

If the Federal Reserve reduces the federal funds rate to almost zero, what next?

HIGHLIGHTS

- The target for the federal funds rate is quickly approaching zero: is the Federal Reserve headed towards a quantitative policy?
- The Bank of Canada has the leeway it needs to continue trimming rates in the months ahead.
- The European central banks have some catching up to do: expect deep rate cuts until the middle of next year.
- The Japanese economy is in danger: the Bank of Japan also takes actions.

CONTENTS

Summary	1
Monetary Policy	
Federal Reserve	6
Bank of Canada	7
European Central Bank	8
Bank of England	9
Bank of Japan	10
Tables	11
Technical analysis	12
Fixed Income Market	
United States	14
Canada	15
Provinces	16
Tables	16-17

Summary

Following several unsuccessful attempts to restore a climate of confidence, the U.S. Congress finally approved a massive US\$700B rescue plan in October. First implemented to absorb toxic assets held by failing financial institutions, the government finally decided to inject US\$250B of the Paulson Plan to recapitalize the banks and ensure their solvency. At the same time, money markets funds were insured and the Federal Deposit Insurance Corporation (FDIC) increased its insurance deposit coverage from US\$100,000 to US\$250,000 in addition to insuring all non-secured senior debt issuances. And the Federal Reserve (Fed) is continuing to aggressively ease its monetary policy and other unconventional measures, like direct buybacks of commercial papers, are gaining momentum.

Since the repercussions of this crisis have now reverberated overseas, several governments in Europe have had to mobilize. Banks have been recapitalized (even nationalized in some cases) and seemingly unlimited guarantees on a range of bank loans have been offered (graph 1). Even the European Central Bank saw fit to take part in the concerted effort on October 8 to have central banks cut rates by 50 basis points.

Graph 1 – Government intervention

Country	Capital injection	Loan guarantees	Guarantees (in % of GDP)
Austria	€15B	€85B	31
Belgium	€5.7B	unlimited	
Denmark		unlimited	
France	€40B	€360B	17
Germany	€70B	€400B	17
Greece	€10B	€15B	7
Holland	€37B	€200B	35
Ireland		€420B	220
Portugal		€20B	12
Spain		€100B	10
Switzerland	CHF6B	if necessary	
United Kingdom	£37B	£250B	18
United States	US\$250B	Unlimited	

Source: Desjardins, Economic Studies

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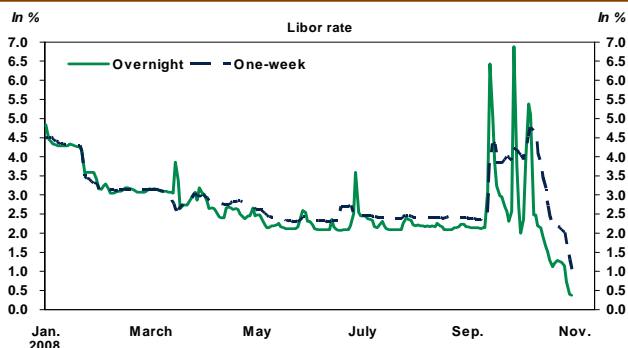
NOTE TO READERS: The letters **k**, **M** and **B** are used in texts and tables to refer to thousands, millions and billions respectively.

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FIRST SIGNS OF IMPROVEMENT?

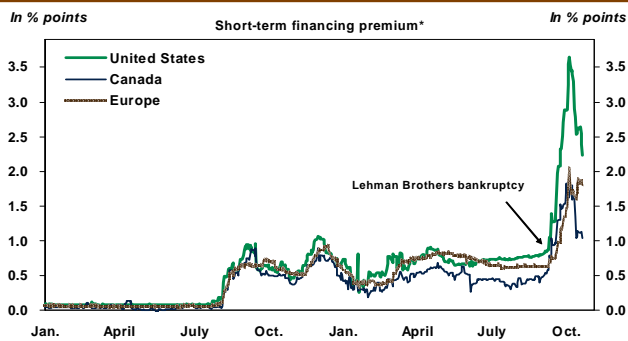
The unprecedented efforts made by monetary authorities and the governments of main industrialized nations are starting to bear fruit. After the dramatic jump in financing costs in the wake of the fallout of the Lehman Brothers bankruptcy, the spreads on the money market are starting to show the first signs of resumption (graphs 2 and 3).

Graph 2 – Loan guarantees created immediate improvements in the workings of the interbank market...



Sources: Bloomberg and Desjardins, Economic Studies

Graph 3 – ...but futures spreads are still larger than they were when the crisis started

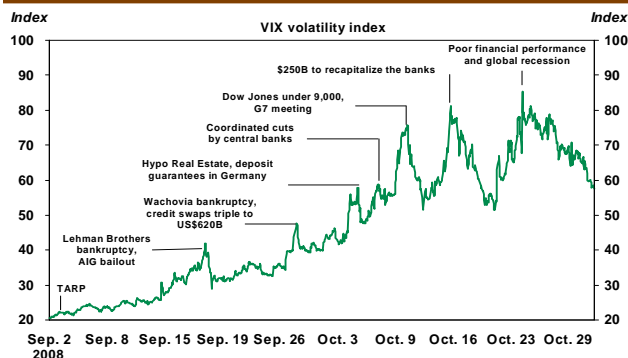


* Spread between the three-month Libor rate and overnight swap rates.
Sources: Bloomberg and Desjardins, Economic Studies

However, the economic and financial environment will remain very volatile in the months to come. The effects of the financial crisis are still lingering and the markets are already focusing on another battle: recession (graph 4).

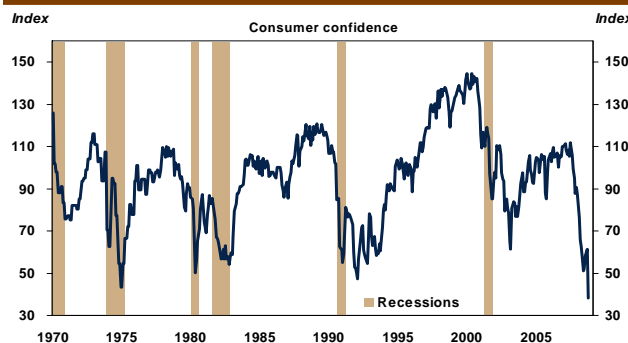
The signs of an economic slowdown are everywhere: above and beyond the stock market and real estate meltdowns, banks have drastically tightened their credit conditions and the labour market's deterioration seems to be gaining speed. As a result, in October consumer confidence plummeted to its lowest level since this index was created in 1967 (graph 5).

Graph 4 – Has volatility peaked?



Sources: Bloomberg and Desjardins, Economic Studies

Graph 5 – Consumer confidence at the lowest point ever recorded



Sources: Institute for Supply Management and Desjardins, Economic Studies

SEVERAL REASONS NOT TO BE CONCERNED ABOUT THE GROWING DEBT

In this financial and economic environment, we believe that U.S. bonds will continue to be subject to downward pressures. Some stakeholders expressed concern about the growing government debt and the effect of servicing this debt on nominal interest rates, but we do not anticipate any hikes in longer term rates. While it is true that an increased supply of government bonds should translate into lower asking prices and higher interest rates, the current situation is clearly out of the ordinary. In our opinion there are several reasons why interest rates should go down instead¹.

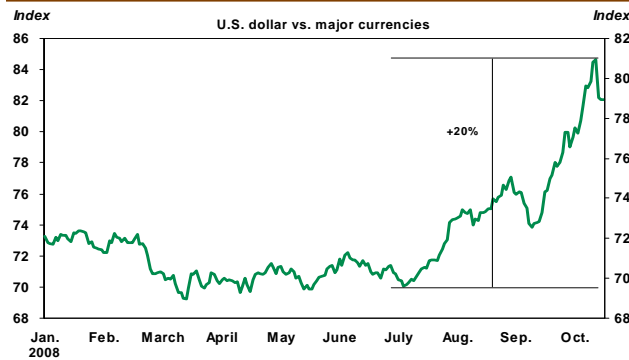
UNITED STATES: A SAFE HAVEN

First of all, financial pressures and newly-increased risk premium continue to favour a flight to higher quality and more liquid securities. There are alternatives to U.S. bonds, but with the spectre of a global recession looming, the United

¹ We will discuss this in greater detail in our next *Economic Viewpoint* which will look at the effects of state intervention on real interest rates, inflation and the U.S. dollar.

