been rising for several months.
- The push by inflation is coming at a very bad time, as Britain's economy could benefit greatly from easier monetary conditions. The slowdown by economic activity, already evident in the first quarter, promises to intensify, with the latest statistics showing monthly drops in industrial production and retail sales. The real estate market's slide seems more and more pronounced, which does not augur well for consumption, particularly as consumer confidence is at a 18-year low. In this context, there is nothing to say that the prudent key rate cuts over the last few months will be enough to keep the British economy from falling into a recession.

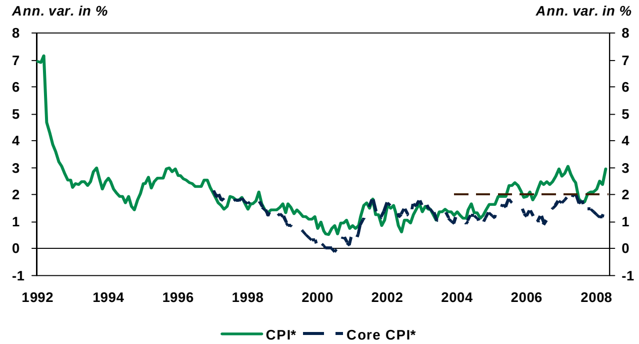
Forecasts: The BoE is well aware of the problems with the British economy, but it will have to put rate cuts on hold for several months to maintain its credibility as a guardian of price stability. The magnitude of the economic slowdown should convince it to return to monetary easing as of the fall, however.

United Kingdom – Monetary rule



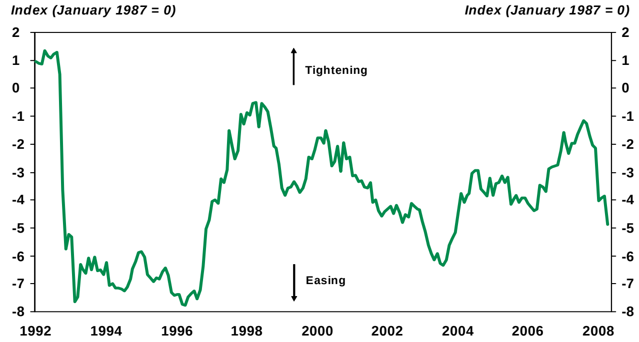
Sources: Datastream and Desjardins, Economic Studies

United Kingdom – Inflation rate



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

United Kingdom – Monetary conditions index



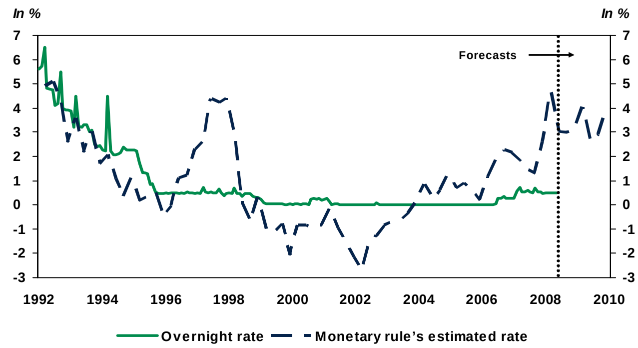
Sources: Datastream and Desjardins, Economic Studies

Bank of Japan (BoJ): Less of a hurry to tighten its monetary policy

- As expected, the BoJ kept its key rate steady at its May 19 monetary policy meeting. Note that the central bank had softened its tone on interest rate increases at its last semi-annual publication on the outlook for the economy and prices, on April 30. The inflation rate seems to have settled more comfortably into positive territory, but the economic outlook, arising from such things as the U.S. economic slowdown and high commodities prices, is still a concern.
- The inflation rate in Japan slowed from 1.2% in March to 0.8% in April, as a gasoline tax expired. However, the tax was reinstated in May, which suggest inflation could soar during the month. If we exclude the fresh food and energy prices, the inflation rate fell back to -0.1%. The bulk of inflation therefore comes from factors that have nothing to do with Japan's domestic economy. However, the job market is tight and wages are rising, which should eventually lead to more sustained inflation.
- Real GDP growth was surprisingly strong in Q1 of 2008. It was an annual 3.3%, while the consensus had been expecting it to be 2.4%. Net exports continued to grow and consumption shot up, buoyed by the increase in household income. Investment also made a positive contribution to Q1's economic performance against the backdrop of a rebound by housing from the final quarter of 2007. Upcoming economic figures from Japan could be less stellar, however. The economic slowdown in the United States should translate into softening Japanese foreign trade. The situation could get worse if the world economy ends up feeling the after-effects of the U.S. economy's problems. The latest increase in energy prices could also put the brakes on Japan's economy. As Japanese Finance Minister Fukushiro Nukaga said on May 23, "higher oil prices may affect corporate profits and consumer spending."
- The monetary conditions index eased slightly in April on the yen's weakness; the yen is being hit by investors' renewed appetite for risk. Still, the yen would have to depreciate further to give the BoJ more breathing room.

