

# The Yield Curve

August 28, 2008

## Will the easing of inflationary pressures start a new cycle of rate decreases?

### HIGHLIGHTS

- Federal Reserve stays the course: status quo is still the way to go.
- A combination of weak growth and inflation places the Bank of Canada in an uncomfortable position.
- No decoupling in euro zone: will the European Central Bank be obliged to take hold of the economic slowdown?
- Bank of England: when is the next rate cut?
- Japanese economy continues to slide: no rate hike before mid-2009.

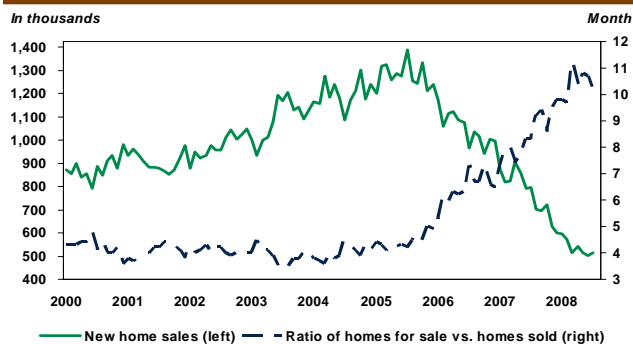
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### Summary

Despite widespread rumours that the U.S. is about to nationalize the country's two top mortgage lenders, the economic and financial situation has not improved. A slowing global economy has caused rampant market volatility and banks are continuing to rack up losses from the slumping housing sector. Although the resale market appears to have stabilized, inventories of unsold homes are still very high, signalling that prices have not yet bottomed out (graph 1). A weakening labour market, tighter lending conditions and high interest rates mean that even financially solid households are now at greater risk of defaulting. Consumer confidence has been sapped and while lower oil prices have provided some relief, the fact that a barrel of crude still costs more than US\$100 continues to take its toll.

**Graph 1 – Existing house sales are stabilizing, but inventories of unsold homes remain high pointing to further prices decreases**



Sources: Census Bureau and Desjardins, Economic Studies

### FEDERAL RESERVE STAYS THE COURSE

Faced with evidence of stagflation, i.e. a combination of high inflation and slow economic growth, the Federal Reserve's (Fed) response has been extremely complex. Headline inflation, which rose to 5.6% in July, is a concern. However, the one-off effects associated with the increase in energy

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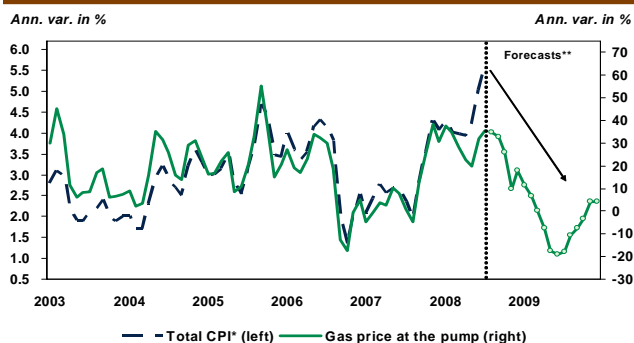
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prices call for extreme caution and are not expected to translate into imminent rate hikes. The impact of lower oil prices will not be fully felt until sometime in the fall (graph 2) but already points to inflation levelling off.

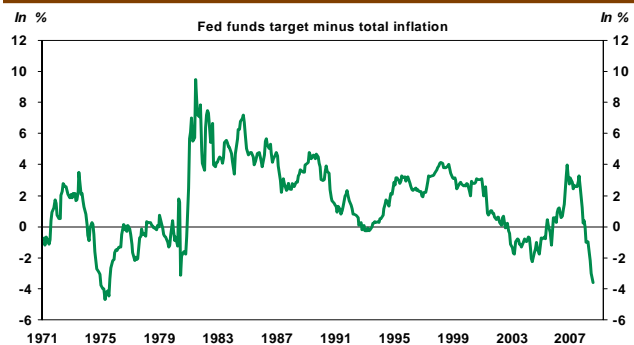
**Graph 2 – The effects of energy prices on inflation should soon start to reverse**



\* Consumer price index; \*\* Forecast following our oil scenario.  
Sources: Bureau of Labor Statistics, Energy Information Administration and Desjardins, Economic Studies

That said, the Fed is not expected to ease monetary policy. Real interest rates are already at a historical low and slashing them further could set the stage for a serious inflation problem later next year (graph 3).

**Graph 3 – Real interest rates are near historical lows**

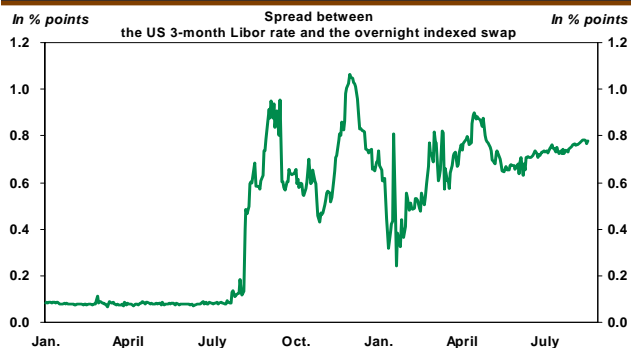


Sources: Bloomberg and Desjardins, Economic Studies

The fact is that despite the rate cuts announced since September 2007 (a total of 325 basis points to date), credit conditions remain very tight (graph 4) and more cuts would only be a band-aid solution to a much deeper problem, namely, the need for banks to clean up their balance sheets.

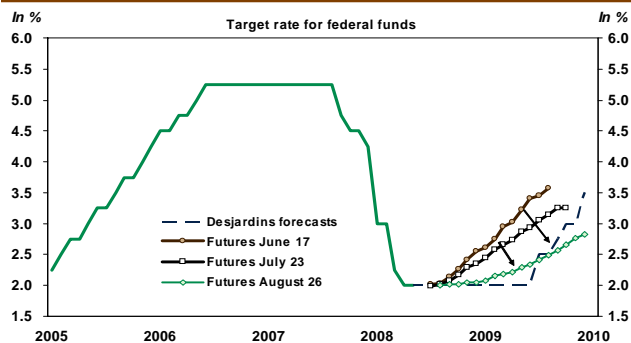
Consequently, we still believe that the Fed will hold the federal funds rate at 2.0% until mid-2009 (graph 5). After being spooked by inflationary fears due to surging oil prices in the spring, the markets have downgraded their rate hike expectations. That said, the economic situation, characterized by a deteriorating labour market, is not yet conducive to monetary tightening (graph 6).