States is still the best safe haven. The greenback's sharp thrust these past few months clearly illustrates this sentiment (graph 6).

Graph 6 – Heightened risk benefits the greenback



Sources: Datastream and Desjardins, Economic Studies

In terms of foreign demand, the tendency of Asian countries to oversave is still high and governments that hold a significant portion of U.S. debt would be well advised to continue to support securities in U.S. dollars. And even if the appetite of foreign investors' for U.S. securities were to wane, economic difficulties should force U.S. households to start saving again which would facilitate local debt financing.

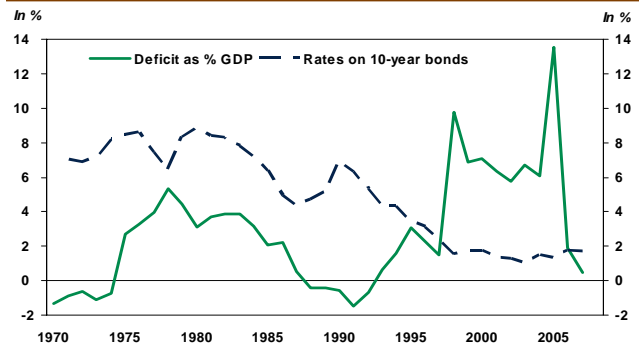
FISCAL COST OF PAULSON PLAN COULD BE LOW

It must also be understood that the U.S. Treasury's Troubled Assets Relief Program (TARP) does not have any fiscal impact. Since this plan was designed to repurchase toxic securities held by financial institutions, the government has the latitude to liquidate these assets once the real estate market (and by extension, the value of mortgage-backed securities) has stabilized. In fact, the Congressional Budget Office is not expecting TARP to be accounted for as a budgetary expenditure².

Should this not be the case, in other words, if the government were to resell these toxic securities at a loss, Japan has shown us that an increased debt can be in keeping with cuts to long-term interest rates. From 1990 to 2004, the loans made by the government of Japan went from -2% to 8% of the GDP while at the same time the yield for 10-year bonds slid consistently from 7% to close to 1% (graph 7).

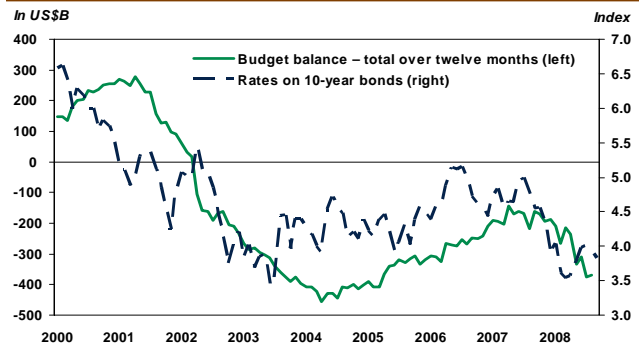
The U.S. seems to be tracking a similar fate. First of all, the war in Iraq, which has cost approximately US\$800B thus far,

Graph 7 – Growth in Japanese debt had little impact on interest rates



Sources: Datastream and Desjardins, Economic Studies

Graph 8 – U.S. bond rates are a better reflection of the state of the economy than of fiscal health



Sources: Datastream and Desjardins, Economic Studies

shows that the government has the capacity to finance astronomical deficits (even non-productive ones) at little cost (graph 8).

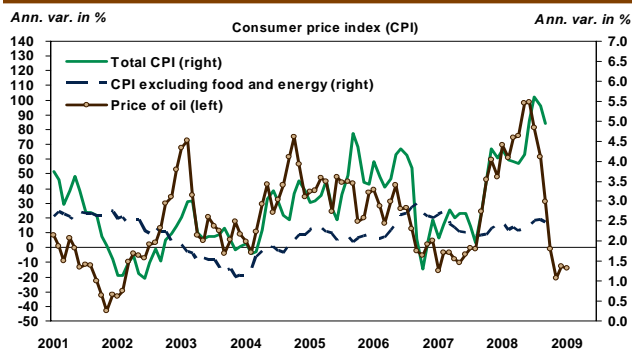
DEFLATION RISKS LURKING

Given that the nominal interest rate is made up of the real interest rate and the expected inflation rate, this should translate into reduced interest rates in this deflationist economic and financial environment. If soaring energy prices in the first half of the year were a concern for the monetary authorities, the severe correction since July signals that the year-over-year change in the consumer price index (CPI) could rapidly fall below 1.0% in the United States (graph 9).

While it is clear the effects of the correction in oil prices are fleeting, the current economic downturn should see the gap in production potential widen and continue to exert downward pressure on the core CPI. In fact, with the labour market clearly deteriorating, wages will continue to trend downward (graph 10).

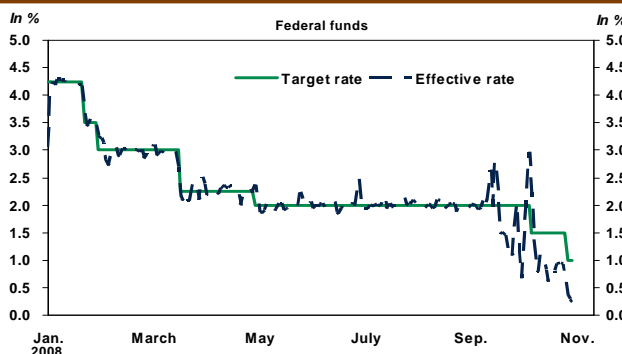
² Peter R. ORSZAG, "Federal Responses to Market Turmoil", in a statement before the Committee on the Budget, U.S. House of Representatives, September 24, 2008.

Graph 9 – The plunge in energy prices should quickly make inflation come down substantially



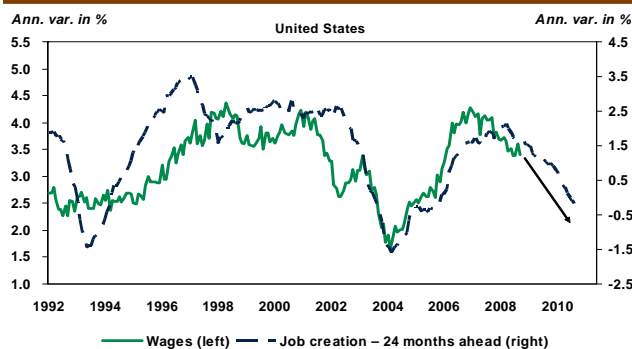
Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

Graph 11 – Effective rates are already almost zero



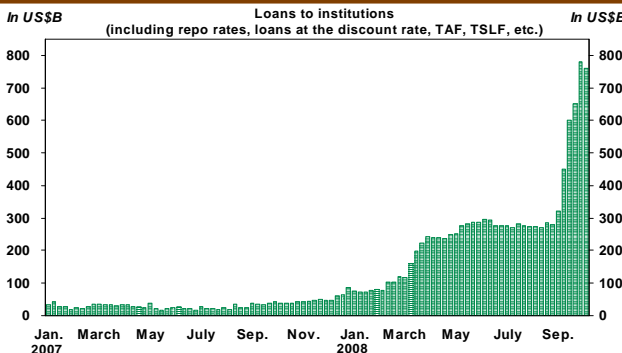
Sources: Federal Reserve and Desjardins, Economic Studies

Graph 10 – Wage growth should slow further



Sources: Datastream and Desjardins, Economic Studies

Graph 12 – The Fed takes its action further



Sources: Datastream, Federal Reserve Board and Desjardins, Economic Studies

ZERO INTEREST RATE A POSSIBILITY

What follows will depend on the economic rebound. To this end, the ongoing reversal of bank leveraging, and the deleveraging of consumers that is bound to follow, should translate into anaemic growth over several years. The Fed already lowered the federal funds (FF) by 100 basis points in October, and the likelihood that we will see the rate fall under 1.00% by year-end, or the lowest rate on record since the 1950s, is now very high.