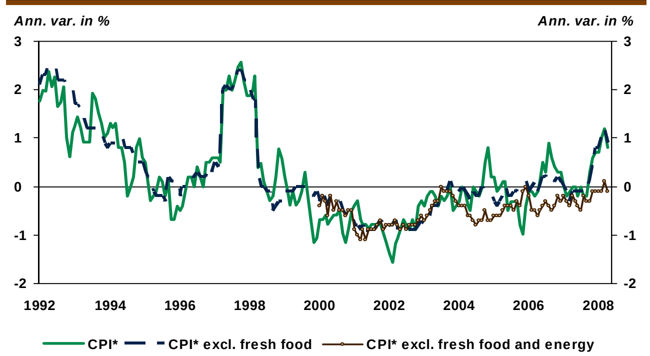
Forecasts: Japan's economy could be hurt by the U.S. slowdown and the increase in oil and commodities prices. Cost inflation is not the BoJ's ideal scenario; the status quo should extend until the end of 2008.

Japan – Monetary rule



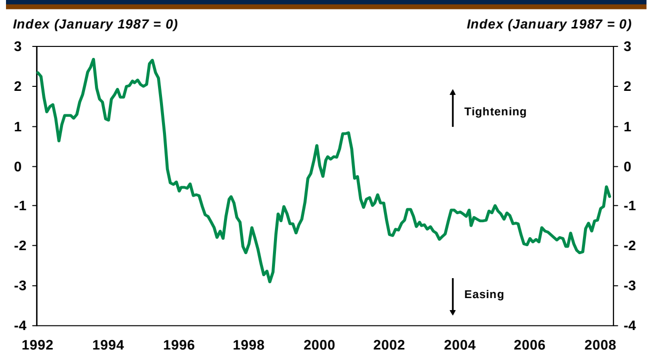
Sources: Datastream and Desjardins, Economic Studies

Japan – Inflation rate



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

Japan – Monetary conditions index



Sources: Datastream and Desjardins, Economic Studies

Table 1
Key interest rates

End of period in %	2007 Q1	2007 Q2	2007 Q3	2007 Q4	2008 Q1	2008 Q2f	2008 Q3f	2008 Q4f	2009 Q1f	2009 Q2f	2009 Q3f	2009 Q4f
United States												
Federal funds	5.25	5.25	4.75	4.25	2.25	2.00	2.00	2.00	2.00	2.00	2.75	3.50
Canada												
Overnight funds	4.25	4.25	4.50	4.25	3.50	2.75	2.75	2.75	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	5.00	5.00	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
March 2008			
5	Reserve Bank of New Zealand	*s.q.*	8.25
5	Bank of Brazil	*s.q.*	11.25
6	Bank of England	*s.q.*	5.25
6	European Central Bank	*s.q.*	4.00
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	Bank of England	-25 b.p.	5.00
10	European Central Bank	*s.q.*	4.00
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
May 2008			
6	Reserve Bank of Australia	*s.q.*	7.25
8	Bank of England	*s.q.*	5.00
8	European Central Bank	*s.q.*	4.00
16	Bank of Mexico	*s.q.*	7.50
19	Bank of Japan	*s.q.*	0.50
28	Bank of Norway	*s.q.*	5.50

s.q.: status quo; b.p. : basis points
Source: Desjardins, Economic Studies

Table 3
Coming soon

Date	Central Bank
June 2008	
3	Reserve Bank of Australia
4	Reserve Bank of New Zealand
4	Bank of Brazil
5	Bank of England
5	European Central Bank
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
5	U.S. Federal Reserve
7	Bank of England
13	Bank of Norway
15	Bank of Mexico
18	Bank of Japan

Source: Desjardins, Economic Studies

TECHNICAL ANALYSIS

CANADIAN 2-YEAR TO 10-YEAR CURVE: (60 BASIS POINTS)

After hitting 110 basis points, the Canadian 2/10 yield curve fell back on the support of the rising trend line initiated last August. If this level gives way, the Canadian bond curve could temporarily correct toward 40 basis points.