**Graph 4 – The monetary market remains tensed**



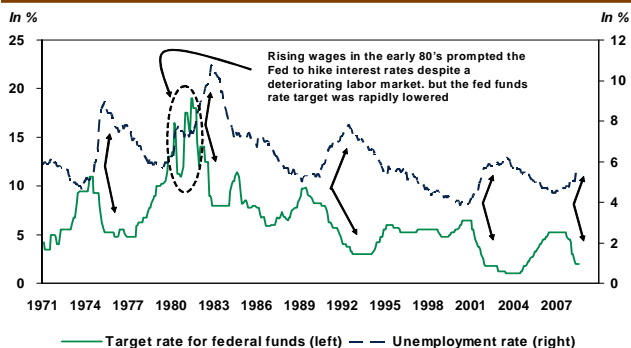
Sources: Bloomberg and Desjardins, Economic Studies

**Graph 5 – Markets have revised rate hike expectations downward some more**



Sources: Federal Reserve and Desjardins, Economic Studies

**Graph 6 – U.S. monetary tightening in periods of labor market deterioration are rare occurrence**

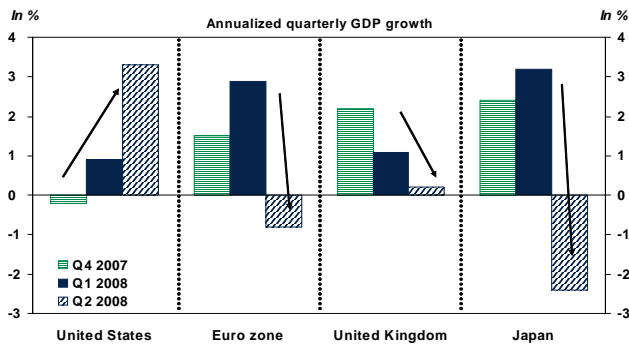


Sources: Datastream and Desjardins, Economic Studies

**NO DECOUPLING IN EURO ZONE: SLOWDOWN HITS 6 MONTHS LATER**

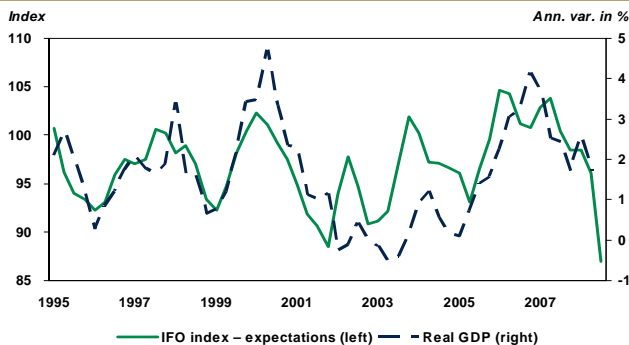
Everyone now agrees that the effects of the sub-prime mortgage crisis and the U.S. economic slowdown have spread to all the industrialized nations (graph 7). As such, the theory of global decoupling is finding fewer takers. The euro zone is showing growing signs of an economic slowdown. After real

**Graph 7 – Recession risks in the United States?**



Sources: Datastream and Desjardins, Economic Studies

**Graph 8 – The IFO index drop in July and in August points to a net economic slowdown in Germany**



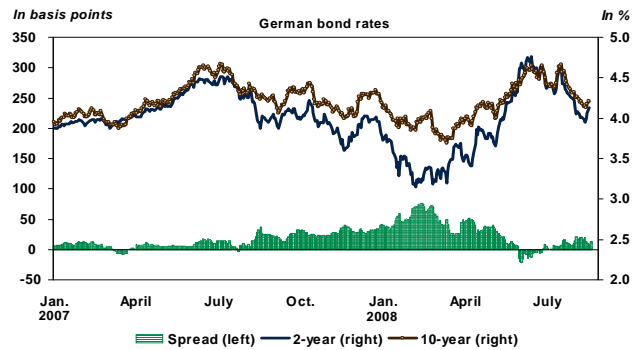
Sources: Datastream and Desjardins, Economic Studies

GDP fell in the second quarter, the drop in the German IFO index in July and August signals a possibility of recession in Germany (graph 8).

The European Central Bank's (ECB) notorious dogmatism as regards its mandate to foster price stability will be sorely tested by year-end. We are already hard pressed to explain why in July, right in the middle of a crisis, it felt the compunction to hike rates by a quarter point to 4.25% to counter the effect of rising energy prices on inflation when in fact, it has no control over world oil prices.

After surging in the first half of the year, the markets recently reacted by pushing down the two-year Schatz yield by almost 75 basis points. However, it is still too early to hope for the curve to sharpen. With the drop in energy prices, the ECB's July hike should be the last, but the bank remains focused on fighting high inflation (graph 9). Therefore, despite tough economic times, the ECB is not likely to cut rates before the end of fall.

**Graph 9 – Still too soon to expect a steepening of the euro zone yield curve**

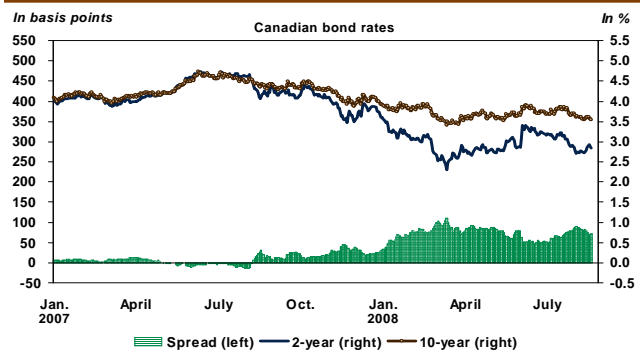


Sources: Datastream and Desjardins, Economic Studies

**CANADA: STATUS QUO MOST LIKELY THE ROUTE**

In this country, the fixed-income securities market has been extremely volatile. Mirroring other industrialized nations, two-year bond yields went up early in the summer as a result of inflationary fears sparked by rising energy prices. The Bank of Canada (BoC) then sharpened the upward movement by not trimming rates in June. However, interest rate expectations were quickly revised downward (graph 10).

**Graph 10 – The Canadian bond market is of low value with 2-year rates below the overnight rate**

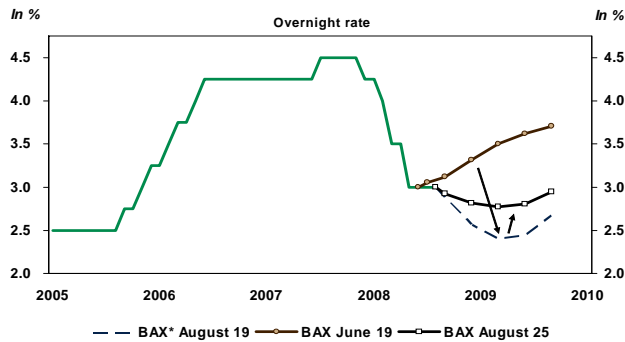


Sources: Datastream and Desjardins, Economic Studies

Characterized by a shaky global economy, softer demand for commodities, lower oil prices and a marked deterioration on the labour front, market observers are banking on the possibility of one or two rate cuts between now and early next year (graph 11).

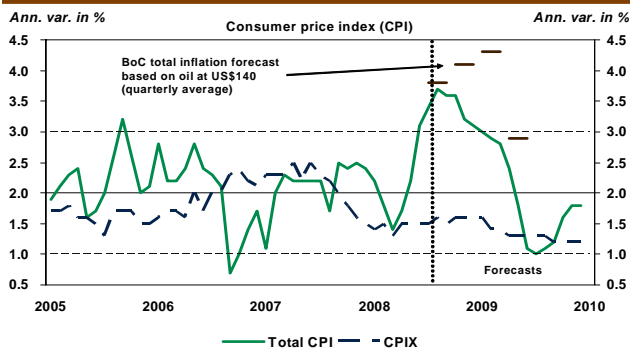
However, despite the fact that risks are tilted to the downside, we think the most likely course of action will be to maintain the status quo. Of course, the BoC's latest forecast (July 2008) was too optimistic on growth and too pessimistic on inflation, but the presence of both upside and downside risks mean that we're in for a period of monetary stability. On the one

**Graph 11 – Volatility is excessive on the Canadian monetary market**



\* Futures on banker's acceptance (adjusted for premia).  
Sources: Bloomberg and Desjardins, Economic Studies

**Graph 12 – Inflation will remain above the BoC upper target**



Sources: Statistics Canada and Desjardins, Economic Studies

hand, while the rainy summer did nothing to help the economy, it should still be able to avoid a serious slump. On the other, while the BoC is no doubt pleased with the impact the drop in oil prices has had on the total consumer price index, inflation is expected to remain above its upper target until early 2009 (graph 12).