We can no longer exclude a scenario of almost 0% rates. In fact, if not for the rate of return on reserves deposited at the Fed (75 basis points under the FF target), the effective FF rate would already be at that rate (graph 11).

The trouble the Fed is having maintaining FF at the expected target shows that the monetary authorities have already opened the door to quantitative policies. The Fed is no longer fully sterilizing its injections of liquidities into the financial system, and new credit facilities, like direct buybacks of commercial papers from businesses and money market funds, have been put in place (graph 12).

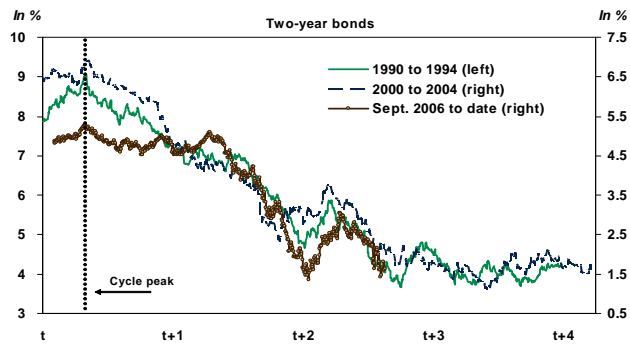
However, a “zero” rate does not signal the end of the Fed’s intervention. In a 2002 speech, Ben Bernanke stated that action would be needed to reduce long-term interest rates³. One way of doing so would be to commit to maintaining short-term interest rates at 0% for an extended period. Since long-term rates reflect the average of current and anticipated short-term rates, this would lower long-term rates. However, the Fed seems more inclined to buyback unlimited amounts of longer term bonds to establish a clear ceiling for bond rates⁴.

In these conditions and much like during previous economic downturns, our scenario calls for weak interest rates (graph 13). That being said, if the Fed should have to resort to printing vast sums of cash, our conclusions on inflation

³ Ben Bernanke, “Deflation: Making Sure ‘It’ Doesn’t Happen Here”, in a speech before the National Economists Club, Washington, D.C., November 2002.

⁴ Prior to the Federal Reserve – Treasury accord of 1951.

Graph 13 – Bond rates will remain low for a long time



Sources: Datastream and Desjardins, Economic Studies

would have to be revised upwards. While still possible, this would be a last resort measure and the Fed would strive to find other alternatives to avoid tarnish its reputation as a world leader.

François Dupuis
Vice-President and Chief Economist

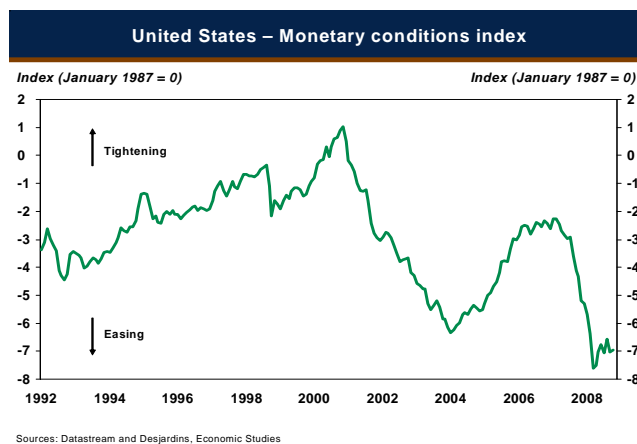
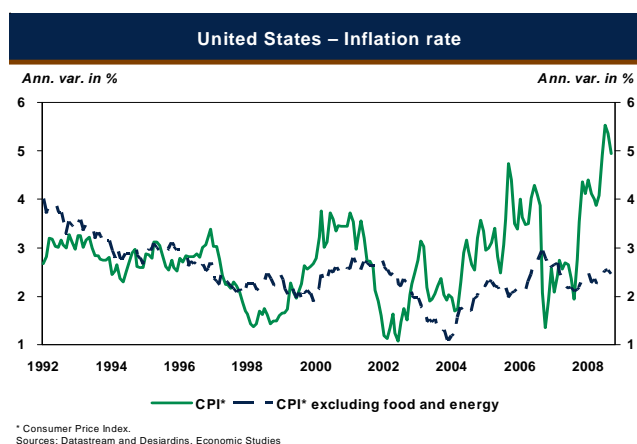
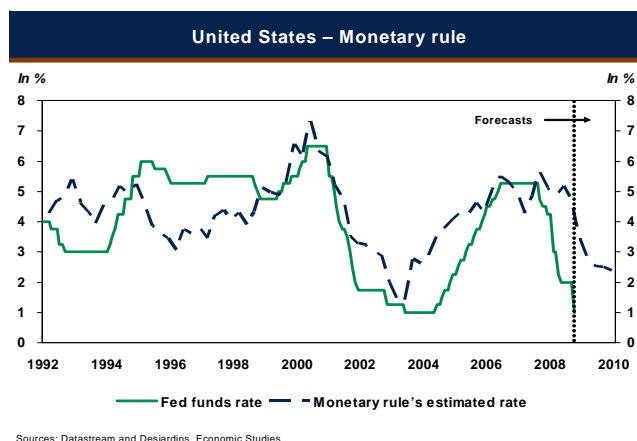
Martin Lefebvre
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FEDERAL RESERVE

Federal funds rate fast approaching zero

- The Fed reacted strongly to the deepening turmoil in financial markets and the darkening economic outlook in the U.S. by cutting its key interest rate by 50 basis points on two separate occasions: on October 8 as part of a coordinated effort by six central banks and again on October 29 during its regular meeting. These actions were made to support investor confidence and prevent a meltdown in financial markets.
- The clear deterioration in the economic outlook and highly fragile financial markets justify this unprecedented response from American monetary authorities to keep the financial system from collapsing and limit the scope of the U.S. recession, now inevitable. The national accounts show that the U.S. economy contracted by 0.3% (annual rate) in the third quarter of 2008 and household consumption dropped by 3.1%. Now it is just a question of time until the National Bureau of Economic Research (NBER) declares that the U.S. is officially in recession. In a press release that accompanied its latest decision, the Fed painted a very grim picture of the U.S. economy's outlook, underscoring that downward risks still exist. The door remains open to further cuts to federal funds, especially now that fears of inflation are no longer much of a concern to U.S. authorities.
- At first glance, the Fed's leeway now appears slight, with the key rate quickly closing in on zero. However, the Fed has already set up the mechanisms it needs to continue taking action even if the key rate instrument were no longer effective.
- Like the Bank of Japan in the early part of the decade, the Fed is ready to stimulate the economy by increasing the money supply, without worrying about the impact on key rates. This would be a quantitative monetary policy. The Fed has already started taking this kind of action, injecting impressive amounts of liquidity into the banking system and money market, and even buying commercial papers. These actions have made the monetary base rebound and seem to be quietly starting to help thaw out the credit market.

Forecasts: The reductions to federal funds targets in October were designed to sustain confidence in financial markets through this extremely difficult period. Other cuts to federal funds are quite likely in future meetings. As such, the key interest rate could rapidly fall to 0.5%, and even a zero rate would not be surprising. However, the Fed could increasingly favour direct injections of liquidity to support the economy as the key rate cuts seem to be having less and less of an impact.

