

The surge in the debt concerns markets

HIGHLIGHTS

- Concerns about financing the colossal government's budget deficits announced by the G7 countries is pushing the bond market to opt for prudence.
- However, four important points should help maintain interest rates at lower levels in 2009:
 - A severe recession, and a tepid recovery
 - The acceleration by deflationary forces
 - The Federal Reserve's quantitative policy is not inflationary
 - Strong demand for Treasuries
- The European Central Bank signals its intention to stay on the line in February, but interest rates convergence toward zero continues amongst large industrialized nations.
- Japan's economy is not doing well and a period of slight deflation seems inevitable. The BoJ's strategy differs from quantitative easing and it should keep its key rate at 0.10% until the end of this year.

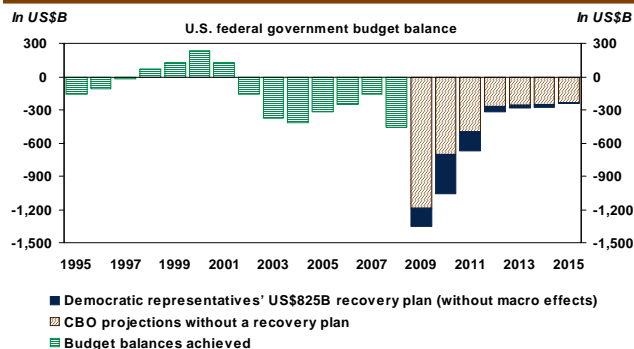
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Summary

The situation in the United States remains strained. The optimism induced by the changing of the guard in Washington did not last, with the bad news from the banking system quickly taking the financial markets back into turmoil. The outlines of the Obama recovery plan have been unveiled and there is a consensus that this will do something to limit the ongoing downturn, but the difficulties involved in spending US\$825B efficiently suggest that the impacts will mainly be felt in 2010 (graph 1).

Graph 1 – The crisis, its impacts and authorities' response lead to substantial deterioration in the public finances



Sources: U.S. Treasury, Office of Management and Budget, Congressional Budget Office, and Desjardins, Economic Studies

In the meantime, the American budget deficit, in combination with all of the jump-start efforts being made by industrialized nations, represents a colossal total; financing it is a substantial concern for the markets. This situation is being exacerbated by the misfortunes of some major American banks and especially British banks, whose astronomical losses attest to worldwide contagion. Fears of nationalization created a shockwave that took stock prices and, in particular, bank indexes sharply down. The rumours regarding another bailout plan and the possibility of creating "bad banks" to be overseen by the FDIC helped to keep the markets from going completely off the rails again.

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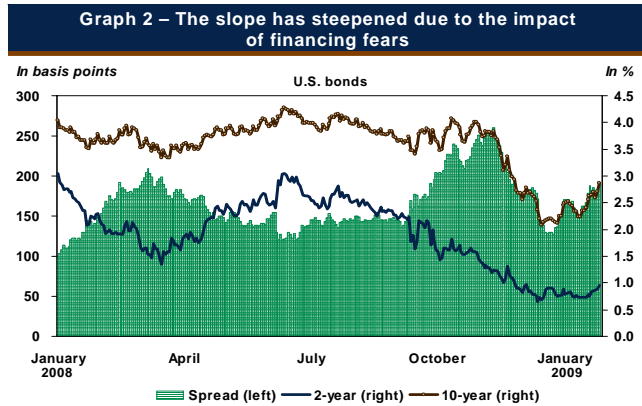
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NOTE TO READERS: The letters **k**, **M** and **B** are used in texts and tables to refer to thousands, millions and billions respectively.

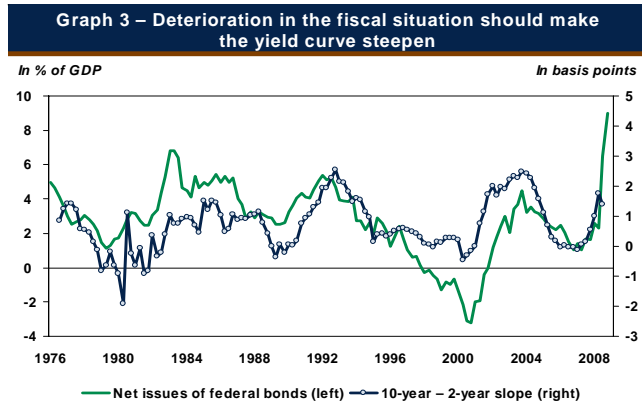
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With two-year bond rates well entrenched at around 0,80%, the market's response has been to drive longer-term rates up. Rates on ten-year bonds thus went from a low of 2.00% at the end of December 2008 up to 2.70% in the last week of January (graph 2).