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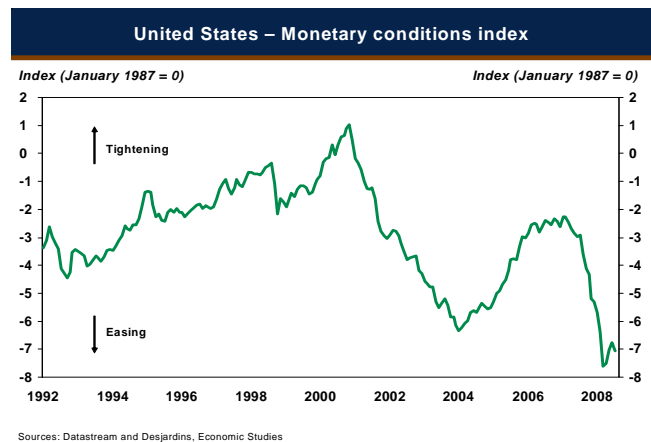
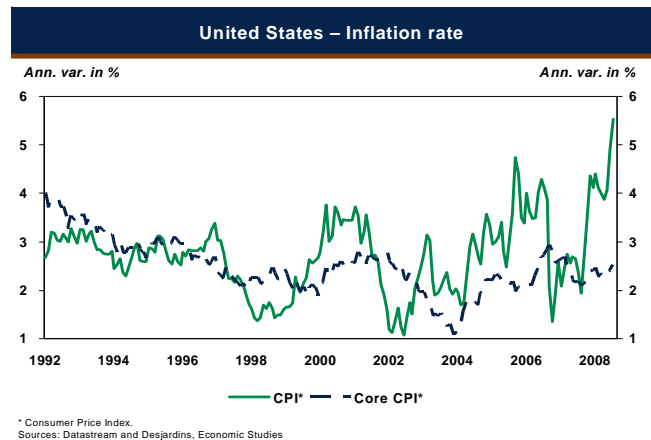
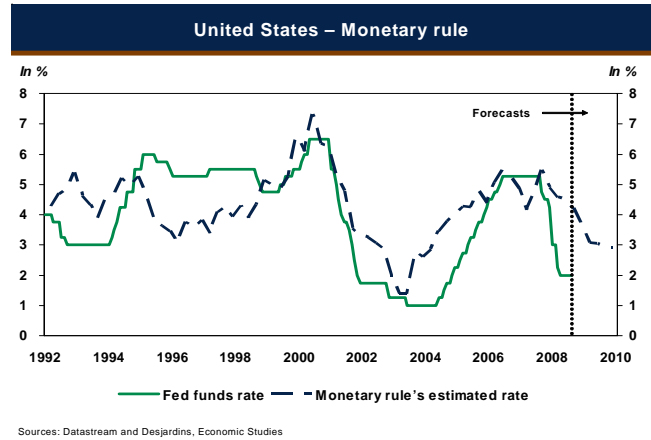
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# FEDERAL RESERVE

## Status quo is still the way to go

- The Federal Reserve (Fed) held its rates steady at its August policy meeting. As in previous occasions, Committee members remained concerned with inflationary pressures. In fact, one member again invoked this reason to vote in favour of a rate hike. However, economic uncertainty convinced the other participants to opt for the status quo.
- Although the economy held up fairly well in the second quarter (GDP rose an annualized 3.3%), several factors are still worrisome. First, household spending could fizzle now that the tax rebate cash is running out. Second, going forward, the contribution of exports to real GDP growth could be far less spectacular than it was in the spring. Third, credit conditions are still extremely tight according to the Fed's most recent survey. And lastly, signs of a stabilizing housing market are still too weak to conclude that the correction is over.
- Credit markets continue to struggle and the spreads between many borrowing rates and government bond rates remain quite high. Banks continue to rack up losses. According to the Federal Deposit Insurance Corporation, the number of banks in trouble rose from 90 at the end of March to 117 at the end of June.
- Up 0.8% in July, the consumer price index (CPI) once again spiked, bringing the annualized increase to 5.6%, the highest since January 1991. Even core inflation picked up in July, to 2.5%, the same worrisome level reached in early 2007.
- However, the good news is that some commodity prices fell, beginning with oil. Gas prices dropped nearly 10% in mid-July, pushing up the consumer confidence indexes slightly and lowering inflation expectations. As a result of the drop in energy prices, headline inflation should soon ease. And the CPI may fall in August for the first time since October 2006.
- The markets are increasingly confident that U.S. policymakers will not raise rates at their next meetings. Despite lower oil prices, the Fed is still caught between an unstable economy and an uncomfortable level of inflation. The minutes of its last meeting show that Committee members felt that the next policy move would likely be a tightening.

**Forecasts:** U.S. interest rates should stay put in 2008. The Fed will keep a slightly tighter bias towards battling inflation, but the credit market's woes and lower oil prices will prompt it to hold steady. We do not expect monetary tightening before the middle of next year.

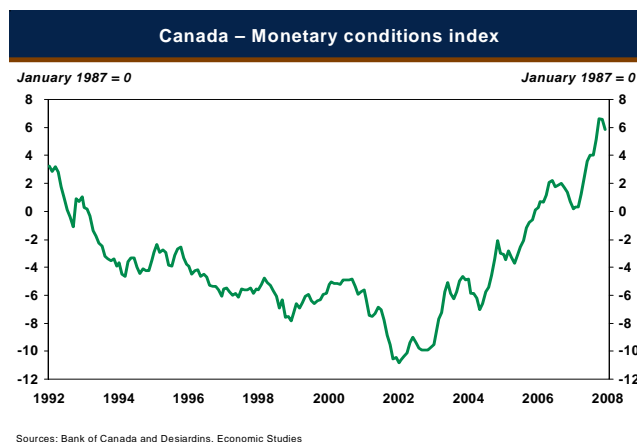
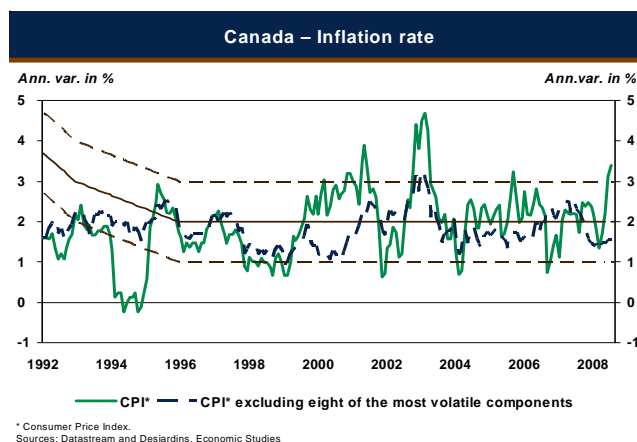
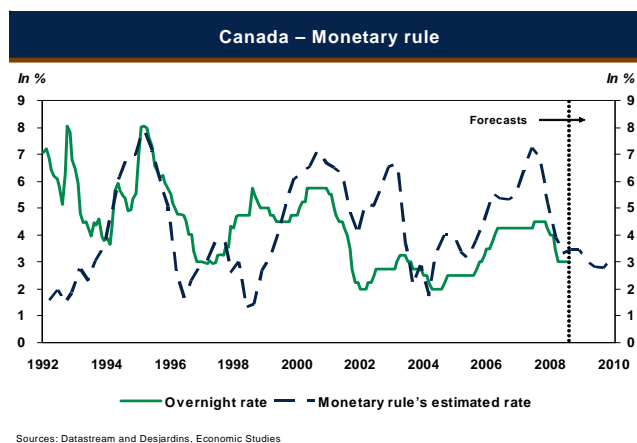