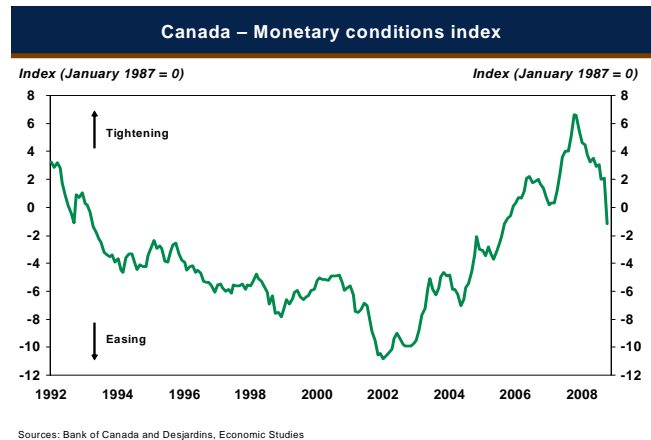
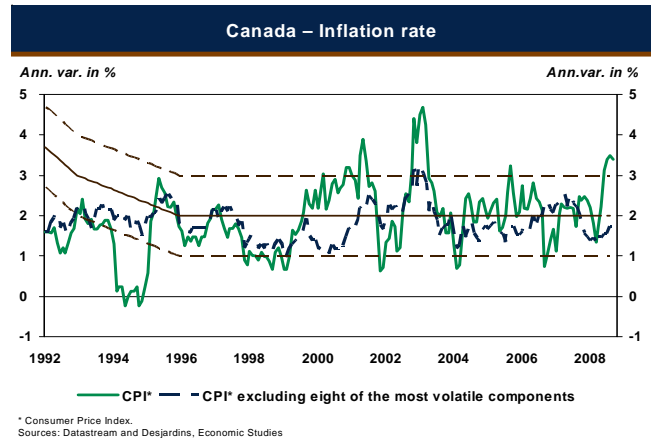
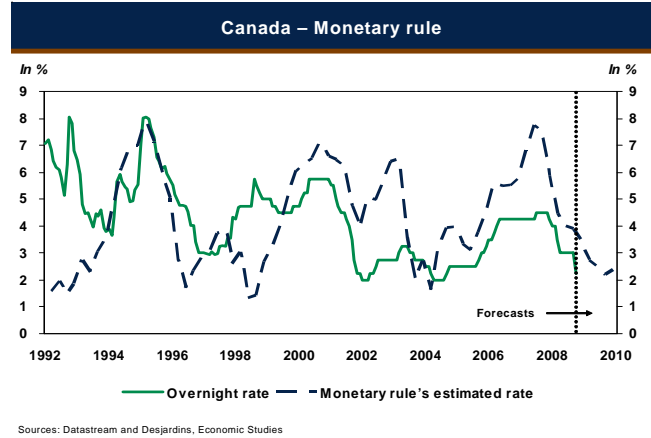


BANK OF CANADA

Monetary easing to continue in the coming months

- As we forecast, the BoC opted to continue easing its monetary policy, lowering its key rate by 25 basis points at its October meeting. This follows the bigger 50 basis point cut ordered on October 8, in conjunction with other major central banks. Most of the forecasters in the consensus had anticipated a more aggressive, 50 basis point cut, but Canada's economic and financial context, though worrisome, did not justify lowering interest rates by 100 basis points in just two weeks.
- That said, using a more gradual approach, there will be further rate cuts by early 2009. The combined effects of the credit crunch, U.S. recession and softening global demand for natural resources will continue to play against Canada's economy in the next few quarters. The downward impact that tumbling commodity prices have had on the Canadian dollar will help rein in the contraction in net exports. However, the flip side of the coin is that the reversal of wealth effects will have repercussions for domestic demand growth. Consequently, the BoC has slashed its growth outlook to 0.6% for 2008 and 2009, forecasts that are much more in line with our scenario.
- Against the backdrop of an economic slowdown and a sharp correction by oil prices, it was clear that the BoC would trim its inflation projection as well. According to our estimates, total inflation will remain high in September (3.4%), but the sharper-than-forecast drop by oil prices should bring the consumer price index (CPI) annual change to less than 1.0% as of mid-2009. Because the output gap has widened, core inflation will stay below 2.0% (the BoC's mean target) over the medium term.

Forecasts: It remains to be seen how the unprecedented actions by the globe's major financiers and governments will affect credit conditions, but the inflation risks are now clearly tilted to the downside, and it seems clear that further rate cuts will be ordered over the next few months. In our opinion, the monetary easing will continue until April, meaning interest rates could reach a historic low of 1.25%.

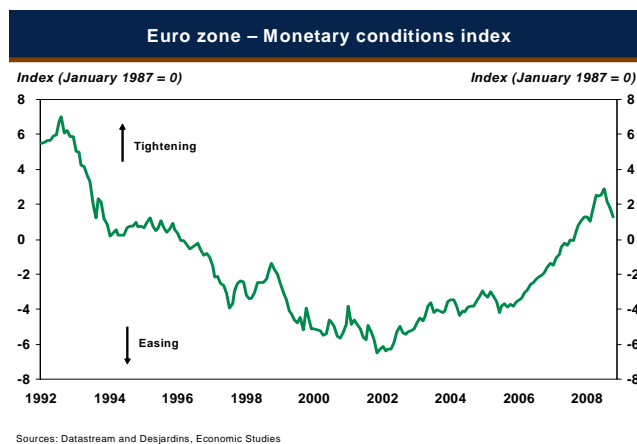
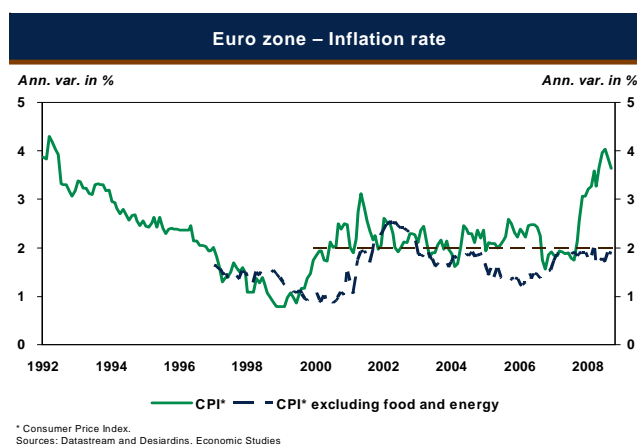
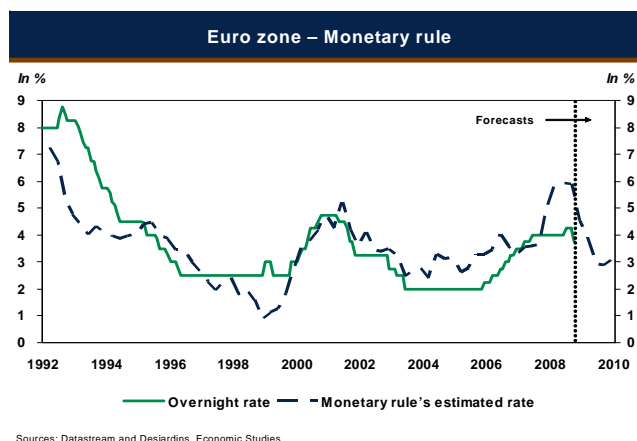


EUROPEAN CENTRAL BANK

Rate cuts in the euro zone, finally

- The change in discourse initiated by the ECB at the end of summer ramped up brutally these past few weeks as the financial crisis intensified. After opening the door to monetary easing during its October meeting, the ECB reduced its key interest rates by 50 basis points a week later in a concerted effort along with five other major central banks. This marked the first cut to key interest rates in the euro zone in more than five years. The question is no longer whether the ECB will continue to reduce its interest rates, but rather when and by how much.
- Even if this crisis originated in the United States, it is hitting Europe hard with banks writing off a total of US\$234B to date. Tensions that have been growing since September suggest that credit conditions will continue to be tightened in the euro zone, yet another worry for consumers and businesses. After the 0.2% pullback in GDP in the second quarter of 2008, the latest statistics show that Euroland's economy is still in turmoil. Activity indicators keep showing declines, a clear indication the economy is contracting. The French authorities are forecasting that the country will soon enter into a recession. And after posting a strong showing at the beginning of the year, the situation has deteriorated sharply in Germany, with the future component of the IFO index tumbling to a historic low point. It is difficult to see how the euro zone could possibly avoid entering into a recession by year-end. The euro's severe depreciation could eventually boost the foreign sector, but its effect in the short term will be offset by the global economic slowdown.
- We could be led to believe that the high annual rate of inflation—3.6% in October—could limit the ECB's leeway. The central banks should instead be concerned about the stability of prices in the medium term. On this front, the situation recently improved since the spectacular correction in the price of raw materials and the global economic slowdown have sharply reduced upward pressures on prices. Inflation in Euroland should return to close to its target of 2% next year. The ECB justified its monetary easing of October 8 by the fact that the deepening financial crisis was reducing the upward risks to price stability even further.