INFLATION EXPECTATIONS ON THE U.S. 10-YEAR TERM

With oil's recent surge, the yield differential between U.S. nominal bonds and real return bonds returned to the 250 to 255 basis point zone, confirming the markets' inflation concerns. However, just one breakout to 275 basis points should confirm that the markets' inflation expectations are slipping.

Martin Laforest
Trésorie du Mouvement Desjardins

FIXED INCOME MARKET

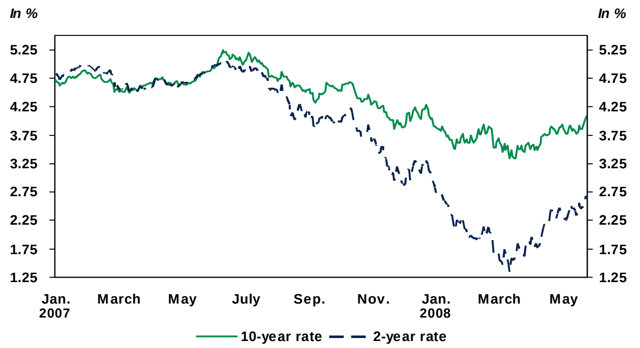
United States: Federal bonds

U.S. FEDERAL BONDS

- The rising trend that has characterized the U.S. bond market since mid-March has stabilized in the last few weeks. The situation is still marked by the economic slowdown, on one hand, and, on the other, by soaring energy prices and the risks that they will pass through to underlying inflation. In the minutes of the last FOMC meeting, the Fed stated its concerns about the risks that inflation expectations will become unmoored. Thus, despite a likely contraction by the U.S. economy, the markets have bet that the Fed's next policy move would be a rate increase.
- After rising from their March 17 low of 1.23% to over 2.50% in early May, two-year rates have oscillated within the 2.15% to 2.75% range. With inflation expectations contained, high oil prices and expectations of Fed rate increases had a more mixed impact on ten-year rates, which went up by about 70 basis points over the same period.
- Inflation fears could continue to put upside pressure on bond rates over the short term. However, this situation should be temporary. With a lot of bad news still to come in the next few weeks, the economic and financial situation remains deflationary, overall. In our opinion, real GDP will probably contract in Q2, and job losses will continue until the fall.
- Recently, the Fed showed unequivocally that it did not intend to lower its key rate further, unless the economic and financial situation deteriorated substantially. We still believe that, over the next few months, the Fed's fight against inflation will be restricted to hardening its stance. Because of this, the rate hikes the market has priced in will probably be unwound.

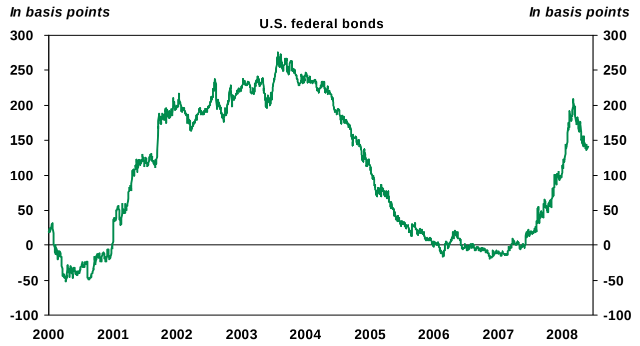
Forecasts: With the Fed on the sidelines, the likelihood that two-year rates will drop abruptly seems illusory. At 2.75%, however, the short end of the curve still has some potential. In our view, the economic and financial situation is still deflationary, and the rate hikes the market has priced in should be unwound soon. We therefore continue to lean toward a slight steepening of the slope on a decrease in the short end of the U.S. yield curve. Ten-year rates should consolidate in a tight range, around 4.0%.