# BANK OF CANADA

## A combination of weak growth and inflation places the Bank in an uncomfortable position

- Recent events justified the central bank's decision to leave the key rate unchanged at 3.0% in July. After inflationary fears sparked by surging energy prices in the first half of the year, the correction in the price of crude and deteriorating growth prospects showed that a hike would have been inappropriate. Although the risks are now tilted more to the downside, the Bank of Canada (BoC) must manage its monetary policy carefully in the months ahead.
- Core inflation remains contained and should stay below the BoC's median target (2%) due to a struggling economy and to the emergence of a negative gap between output and potential. However, the impact of the drop in oil prices on consumer prices will not be fully felt until the fall. Consequently, headline inflation should remain above the Bank's upper target (3%) until early 2009.
- As regards growth, recent events are in line with our projections. The BoC now feels that real GDP growth in the second quarter will be slightly weaker than projected in July, but the slowdown will not be so severe as to justify a change of course and a return to monetary easing. We are maintaining our growth projection at only 1.0% for 2008. However, a pickup into 2009 should result in growth of nearly 2.0% next year.
- The labour market deteriorated further in July, shedding 55,000 jobs. As well, residential investment is starting to waver, with the number of housing starts tumbling 13.6% to 186,500 in July. However, these figures were probably heavily affected by poor weather in the central-eastern part of the country. Consequently, we should wait for August's statistics before concluding that domestic demand is at risk.

**Forecasts:** The risks seem tilted to the downside in the near term. However, high inflation will have the central bank acting cautiously until year-end. Although the economy is showing signs of weakness, there is still no risk of a severe recession. Consequently, the most likely course of action is a long period of status quo. That said, a protracted period of economic difficulties could prompt the BoC towards monetary easing before the start of 2009.

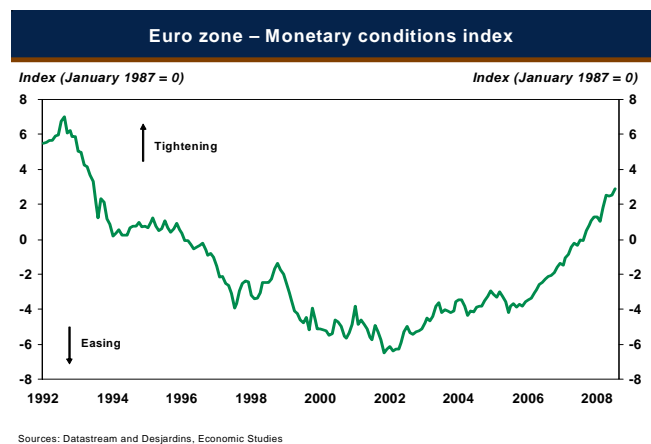
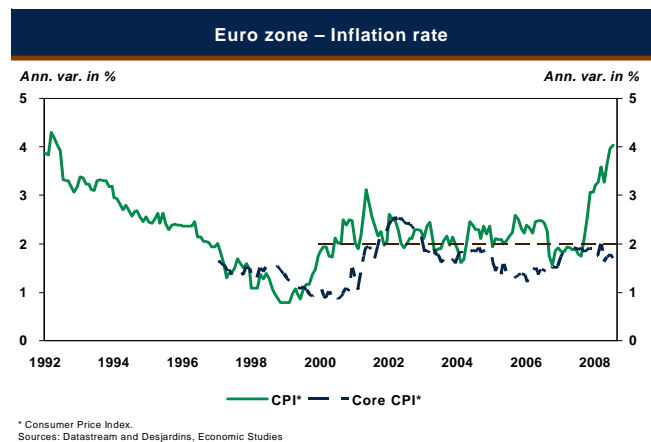
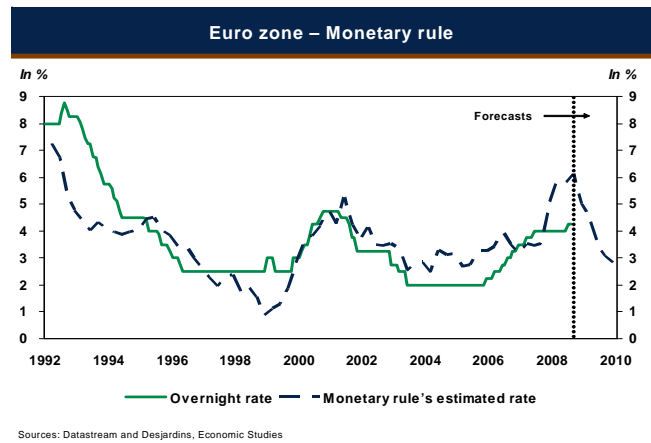


# EUROPEAN CENTRAL BANK

## ECB can't deny economic slowdown

- After raising interest rates by a quarter point to 4.25% in early July, the European Central Bank (ECB) stayed pat in August and said it had no bias about its future policy. However, ECB members did soften their tone recently as the Euroland economy slowed more than expected. Although the central bank maintained that the risk to price stability remains tilted to the upside, all signs indicate that interest rates have reached their cyclical peak.
- The economic outlook has weakened sharply in Euroland over the last few months to the point where the ECB can no longer close its eyes. After a fairly strong first quarter, real GDP fell by 0.2% (non-annualized) from April to June and seems headed for another contraction in the next quarter. The July and August PMI (Purchasing Managers' Index) are well below the 50 mark, signalling a decrease in services and manufacturing activity. Moreover, industrial production, retail sales and new orders are all down from the same time last year and confidence indexes are quite weak. This bad news was only partially expected by the ECB, whose president, Jean-Claude Trichet, recently said: "We knew that there were (downside economic) risks, and those risks are materializing."
- Despite the listless economy, rapidly rising retail prices continue to be the ECB's main concern. Inflation remained stuck at 4% in July and threatens to stay well above the Bank's upper target of 2% for months to come. For now, high commodity prices around the world are fuelling most of the inflationary pressures. The recent drop in commodity prices was no doubt greeted with a sigh of relief by the ECB. However, unlike what is happening in most of the world's other major economies, wage growth has picked up in the euro zone in recent months. Explained in part by the fact that some wages are automatically indexed, this development is worrisome and may signal the beginning of second round effects as a result of higher food and energy prices.

**Forecasts:** The combination of a real recession risk and very high inflation seems to condemn the ECB to inaction for several months. However, lower commodity prices and a slowing economy should gradually reduce inflationary pressures and allow the ECB to relax monetary policy next year. Of course, the Bank will wait until it is sure that the second round effects are limited before contemplating a rate cut.