Forecasts: The scope of the financial crisis and the correction in the price of raw materials finally gave the ECB the leeway it needed to soften its monetary policy. At 3.75%, the ECB's key interest rate is relatively high and several other cuts will be required to support Euroland's economy. A reduction of 50 basis points is likely as of November, and the key interest rate should reach a low point of 2.5% by mid-2009.

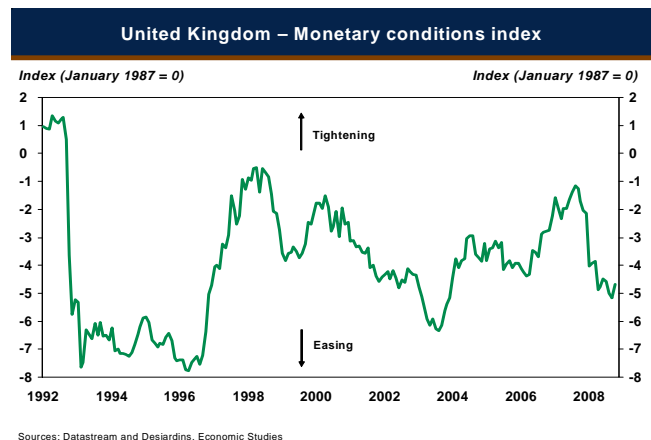
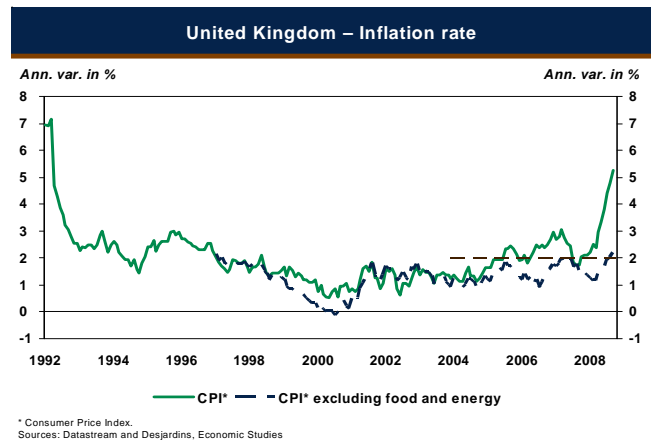
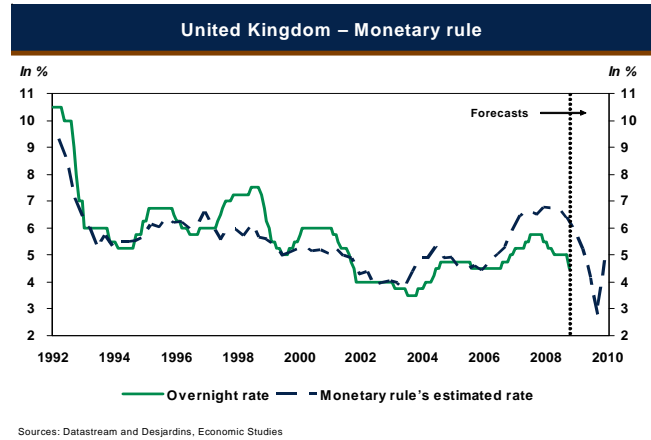


BANK OF ENGLAND

How low will key interest rates go?

- Increasing financial turmoil convinced the BoE to resume monetary easing faster than originally anticipated. As such, Britain's central bank was part of the concerted effort made on October 8, holding its monthly meeting ahead of time and cutting its key interest by 50 basis points. At 4.50%, the key interest rate in Britain is still higher than in other major economies and further reductions will be required to limit the scope of the economic slowdown.
- Britain's economy was already teetering on the edge this summer when the housing market correction started to look like the real estate meltdown in the United States. The deepening of the financial crisis now makes a recession in the UK almost all but inevitable. The contraction of Britain's economy by 0.5% (non-annualized) in the third quarter of 2008 signalled the first step towards recession. This decline in activity, the first since 1992, has impacted the goods and services sectors equally. The ongoing tightening of credit conditions will compel British households—already reeling from sharp drops in the value of their homes and stock portfolios—to limit their consumption in the next few months. The latest surveys show that business outlooks have also deteriorated significantly. The monetary authorities are well aware of the difficulties in the British economy and Mervyn King, Governor of the BoE, recently declared, "Indeed, it now seems likely that the UK economy is entering a recession."
- Under normal circumstances, the acceleration of the annual inflation rate to 5.2% in September—more than 2.5 times the BoE's target—would be enough to exclude any key rate reduction in the United Kingdom. However, the British monetary authorities quickly realized the scope of the current crisis and it was no surprise that they decided to ignore the current inflation rate to focus instead on movements in the medium term. The severe correction in prices for raw materials and the significant downturn in the British economy suggest that inflation pressures will soon be trending downward. On October 8, the members of the committee that determines monetary policy deemed that, "during the past month, the balance of risks to inflation in the medium term had shifted decisively to the downside."

Forecasts: Like the British government, which put extraordinary measures in place to recapitalize British banks and prevent a meltdown in this vital sector, the BoE is well aware of the serious threats to the United Kingdom. The monetary policy will have to be softened decisively to limit the scope of the recession. In our opinion, a 50-basis point reduction in November will be followed by other cuts that could see key interest rates fall to close to 3% next year.



BANK OF JAPAN

Japan's economy in danger

- The BoJ broke with the status quo at its October 31 meeting, cutting its key interest rate, which has been at 0.5% since February 2007, to 0.30%. The escalating financial crisis and global economic slowdown finally forced the BoJ to join the world's other major central banks' rate cuts. The risks to growth are heavily tilted to the downside, as is the inflation risk, to the point where another round of deflation is a possibility.
- Japan's economy is having serious difficulties due to the financial crisis and the economic slowdown, which has taken hold in a number of other countries as well. Real GDP growth in the second quarter was revised downward to -3% (annual pace): not one component posted a positive contribution. Everything seems to suggest that the current economic weakness in Japan will continue. In August, industrial production fell back to the same level recorded in June 2006. Housing starts and exports declined as well. Consumer confidence remains weak, as is business confidence and the labour market is showing signs of fatigue. The unemployment rate rose to 4.2% in August, an increase of 0.2% vs. July's rate. In 2008 to date, the only months that saw job creation were March and April. The real GDP should post gains of no more than 0.7% for this year, which will slow to 0.5% in 2009.
- Total inflation remains above 2.0%, but core inflation, which excludes food and energy, is having trouble staying above 0%. Core inflation was 0.2% in September vs. 0% in August. The drop in prices for energy and raw materials should soon translate into a drop in total inflation. Economic difficulties are added to disinflationary pressures.
- The index on monetary conditions increased sharply recently in tandem with the yen's appreciation. The reversal of carry trade positions due to tensions in financial markets explains the basics of these currency movements. The yen should return to values that better represent Japan's economic weakness once the markets have calmed down. An intervention on currency markets is not excluded in the short term.

Forecasts: The recession is taking hold in Japan and disinflationary pressures are becoming more pronounced. The most likely scenario for Japan's monetary policy is to hold its key rate at 0.3% for the time being. However, a return to 0% and a quantitative monetary policy could win out if the situation were to be aggravated further than anticipated and if other central banks, especially the Federal Reserve, elect to lower their key interest rates to approximately 0%.