Sources: Datastream and Desjardins, Economic Studies

Of course, all else being equal, economic theory suggests that an increase in the debt supply is compatible with an increase in real interest rates¹. However, that is primarily a long-term relationship and the rule is sometimes broken. The current period is a good example of this. Judging by the U.S. budget deficit's rapid deterioration, the interest rate slope should be a lot steeper (graph 3). In fact, however, all else is *not* equal and the critical situation the United States is in is not compatible in the short term with an increase in interest rates.



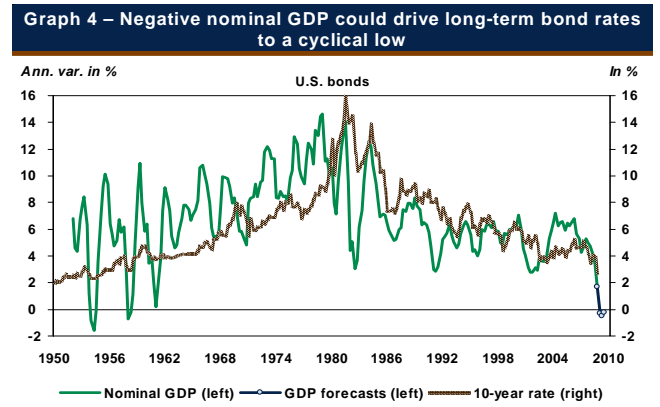
Sources: Federal Reserve Board and Desjardins, Economic Studies

¹ For a given level of demand, increasing the debt supply must occur through a decrease in prices which, conversely, is compatible with interest rate increases.

The bond market remains guarded, preferring to trade within a tight range, but there is still a strong likelihood of lower rates. In 2009, four major points will keep interest rates at low levels:

1. Severe recession, tepid recovery
2. Acceleration by deflationary forces
3. The Federal Reserve's (Fed) quantitative policy is not inflationary
4. Strong demand for Treasuries

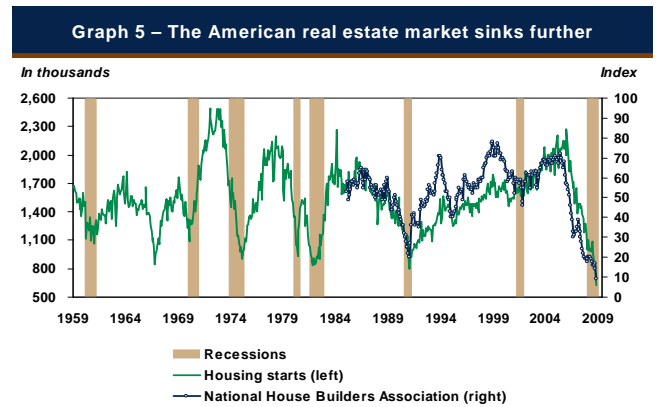
Under these circumstances, the economic and financial context will continue to be marked by negative nominal growth, a situation that is compatible with bond rates at historic lows (graph 4).



Sources: Datastream and Desjardins, Economic Studies

SEVERE RECESSION, TEPID RECOVERY

The latest economic data are still grim. The housing market's slide is taking on bottomless proportions, with the lowest level of starts ever recorded and unparalleled pessimism among American home builders (graph 5).

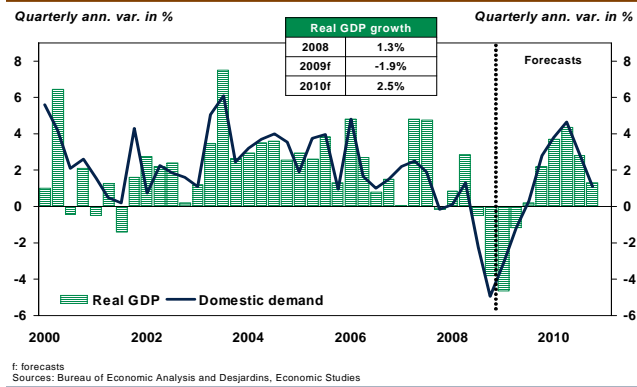


Sources: Datastream and Desjardins, Economic Studies

Because of a drop in mortgage rates, the refinancing market is more active, but nothing suggests that the real estate market is about to stabilize. The inventory of unsold homes is still too large and the economic problems and job losses are doing nothing to help. Moreover, confidence is at a low ebb and the leading indicator's timid rise in December cannot be read as a trend change.

Given the lack of traditional growth drivers (construction, consumption and investment), the economic recovery promises to be tepid, at best (graph 6).