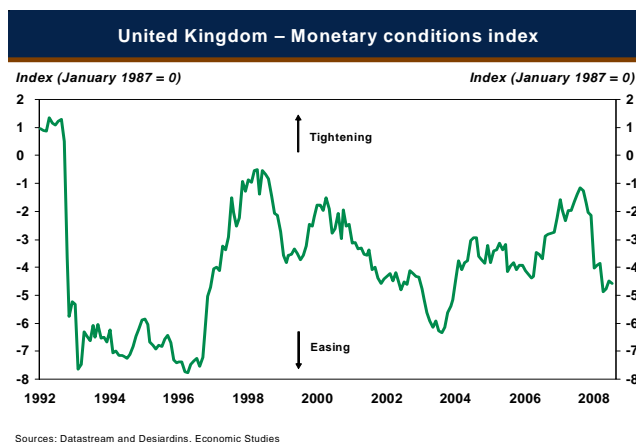
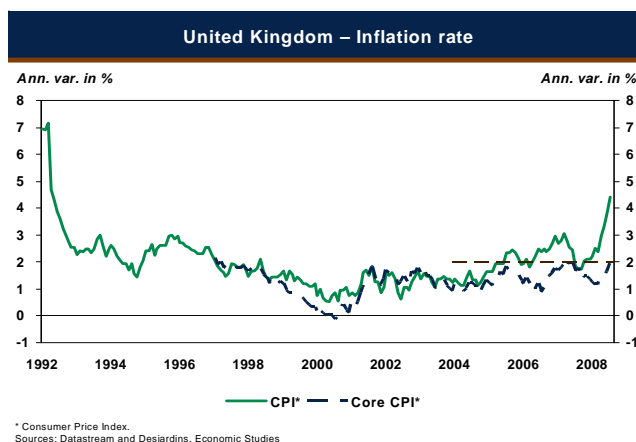
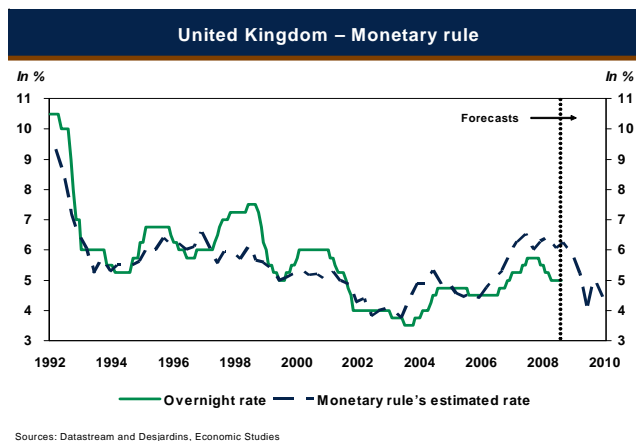


# BANK OF ENGLAND

## When is the next rate cut?

- Not surprisingly, the Bank of England (BoE) maintained its key rate at 5.00% in August. The last change to British monetary policy was a quarter-point cut in April. The BoE is facing a tough situation because it must deal with ever increasing inflation and economic risks. The minutes of the August meeting reveal some dissention among policymakers, with one voting in favour of a rate cut to avoid a sharp economic slowdown while another preferred to raise rates to ensure inflation expectations remain near the 2% target.
- Inflation in the U.K. has worsened over the past few months. Rising energy prices drove annual inflation to 4.4% in July, and as a result of impending gas and electricity hikes, it may reach 5% in the months ahead. The BoE realizes, however, that so long as higher commodity prices don't push up other prices, they don't threaten price stability in the medium term. In this regard, the news is rather encouraging because there are no indications that wage growth has picked up. This, combined with the sharp drop in capacity utilization rates and the recent decline in commodity prices, should help bring inflation back down near its 2% target by the end of 2009.
- The British economic situation has taken a turn for the worse. Real GDP stagnated in the second quarter and the drop in consumption and investment should drag into the second half of the year. Although weak wage growth reduces the risks of an inflationary spiral, at the same time, it impoverishes households that have to absorb the spike in energy and food prices. Consumer confidence has also been badly shaken by the real estate and stock market correction. The investment outlook is also worrisome as there are no signs that the construction slump is about to end and as recent surveys indicate that businesses have cut back on investments. Tight credit conditions will also continue to sap domestic demand.

**Forecasts:** In the current context of stagflation, the BoE will have no choice but to hold its key rate in the months ahead. Unless energy prices unexpectedly start climbing again, the risk of recession will loom larger over the next few months, allowing the BoE to start easing its monetary policy towards year-end.

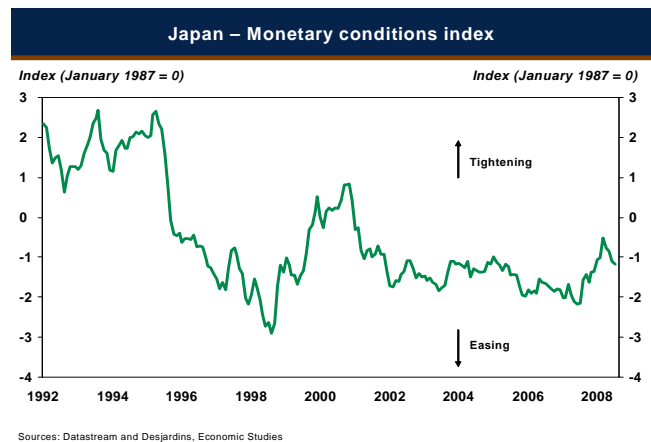
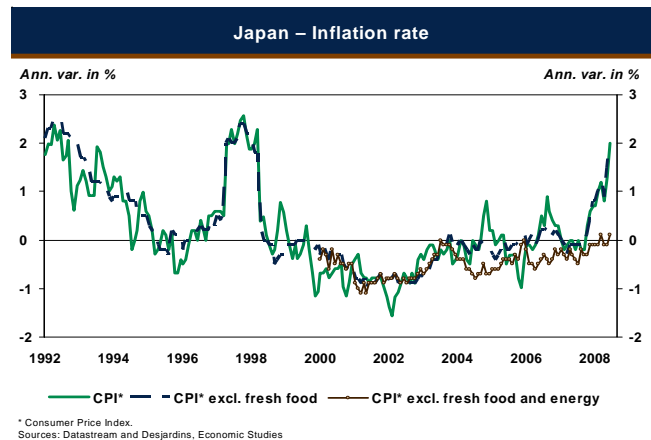
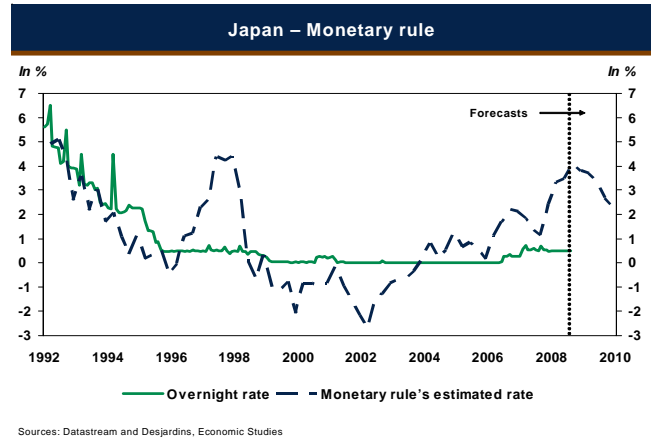