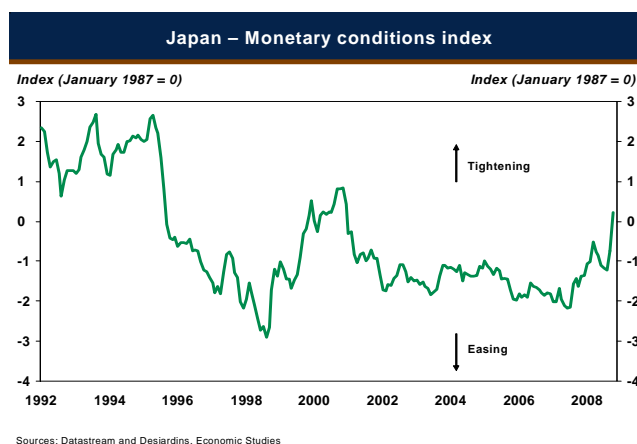
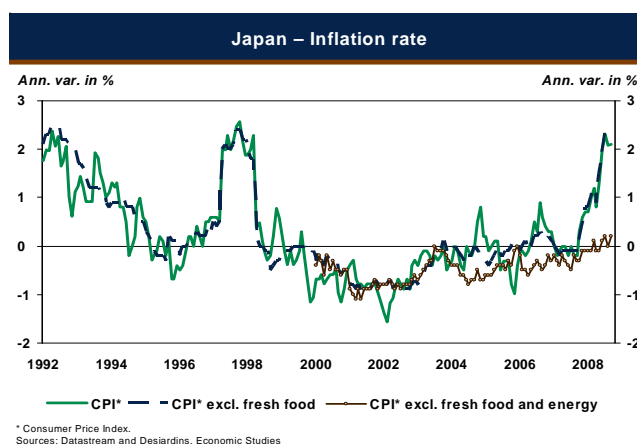
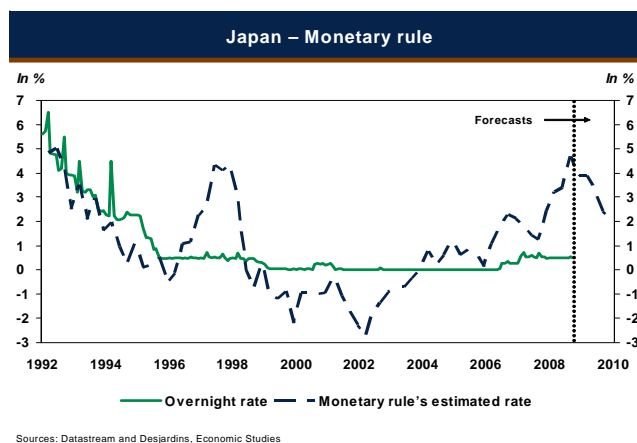


Table 1
Key interest rates

End of period in %	2007				2008				2009			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4f	Q1f	Q2f	Q3f	Q4f
United States												
Federal funds	5.25	5.25	4.75	4.25	2.25	2.00	2.00	0.75	0.50	0.50	0.50	0.50
Canada												
Overnight funds	4.25	4.25	4.50	4.25	3.50	3.00	3.00	2.00	1.50	1.25	1.25	1.25
Euro zone												
Refinancing rate	3.75	4.00	4.00	4.00	4.00	4.00	4.25	3.25	2.75	2.25	2.25	2.25
United Kingdom												
Base rate	5.25	5.50	5.75	5.50	5.25	5.00	5.00	4.00	3.50	3.00	3.00	3.00
Japan												
Overnight funds	0.50	0.50	0.50	0.50	0.50	0.50	0.54	0.30	0.30	0.30	0.30	0.30

f: forecasts

Sources: Datastream and Desjardins, Economic Studies

Table 2
Schedule and key rates

Date	Central Bank	Decision	Rate
September 2008			
4	Bank of Sweden	+25 b.p.	4.75
12	Reserve Bank of New Zealand	-50 b.p.	7.50
19	Bank of Brazil	+75 b.p.	13.75
16	Bank of Japan	s.q.	0.50
20	Federal Reserve	s.q.	2.00
25	Swiss National Bank	s.q.	2.75
25	Bank of Mexico	s.q.	8.25
24	Bank of Norway	s.q.	5.75
October 2008			
2	European Central Bank	s.q.	4.25
6	Reserve Bank of Australia	-100 b.p.	6.00
6	Bank of Japan	s.q.	0.50
8	European Central Bank	-50 b.p.	3.75
8	Bank of England	-50 b.p.	4.50
8	Bank of Sweden	-50 b.p.	4.25
8	Bank of Canada	-50 b.p.	2.50
8	Swiss National Bank	-25 b.p.	2.50
8	Federal Reserve	-50 b.p.	1.50
15	Bank of Norway	-50 b.p.	5.25
17	Bank of Mexico	s.q.	8.25
21	Bank of Canada	-25 b.p.	2.25
22	Reserve Bank of New Zealand	-100 b.p.	6.50
23	Bank of Sweden	-50 b.p.	3.75
29	Bank of Norway	-50 b.p.	4.75
29	Bank of Brazil	s.q.	13.75
29	Federal Reserve	-50 b.p.	1.00
30	Bank of Japan	-20 b.p.	0.30
November 2008			
3	Reserve Bank of Australia	-75 b.p.	5.25

s.q.: status quo; b.p. : basis points
Source: Desjardins, Economic Studies
Table 3
Coming soon

Date	Central Bank
November 2008	
6	Bank of England
6	European Central Bank
20	Bank of Japan
28	Bank of Mexico
December 2008	
1	Reserve Bank of Australia
3	Reserve Bank of New Zealand
4	Bank of England
4	European Central Bank
9	Bank of Canada
10	Bank of Brazil
11	Swiss National Bank
16	Federal Reserve
17	Bank of Sweden
18	Bank of Japan
January 2009	
8	Bank of England
15	European Central Bank
20	Bank of Canada
21	Bank of Brazil
22	Bank of Japan
28	Federal Reserve
29	Reserve Bank of New Zealand
February 2009	
3	Reserve Bank of Australia
4	Bank of Norway
5	Bank of England
5	European Central Bank
10	Bank of Sweden

Source: Desjardins, Economic Studies

TECHNICAL ANALYSIS

U.S. 10-YEAR RATES

In April 2008, the downward trend to close to 200 basis points that started in June 2007 was shattered. Since the start of 2008, rates have fluctuated within a fairly wide range of close to 100 basis points (3.25% - 4.30%). However, since September 2008, the rates seem to be trending upwards. The target is close to 4.3%.



U.S. 2-YEAR - 10-YEAR CURVE

The slope started to shift upwards at the start of 2007 when market stakeholders expected the Federal Reserve to cut its rates. We have noted that the highest level, reached in 2003, was 274 basis points. The key interest rate is currently 1%, as it was in 2003-2004, and further reductions are all but assured. Based on this hypothesis, and after seeing some resistance at around 238, the peak of 275 points could be tested once again.



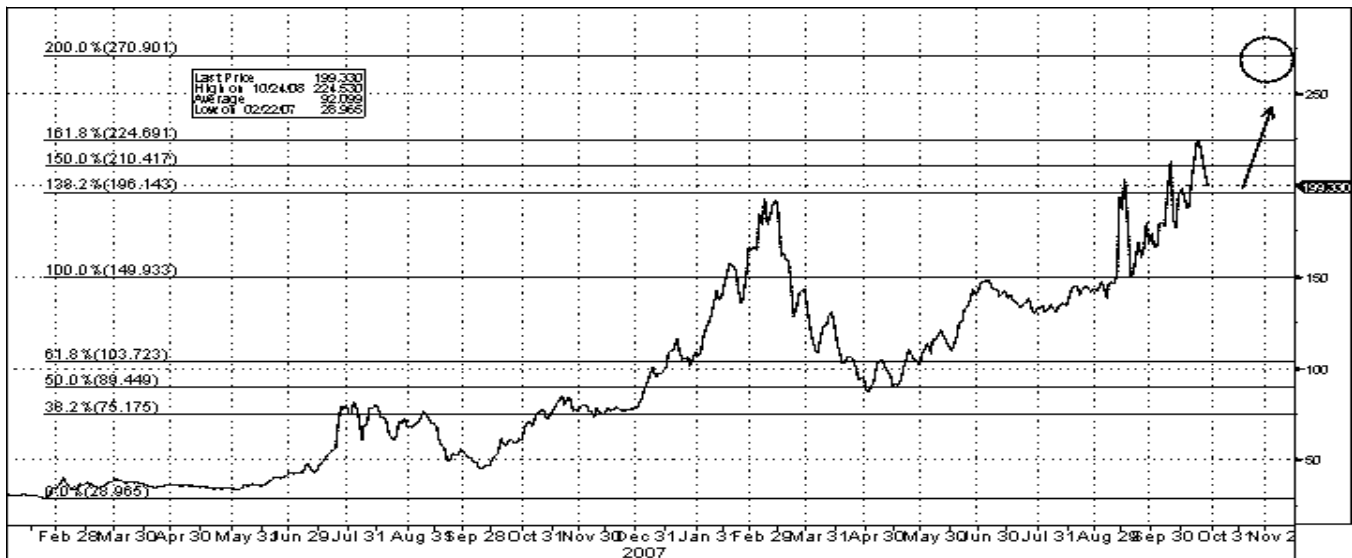
2-YEAR SPREAD - U.S. AND GERMANY

After hitting a peak of 225 basis points in June 2008, the spread between two-year rates in Germany and the U.S. started to shrink. Market stakeholders expect the European Central Bank to continue to cut its key interest rate, which would accelerate shrinking. It bears noting that a key interest rate of 3.75% in Europe is relatively high compared to the rate in the United States (1%). Support for the trend that began in 2006 was levelled off, bringing the next level to 70 points. If this Fibonacci level is crossed, a consolidation at around 20 points would be possible – a level that represents 50% of the total movement.