United States – Federal bonds



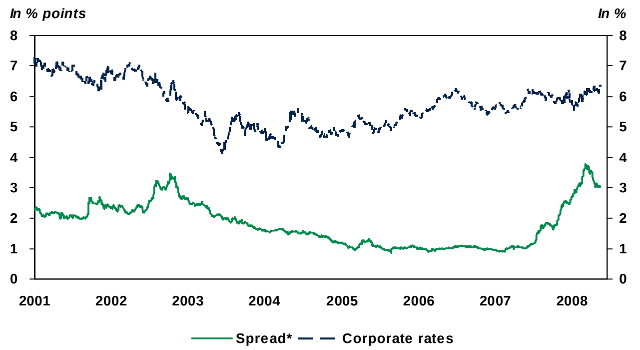
Sources: Datastream and Desjardins, Economic Studies

United States – Slope between the 10 and 2 years maturities



Sources: Datastream and Desjardins, Economic Studies

United States – Corporate bonds



* 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 ascend in the last few weeks, especially in the short end of the curve. Intensified inflation pressure worldwide and clear signs that the U.S. Federal Reserve is done with monetary easing made the markets expect fewer key rate cuts in Canada.
- Canadian two-year federal bonds have thus climbed about 20 basis points since the end of April, going above 3.00%. The ten-year rate's increase was much smaller (under 10 basis points), as this rate is much less affected by changes in monetary policy expectations and, although it ticked up in April, Canadian inflation is well under control. The Canadian 2/10 slope continued to retreat and is now at just 60 basis points.
- The spreads between Canadian and American rates behaved differently over the last few weeks, depending on the terms. The change in expectations as to action by the Bank of Canada made the spread between Canadian and American two-year rates go up by just over 10 points. Conversely, as inflation pressure intensified more south of the border, the ten-year rate went up more sharply in the United States than Canada. Contrary to what we saw in April, the Canadian 2/10 slope flattened more than the U.S. slope in May.
- Although the strain on the financial markets has eased and the Canadian stock market is recording excellent performance, credit spreads have not narrowed much for now in Canada. The bond indexes show that the spread between corporate and federal bonds has only closed by 15 basis points from its cyclical peak, and is still twice as large as it was before the crisis broke out in July of 2007.

Forecast: In our view, the short end of the Canadian curve is still appealing due to the economic slowdown and relatively limited inflation pressure in Canada. To capitalize on the situation while limiting the impact of inflation accelerating more quickly than forecast, we recommend betting on an increase in the Canadian 2/10 slope.

Canada – Federal bonds

Sources: Datastream and Desjardins, Economic Studies

Canada – Slope between the 10 and 2 years maturities

Sources: Datastream and Desjardins, Economic Studies

Canada – Spread with the U.S. federal bond

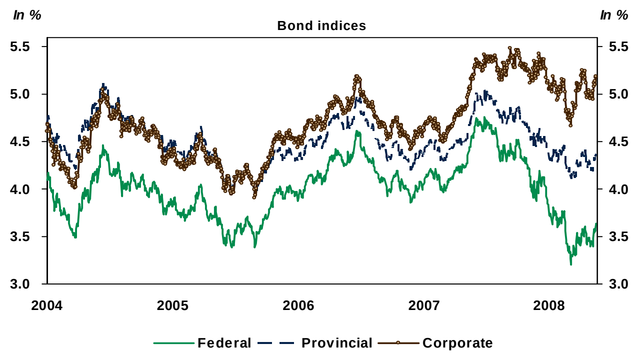
Sources: Datastream and Desjardins, Economic Studies

PROVINCIAL BONDS

- Provincial bond rates edged slightly closer to rates on federal securities in the last few weeks. As with corporate bonds, the spreads are still fairly wide in comparison with historical averages. The improvement is especially striking with Québec 10-year bonds: the rate is now very close to the rate on Ontario's securities.
- In addition to struggling with problems with foreign trade, the Québec and Ontario economies now have to deal with a drop in consumer confidence, which has been shaken by soaring gas prices. In both provinces, the domestic economy's strength can no longer be taken for granted; there is a very real risk that consumer spending will run out of steam. Despite some disappointing employment figures, the situation is not as precarious in Québec as in Ontario, where the problems in the automotive industry are still doing a lot of damage.
- The latest data on the provinces' real GDP showed that regional disparities had plummeted in 2007. Western Canada still recorded growth above the national average, but the gap was much smaller than in previous years.