# BANK OF JAPAN

## Japanese economy continues to slide

- On August 18, the Bank of Japan (BoJ) once again decided to hold its key rate at 0.5%, where it has been for the last 19 months and where it is expected to remain in the near term. Although inflation is up, the monetary authorities are much more concerned about the disappointing economic outlook. High commodity and energy prices and the economic slowdown that is taking shape in some industrialized countries are particularly worrisome.
- The Q2 national accounts results showed that real GDP dropped at annual pace of 2.4% compared with the first quarter of 2008. Both consumption and investment fell, and exports made their weakest contribution to growth in two years. It looks like a recession is inevitable. Other indicators also attest to the economy's current and future sluggishness. The Tankan index, which measures sentiment as regards capital and machinery investments, slipped again. Manufacturing profits have taken a hit as a result of higher commodity prices and softer foreign demand. The employment market is also beginning to wilt, with weaker wage growth and an unemployment rate that has been climbing since March.
- Inflation has picked up in Japan this year, but a closer look reveals no need for concern. Annual inflation reached 2% in June for the first time in 10 years. However, excluding fresh food and energy, prices rose just 0.1% year over year. Although headline inflation is expected to pick up again in July, it will remain low and stable at 0.1% if fresh food and energy are excluded. The BoJ will therefore maintain his bias in favour of slowing growth and will not hurry up a rate-hike. And with rates already so low, it certainly will not trim them further.
- Despite the status quo, monetary conditions in Japan are easing as a result of a weak yen, whose depreciation reflects deteriorating fundamentals.

**Forecasts:** The Japanese economy is slowing, and as such, the BoJ will postpone a rate hike for a few more months until it sees signs of recovery. The fact that headline inflation is high is not a reason for undue concern.



**Table 1**  
**Key interest rates**

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

f: forecasts

Sources: Datastream and Desjardins, Economic Studies

**Table 2**  
**Schedule and key rates**

Date	Central Bank	Decision	Rate
<b>June 2008</b>			
3	Reserve Bank of Australia	s.q.	7.25
4	Reserve Bank of New Zealand	s.q.	8.25
4	Bank of Brazil	+50 b.p.	12.25
5	Bank of England	s.q.	5.00
5	European Central Bank	s.q.	4.00
10	Bank of Canada	s.q.	3.00
12	Bank of Japan	s.q.	0.50
19	Swiss National Bank	s.q.	2.75
20	Bank of Mexico	+25 b.p.	7.75
25	Bank of Norway	+25 b.p.	5.75
25	Federal Reserve	s.q.	2.00
<b>July 2008</b>			
1	Reserve Bank of Australia	s.q.	7.25
3	European Central Bank	+25 b.p.	4.25
3	Bank of Sweden	+25 b.p.	4.50
10	Bank of England	s.q.	5.00
15	Bank of Canada	s.q.	3.00
15	Bank of Japan	s.q.	0.50
18	Bank of Mexico	+25 b.p.	8.00
23	Reserve Bank of New Zealand	-25 b.p.	8.00
23	Bank of Brazil	+75 b.p.	13.00
<b>August 2008</b>			
5	Reserve Bank of Australia	s.q.	7.25
5	Federal Reserve	s.q.	2.00
7	Bank of England	s.q.	5.00
7	European Central Bank	s.q.	4.25
13	Bank of Norway	s.q.	5.75
15	Bank of Mexico	+25 b.p.	8.25
18	Bank of Japan	s.q.	0.50

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

Source: Desjardins, Economic Studies

**Table 3**  
**Coming soon**

Date	Central Bank
<b>September 2008</b>	
2	Reserve Bank of Australia
3	Bank of Canada
4	Bank of England
4	European Central Bank
4	Bank of Sweden
10	Reserve Bank of New Zealand
10	Bank of Brazil
16	Bank of Japan
16	Federal Reserve
18	Swiss National Bank
19	Bank of Mexico
24	Bank of Norway
<b>October 2008</b>	
2	European Central Bank
6	Bank of Japan
7	Reserve Bank of Australia
9	Bank of England
17	Bank of Mexico
21	Bank of Canada
22	Reserve Bank of New Zealand
23	Bank of Sweden
29	Bank of Norway
<b>November 2008</b>	
3	Reserve Bank of Australia
6	Bank of England
6	European Central Bank
20	Bank of Japan
28	Bank of Mexico

Source: Desjardins, Economic Studies

# TECHNICAL ANALYSIS

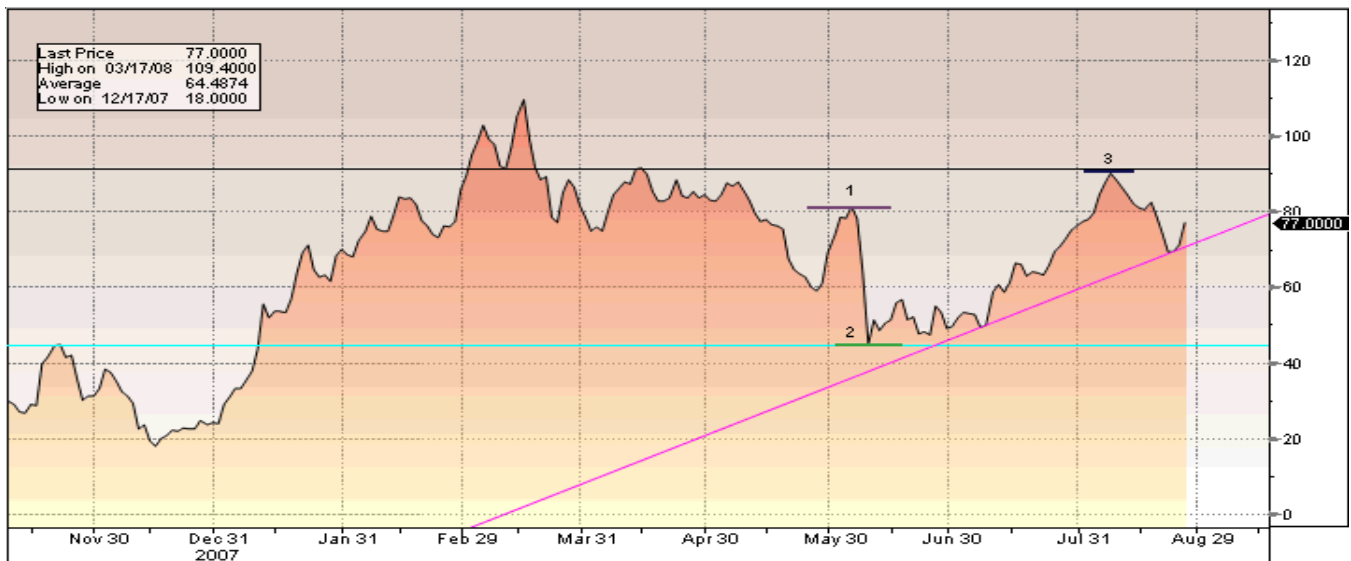
## CANADIAN 10-YEAR YIELD

At the beginning of the month, Canadian 10-year bond yields broke an upward corridor that began at the end of March. After falling sharply, they hit a support level around 3.52%. The downward potential is limited at around 3.38% (a historically very low level). However, we could easily go back to testing the double-top of mid-June to mid-July, around 3.92%.



## CANADIAN 2-10-YEAR CURVE

At the beginning of June, the 2-10 curve flattened aggressively (level 1 to 2), when the Bank of Canada decided not to cut rates. Since then, the yields went back up to higher levels and the upward trend indicates that we are heading for the last peak (level 3), close to 92 points.