CREDIT SPREADS (CDX IG 5-YEAR INDEX)

Fluctuations in credit spreads have been relatively broad since the start of this crisis. However, an upward trend has been clearly defined. A range between 190 and 225 basis points could act as the consolidation zone, whereas the Fibonacci projections show that a peak of 275 basis points is not unlikely.

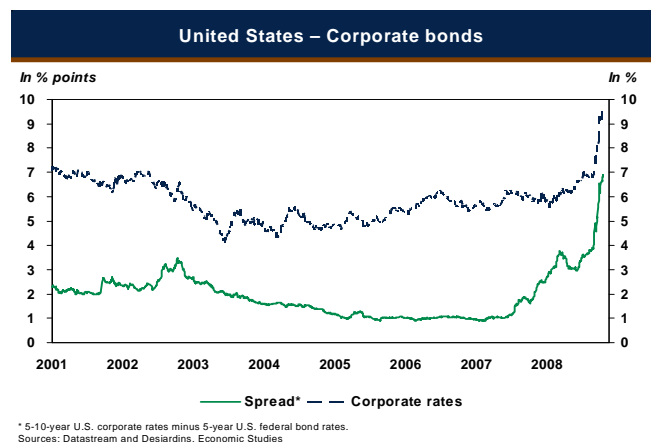
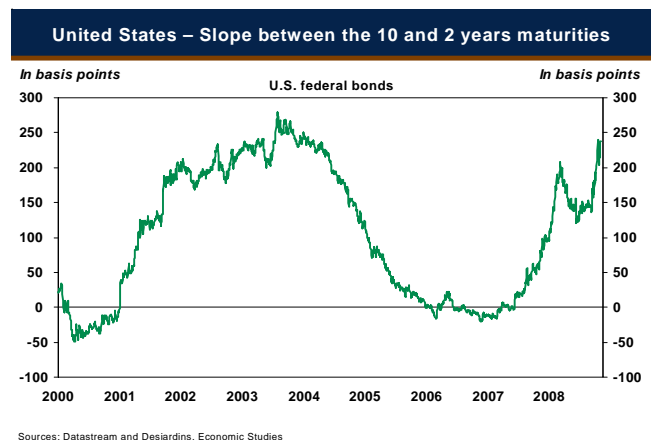
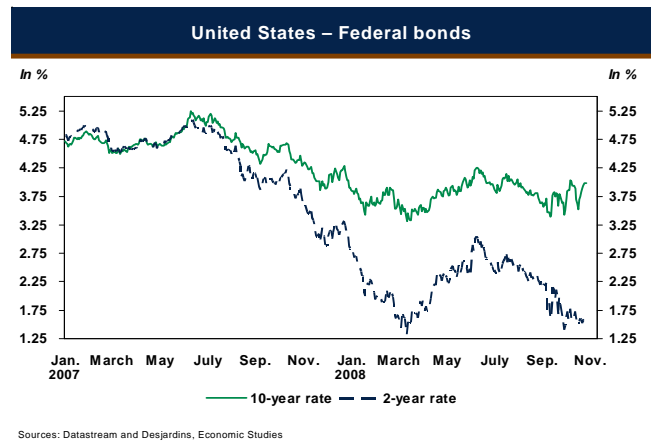


FIXED INCOME MARKET

Safe haven securities still popular

U.S. FEDERAL BONDS

- Financial pressures coupled with the growing likelihood of a global recession boost the U.S. bond market.
- The short portion of the yield curve kept its momentum these past few weeks. The 2-year rates dipped under 1.5% for the first time since March 2008, or a drop of approximately 150 basis points since reaching its cyclical peak in mid-June. Now that the Federal Reserve (Fed) is in monetary easing mode, the short portion of the bond curve is testing the cyclical low point (1.23%) reached last March. For the time being, the stabilization of two-year rates at close to 1.50% signals that the Fed is nearing the end of its monetary softening. However, the inefficiency of the current monetary policy in the U.S. due to difficult credit conditions could require the Fed to do more than the 25-basis point cut expected in December.
- Market concerns about potential increases to the U.S. debt had downward repercussions on longer maturities, pushing 10-year bond rates up briefly from 3.40% in mid-September to a peak of 4.04% in mid-October. Since then, the risks of an economic slowdown and the absence of inflationary pressures pushed the rate down to close to 3.60%, but the upward trend has remained intact, bringing the 10-year rate to over 3.90%. With the Fed on the verge of having little ammunition, the option of printing more money (monetizing the debt) is becoming more of a possibility. The effect on inflationist expectations should in fact push 10-year bond rates higher.
- The economic and financial environment is still in keeping with a deepening of the yield curve. The spread between the 2-year rates and 10-year maturities reached more than 240 basis points by mid-October. The recent drop in the 10-year rates brought the slope back down to close to 225 basis points. The slope will remain high in our opinion, with a strong likelihood that it will heighten in the short term rather than flatten.



CANADIAN FEDERAL BONDS

- Canadian federal bond rates have suffered many downward pressures in the past few weeks. The deepening financial turmoil and the darkening economic outlooks around the globe pumped up demand for safe havens. The spectacular correction in the price of raw materials has dampened concerns about inflation. Lastly, the Bank of Canada (BoC) cut its key interest rate by 75 basis points in October.
- The decline in the two-year rate ramped up in the past few weeks, moving from 2.78% to about 2.10% since the end of September. This rate is now about 15 basis points lower than the overnight funds rate due to the expectation that the BoC will continue to lower its rates in the months ahead. The 10-year rate was much more stable despite the drop in inflationary pressures. The influence of long rates in the U.S., which seem to be supported by the U.S. government's need for massive financing, and, to a lesser extent, the deterioration of Canada's budget, could explain why long-term Canadian securities did not benefit from the financial turbulence these past few months. The Canadian slope between 10- and 2-year maturities jumped to over 160 basis points, reaching a new peak since September 2004.
- Despite the sharper cuts to the key interest rate in the U.S. in October, the spread in the two-year rates in Canada and the U.S. has shrunk by almost 30 basis points since the end of September. This reflects the sharp change in the discourse of Canada's monetary authorities. Furthermore, the BoC has more leeway to keep softening its monetary policy while the key interest rate in the U.S. is rapidly approaching zero. After rising over 25 basis points in mid-October, the negative spread between the Canadian and U.S. 10-year rates has dwindled in the last few days. The greenback's strong rebound appears to be bumping up demand for U.S. bonds, offsetting somewhat the precarious fiscal situation in that country.

Forecasts: We believe the weak bond rates in Canada are fully justified given the grim economic and financial situation worldwide and the drop in inflationary pressures. Rates could potentially fall even further in the months to come, to better reflect the disinflationary economic and financial environment.