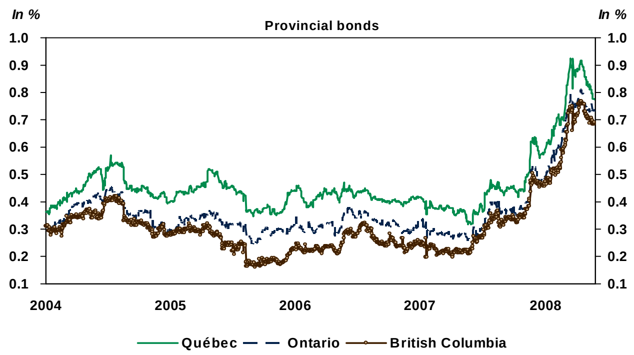
Forecast: Rate spreads between provincial and federal securities should, over the next few months, continue to narrow gradually. Now that the Ontario economy's problems are well known, the relative underperformance by its securities could come to an end. It would now be tempting to look for the spread between Québec and Ontario rates to widen.

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

	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	34.9	AAA	Aaa
Newfoundland	154	1,377	4.7	35.0	A	Aa2
Prince Edward Island	24	-37	-0.8	37.6	A	Aa2
Nova Scotia	-336	-317	-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	329	0.7	30.4	AA	Aa1
Saskatchewan	398	693	1.4	26.5	AA	Aa1
Alberta	8,510	4,031	1.6	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 Q1	2007 Q2	2007 Q3	2007 Q4	2008 Q1	2008 Q2f	2008 Q3f	2008 Q4f	2009 Q1f	2009 Q2f	2009 Q3f	2009 Q4f
Key rate												
Federal funds	5.25	5.25	4.75	4.25	2.25	2.00	2.00	2.00	2.00	2.00	2.75	3.50
Treasury bills												
3-month	5.04	4.82	3.82	3.36	1.38	1.95	2.10	2.00	2.05	2.15	2.90	3.60
Federal bonds												
2-year	4.58	4.87	3.96	3.07	1.62	2.25	2.40	2.00	2.90	3.30	3.80	4.20
5-year	4.54	4.93	4.23	3.46	2.47	3.10	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	3.80	4.10	4.20	4.40	4.70
30-year	4.85	5.13	4.83	4.45	4.30	4.55	4.65	4.60	4.65	4.70	4.80	4.90
Yield curve												
5-year - 3-month	-0.50	0.11	0.41	0.10	1.09	1.15	1.00	0.90	1.45	1.65	1.20	1.00
10-year - 2-year	0.07	0.16	0.62	0.96	1.81	1.55	1.55	1.80	1.20	0.90	0.60	0.50
30-year - 3-month	-0.19	0.31	1.01	1.09	2.92	2.60	2.55	2.60	2.60	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 Q1	2007 Q2	2007 Q3	2007 Q4	2008 Q1	2008 Q2f	2008 Q3f	2008 Q4f	2009 Q1f	2009 Q2f	2009 Q3f	2009 Q4f
Key rate												
Overnight funds	4.25	4.25	4.50	4.25	3.50	2.75	2.75	2.75	2.75	3.25	3.50	4.00
Treasury bills												
3-month	4.18	4.43	3.98	3.83	1.88	2.80	2.85	2.80	2.90	3.55	3.75	4.15
Federal bonds												
2-year	3.98	4.58	4.08	3.74	2.63	3.00	3.10	2.70	3.10	3.80	4.00	4.35
5-year	4.01	4.56	4.21	3.87	2.91	3.20	3.30	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	3.65	4.05	4.15	4.40	4.70
30-year	4.20	4.49	4.45	4.10	3.94	4.10	4.30	4.35	4.45	4.55	4.65	4.80
Yield curve												
5-year - 3-month	-0.17	0.13	0.23	0.04	1.03	0.40	0.45	0.05	0.55	0.45	0.45	0.35
10-year - 2-year	0.13	-0.03	0.26	0.25	0.80	0.60	0.80	0.95	0.95	0.35	0.40	0.35
30-year - 3-month	0.02	0.06	0.47	0.27	2.06	1.30	1.45	1.55	1.55	1.00	0.90	0.65
Spreads (Canada - U.S.)												
3-month	-0.86	-0.39	0.16	0.47	0.50	0.85	0.75	0.80	0.85	1.40	0.85	0.55
2-year	-0.60	-0.29	0.12	0.67	1.01	0.75	0.70	0.70	0.20	0.50	0.20	0.15
5-year	-0.53	-0.37	-0.02	0.41	0.44	0.10	0.20	-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	-0.45	-0.35	-0.25	-0.20	-0.15	-0.15	-0.10

f: forecasts
Sources: Datastream and Desjardins, Economic Studies