## FUTURES CONTRACT ON 10-YEAR U.S. BONDS

The TY is very well defined by the upward corridor that began at the end of July. However, it seems to have reached a resistance level around 116-28. A break at this level would speed up the movement, bringing the TY close to 117-20.



## 10-YEAR SPREAD (CAN-US)

The Canadian market has outperformed the U.S. market since the beginning of the year. However, the floor seems to be around -38 points, a level that was reached twice in June. Since then, a range seems to have been defined between -20 and -40, which could last unless an upward occurs, changing the trend and pushing the spread around -5, the high of July 10, 2008.



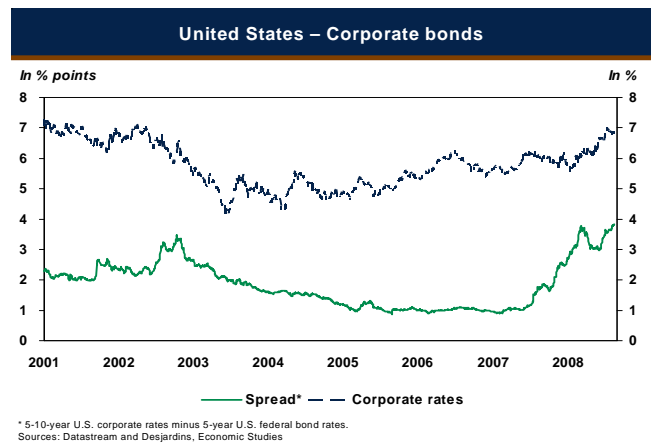
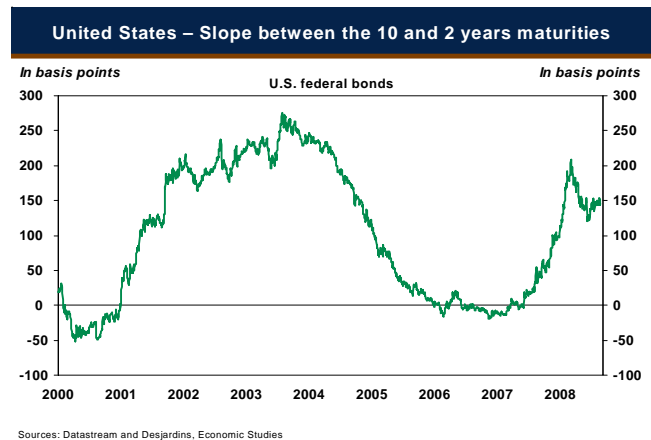
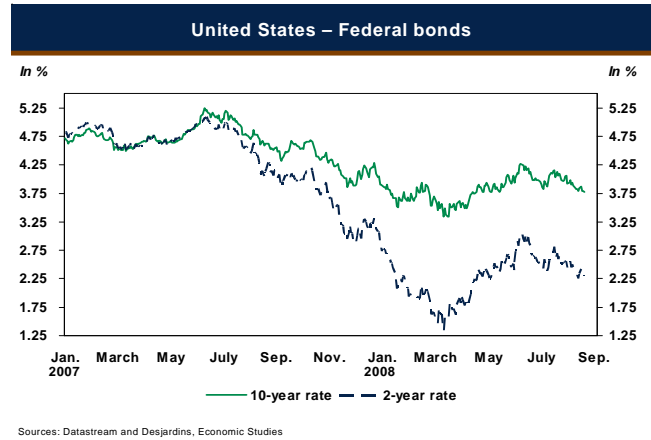
# FIXED INCOME MARKET

## U.S. Treasuries near a new cyclical low

### U.S. FEDERAL BONDS

- As expected, bond yields have decreased in the past few months. In light of the sharp increase in yields in the spring, evidence of a protracted slowdown in the U.S., the undercapitalization of Fannie Mae and Freddy Mac (America's two main mortgage lenders), and the drop in oil prices, the market has lessened its rate hike expectations.
- After climbing to a cyclical high of 3.11% in mid-June, two-year yields gradually fell back to around 2.30%, a decrease of about 80 basis points. With high inflation, the drop was less pronounced for 10-year maturities, for which the yields fell just under 50 basis points during the same period, from a high of 4.27% to a recent low of about 3.78%.
- In our view, inflationary fears continue to exert upward pressure on short-term bond yields. However, with no shortage of bad news expected in the weeks ahead, the economic and financial situation remains overall deflationary.

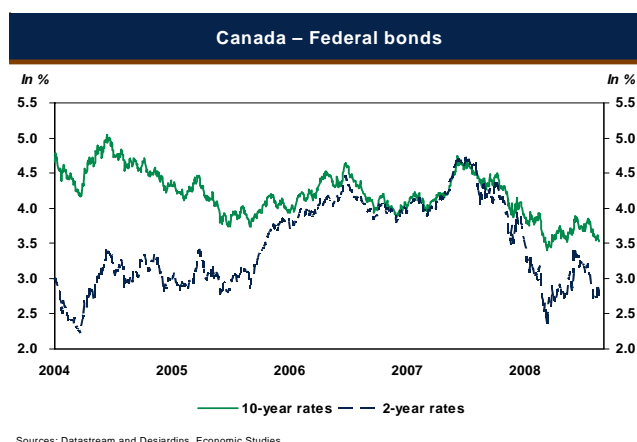
**Forecasts:** With the Federal Reserve on the sidelines, the possibility of a sudden decrease in two-year yields is unlikely. At 2.30%, the short portion of the curve shows little potential. In our view, the economic and financial situation is deflationary, and as such, we expect inflation to fall in the months ahead. However, headline inflation is very high and some policymakers are worried that low interest rates will trigger a long period of inflation later in 2009. Given that the nationalization of Fannie Mae and Freddy Mac could reduce risk aversion, we now favour a neutral position.



### CANADIAN FEDERAL BONDS

- Canadian bond yields have slipped in recent weeks as the global economic slowdown and ongoing strong financial tensions prompted investors to seek refuge in government securities. A change in market expectations as regards Canadian monetary policy also explains the drop, particularly in the short portion of the curve. Whereas in early summer, many analysts expected interest rates to rise rapidly, some now believe that monetary policy could be relaxed instead.
- Canadian two-year bond yields, which had reached 3.40% in mid-June, have now fallen back to 2.80%. The 10-year yield also fell over the last few weeks, from 3.80% at the end of July to just shy of 3.60%. The drop in oil prices and a weakening global economic outlook have tempered inflationary fears. The decrease in long-term yields since mid-June has, however, been less marked than in the short portion, and as we hoped, the 2/10 slope, which had flattened aggressively by 45 basis points, sharpened to almost 75 points.
- The spread between two-year Canadian and U.S. yields has fluctuated heavily in recent months, reflecting rapid changes in expectations regarding Canadian monetary policy. The spread, which reached 75 basis points at the beginning of July, gradually narrowed to a low of 19 points, following net losses of 55,000 jobs in Canada in July, before going back up close to 50 points in the last few days. This recent widening of the spread seems logical given the 100-point difference between Canadian and U.S. interest rates, a difference that is expected to remain for some time. For its part, the negative spread between the 10-year Canadian and U.S. yield shrank slightly while Canadian long-term yields fell less rapidly than in the U.S. The greenback's strong rebound in the last few weeks may partially explain why U.S. bonds have performed better, as U.S. assets seem to be regaining favour with international investors.