Canada – Federal bonds



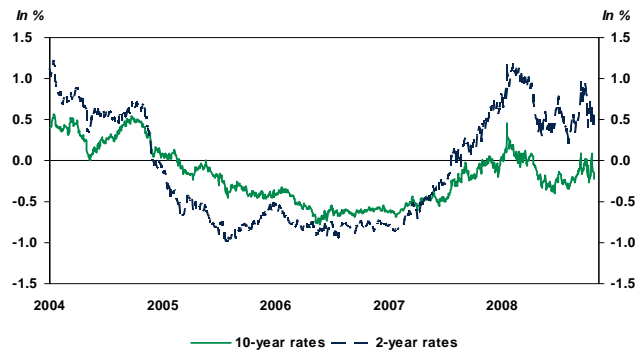
Sources: Datastream and Desjardins, Economic Studies

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

- The financial crisis that unravelled to almost unprecedented levels in September had an adverse effect on higher-risk bonds vs. federal government bonds. Corporate bond rates increased sharply since mid-September while financial problems and the risk of recession could see the number of business bankruptcies grow. Provincial bond rates have also increased since the crisis intensified. The spread between federal and provincial 10-year rates jumped to more than 120 basis points for all provinces. There was little difference in the spreads between the different provincial securities.
- The economic outlook for all provinces is not very encouraging. The Q2 jump in real GDP in Québec and Ontario allowed both of these provinces to skirt a recession, but they are not out of the woods yet. The sharp downturn in U.S. domestic demand will continue to halt the manufacturing sector despite the recent drop in the loonie's value. The western provinces will not be spared: the spectacular correction in the price of raw materials and a housing market that has now run out of steam will slow growth.
- The consequences of this economic downturn are starting to have an impact on public finances. The government of Ontario now projects a deficit of \$500M for fiscal 2008-2009. In Québec, the budget is expected to be updated later today. Given the total budgetary reserve that has grown over the past two fiscal years, a balanced budget is all but assured for 2008-2009 and 2009-2010.

Forecasts: In the short term, rate spreads between provincial and federal securities will continue to reflect shifts in financial tensions. Other severe movements are likely. Despite the increased risk that some provinces will post slight deficits, the situation is not alarming and in normal circumstances it wouldn't even justify the current rate spreads. Provincial bonds will therefore continue to entice investors seeking medium- and long-term investments.

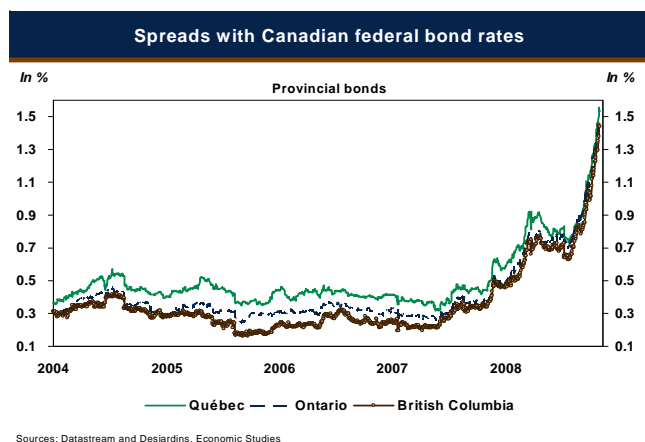
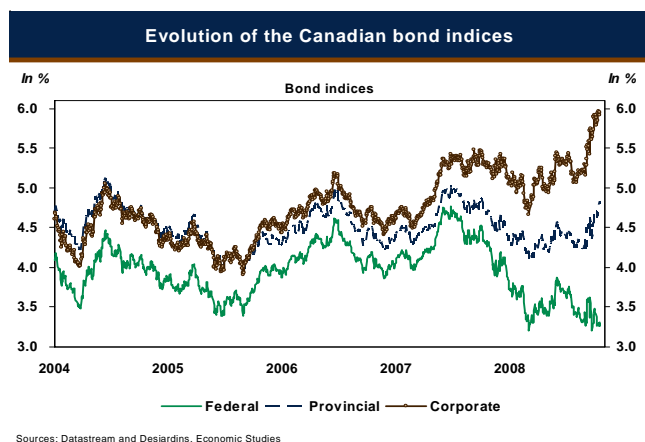


Table 4
Canada: public finance of the federal and provincial governments

	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	9,597	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	-67	-170	-0.5	34.4	A+	Aa2
New Brunswick	87	19	0.1	28.9	AA-	Aa1
Québec	1,695	-278	-0.1	55.3	A+	Aa2
Ontario	600	-500	-0.1	26.4	AA	Aa1
Manitoba	576	96	0.2	30.4	AA	Aa1
Saskatchewan	1,282	3,020	5.9	26.5	AA	Aa1
Alberta	4,581	8,533	3.3	0.0	AAA	Aaa
British Columbia	2,886	1,770	0.9	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	Q3	Q4f	Q1f	Q2f	Q3f	Q4f
Key rate												
Federal funds	5.25	5.25	4.75	4.25	2.25	2.00	2.00	0.75	0.50	0.50	0.50	0.50
Treasury bills												
3-month	5.04	4.82	3.82	3.36	1.38	1.90	0.92	0.50	0.50	0.50	0.50	0.70
Federal bonds												
2-year	4.58	4.87	3.96	3.07	1.62	2.61	1.99	1.30	1.60	1.70	2.20	2.40
5-year	4.54	4.93	4.23	3.46	2.47	3.33	2.98	2.50	2.60	2.70	2.90	3.20
10-year	4.65	5.03	4.58	4.03	3.43	3.98	3.79	3.60	3.60	3.60	3.70	4.00
30-year	4.85	5.13	4.83	4.45	4.30	4.53	4.30	4.10	4.10	4.15	4.20	4.30
Yield curve												
5-year - 3-month	-0.50	0.11	0.41	0.10	1.09	1.43	2.06	2.00	2.10	2.20	2.40	2.50
10-year - 2-year	0.07	0.16	0.62	0.96	1.81	1.36	1.81	2.30	2.00	1.90	1.50	1.60
30-year - 3-month	-0.19	0.31	1.01	1.09	2.92	2.63	3.38	3.60	3.60	3.65	3.70	3.60

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	Q3	Q4f	Q1f	Q2f	Q3f	Q4f
Key rate												
Overnight funds	4.25	4.25	4.50	4.25	3.50	3.00	3.00	2.00	1.50	1.25	1.25	1.25
Treasury bills												
3-month	4.18	4.43	3.98	3.83	1.88	2.50	1.90	1.75	1.40	1.25	1.25	1.40
Federal bonds												
2-year	3.98	4.58	4.08	3.74	2.63	3.25	2.79	1.80	2.00	2.00	2.40	2.60
5-year	4.01	4.56	4.21	3.87	2.91	3.46	3.17	2.65	2.60	2.70	2.90	3.20
10-year	4.11	4.55	4.34	3.99	3.43	3.74	3.76	3.60	3.60	3.70	3.80	3.90
30-year	4.20	4.49	4.45	4.10	3.94	4.08	4.23	4.10	4.10	4.15	4.20	4.30
Yield curve												
5-year - 3-month	-0.17	0.13	0.23	0.04	1.03	0.96	1.27	0.90	1.20	1.45	1.65	1.80
10-year - 2-year	0.13	-0.03	0.26	0.25	0.80	0.49	0.97	1.80	1.60	1.70	1.40	1.30
30-year - 3-month	0.02	0.06	0.47	0.27	2.06	1.58	2.33	2.35	2.70	2.90	2.95	2.90
Spreads (Canada - U.S.)												
3-month	-0.86	-0.39	0.16	0.47	0.50	0.60	0.98	1.25	0.90	0.75	0.75	0.70
2-year	-0.60	-0.29	0.12	0.67	1.01	0.63	0.80	0.50	0.40	0.30	0.20	0.20
5-year	-0.53	-0.37	-0.02	0.41	0.44	0.13	0.19	0.15	0.00	0.00	0.00	0.00
10-year	-0.54	-0.48	-0.24	-0.04	0.00	-0.24	-0.03	0.00	0.00	0.10	0.10	-0.10
30-year	-0.65	-0.64	-0.38	-0.35	-0.36	-0.45	-0.07	0.00	0.00	0.00	0.00	0.00

f: forecasts

Sources: Datastream and Desjardins, Economic Studies