**Forecasts:** In our opinion, Canadian bond yields are currently at levels commensurate with the economic and financial situation. Provided the Canadian economic slowdown does not take a sharp turn for the worse, they are not likely to fall much further. This is particularly true for the two-year yield, which is already below the overnight rate. Yields should stay at this level in the months ahead and as such, we recommend a neutral position on the Canadian bond market.

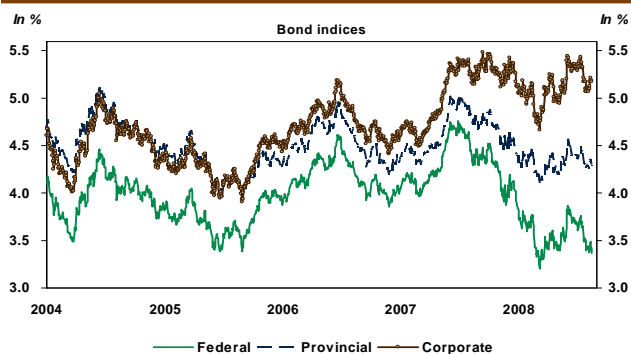


## PROVINCIAL BONDS

- Financial instability and stock market woes have played in favour of federal bonds over other bonds in the past few months. Accordingly, the premium demanded on Canadian corporate bonds has climbed to levels unseen since the recession of the early '80s. The spread between provincial and federal bond yields, which shrank from 90 basis points in mid-March to less than 70 points in June, also began to widen recently, almost reaching the high of March. The yield difference between the bonds of the main issuing provinces is now almost nil.
- The economic situation is very worrisome in the central and eastern regions of Canada. The Québec economy contracted by 0.8% in the first quarter, and the situation on the export and employment fronts indicate that there are still problems. That said, we should be able to avoid a recession. The beginning of the year was even tougher for Ontario, which saw output shrink by 1.4% in the first quarter. The ailing manufacturing sector, particularly the automobile industry, is weighing heavily on the Ontario economy and the second quarter figures are expected to confirm a recession in this province. For its part, the West is not escaping this slump as non-residential investment runs out of steam; however, the situation is less critical than in the East.

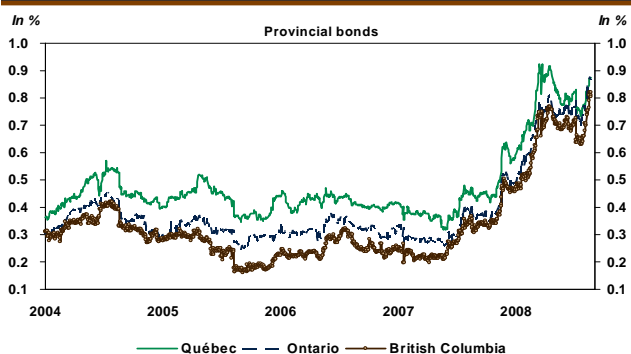
**Forecasts:** The persisting financial crisis could keep the yield spreads between provincial and federal bonds high for several months. The very high premium on provincial bonds makes them highly attractive for any investor seeking a long-term investment. Relatively speaking, Québec bonds are less attractive because there doesn't seem to be any valid reason for the elimination of the premium historically paid on these bonds.

### 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	
	2007-2008	2008f-2009f	2008f-2009f	2007f-2008f	S&P	Moody's
Federal government	10,200	2,305	0.2	34.9	AAA	Aaa
Newfoundland	1,377	544	1.9	35.0	A	Aa2
Prince Edward Island	-37	-35	-0.8	37.6	A	Aa2
Nova Scotia	-317	-340	-1.0	34.4	A+	Aa2
New Brunswick	18	19	0.1	28.9	AA-	Aa1
Québec	1,695	-278	-0.1	55.3	A+	Aa2
Ontario	600	750	0.1	26.4	AA	Aa1
Manitoba	329	97	0.2	30.4	AA	Aa1
Saskatchewan	693	260	0.5	26.5	AA	Aa1
Alberta	4,031	1,568	0.6	0.0	AAA	Aaa
British Columbia	2,120	800	0.4	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	Q2	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
<b>Key rate</b>												
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
<b>Treasury bills</b>												
3-month	5.04	4.82	3.82	3.36	1.38	1.90	1.90	2.00	2.05	2.15	2.90	3.60
<b>Federal bonds</b>												
2-year	4.58	4.87	3.96	3.07	1.62	2.61	2.40	2.30	2.60	3.30	3.80	4.20
5-year	4.54	4.93	4.23	3.46	2.47	3.33	3.20	3.20	3.50	3.80	4.10	4.60
10-year	4.65	5.03	4.58	4.03	3.43	3.98	3.90	3.90	4.10	4.20	4.40	4.70
30-year	4.85	5.13	4.83	4.45	4.30	4.53	4.60	4.65	4.60	4.70	4.80	4.90
<b>Yield curve</b>												
5-year - 3-month	-0.50	0.11	0.41	0.10	1.09	1.43	1.30	1.20	1.45	1.65	1.20	1.00
10-year - 2-year	0.07	0.16	0.62	0.96	1.81	1.36	1.50	1.60	1.50	0.90	0.60	0.50
30-year - 3-month	-0.19	0.31	1.01	1.09	2.92	2.63	2.70	2.65	2.55	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	Q2	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
<b>Key rate</b>												
Overnight funds	4.25	4.25	4.50	4.25	3.50	3.00	3.00	3.00	3.00	3.25	3.50	4.00
<b>Treasury bills</b>												
3-month	4.18	4.43	3.98	3.83	1.88	2.50	2.60	2.80	3.10	3.55	3.75	4.15
<b>Federal bonds</b>												
2-year	3.98	4.58	4.08	3.74	2.63	3.25	3.00	3.05	3.30	3.70	4.00	4.35
5-year	4.01	4.56	4.21	3.87	2.91	3.46	3.20	3.20	3.60	3.90	4.30	4.60
10-year	4.11	4.55	4.34	3.99	3.43	3.74	3.70	3.75	4.05	4.15	4.40	4.70
30-year	4.20	4.49	4.45	4.10	3.94	4.08	4.05	4.20	4.40	4.55	4.65	4.80
<b>Yield curve</b>												
5-year - 3-month	-0.17	0.13	0.23	0.04	1.03	0.96	0.60	0.40	0.50	0.35	0.55	0.45
10-year - 2-year	0.13	-0.03	0.26	0.25	0.80	0.49	0.70	0.70	0.75	0.45	0.40	0.35
30-year - 3-month	0.02	0.06	0.47	0.27	2.06	1.58	1.45	1.40	1.30	1.00	0.90	0.65
<b>Spreads (Canada - U.S.)</b>												
3-month	-0.86	-0.39	0.16	0.47	0.50	0.60	0.70	0.80	1.05	1.40	0.85	0.55
2-year	-0.60	-0.29	0.12	0.67	1.01	0.63	0.60	0.75	0.70	0.40	0.20	0.15
5-year	-0.53	-0.37	-0.02	0.41	0.44	0.13	0.00	0.00	0.10	0.10	0.20	0.00
10-year	-0.54	-0.48	-0.24	-0.04	0.00	-0.24	-0.20	-0.15	-0.05	-0.05	0.00	0.00
30-year	-0.65	-0.64	-0.38	-0.35	-0.36	-0.45	-0.55	-0.45	-0.20	-0.15	-0.15	-0.10

f: forecasts

Sources: Datastream and Desjardins, Economic Studies