Graph 6 – American domestic demand will be soft into 2010



Sources: Bureau of Economic Analysis and Desjardins, Economic Studies

ACCELERATION BY DEFLATIONARY FORCES

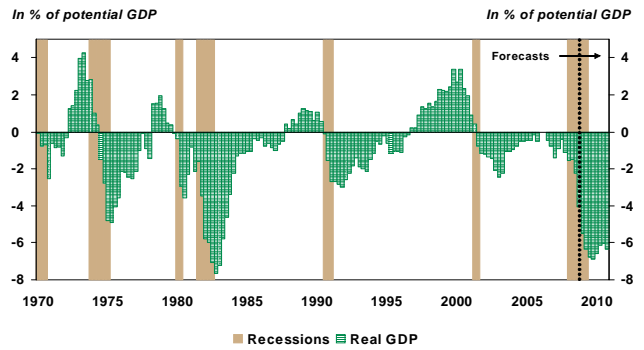
Against the backdrop of surplus production capacity, bank deleveraging, a return to savings and massive job losses, deflation will remain 2009's dominant theme.

A reflection of the big correction in energy prices, the annual change in the American total consumer price index had already tumbled to a low of 0.1% in December 2008, the lowest level since 1955. What is most troubling though is the pace at which the activity level observed is distancing itself from the U.S. economy's potential level. After over a year of recession, the economy is now evolving at more than 4% under potential GDP; our forecasts suggest that the gap could widen quickly to almost 6% and stay there until the end of 2010 (graph 7).

Moreover, nominal wage growth is already slowing steeply and the labour market's rapid deterioration should intensify the downward pressures (graph 8).

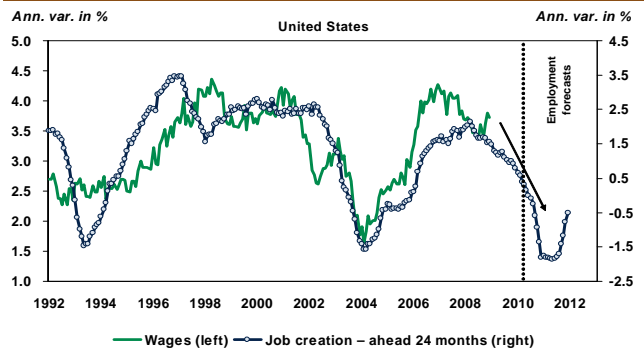
Following the inflationary fears associated with the July 2008 surge by oil prices, the possibility of inflation that is under the Fed's comfort zone will be a source of concern in the next few quarters.

Graph 7 – The output gap in the United States will reach record proportions



Sources: Bureau of Economic Analysis and Desjardins, Economic Studies

Graph 8 – Wage growth should slow further



Sources: Datastream and Desjardins, Economic Studies

“In light of the declines in the prices of energy [...] and the prospect for considerable economic slack [...] inflation pressures will remain subdued in the coming quarters. Moreover, the Committee sees some risk that inflation could persist for a time below rates that best foster economic growth and price stability in the longer term.”

THE FED'S QUANTITATIVE POLICY IS NOT INFLATIONARY

For some, the Fed's rapidly expanding balance sheet is evidence that it is using the money printer, an action that is inevitably inflationary over the medium range. In fact, nothing is less certain. First, the degree to which the Fed is using the printing press to finance its credit action is unclear. According to the Fed, the various credit facilities set up in the last few months have led to a considerable increase in financial institutions' excess reserves. However, it is hard to pinpoint the source of the funds used to finance its operations. It could be that, as a precaution, banks prefer to take advantage of the Fed's remuneration policy rather than lending their excess funds to other financial institutions or their clients. In

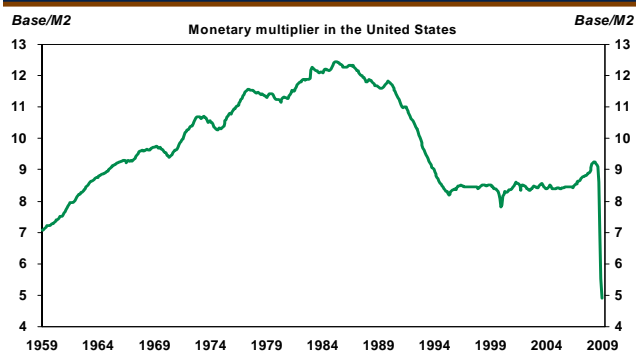
this case, the Fed is simply playing its role as a lender of last resort by redistributing funds to where it can help make the markets run smoothly again.

Given the speed at which the Fed's balance sheet is expanding, it is clear that it will increasingly be resorting to the money printer. Here, the Fed has reiterated that it intends to use all the tools at its disposal to promote a return to lasting economic growth.

“The focus of the Committee’s policy is to support the functioning of financial markets and stimulate the economy through open market operations and other measures that are likely to keep the size of the Federal Reserve’s balance sheet at a high level.”

In any event, what we must remember is that, for now, the Fed's policy is not inflationary. The drastic expansion of the Fed's balance sheet has had sizeable repercussions for the monetary base, but the tightened credit conditions mean that banks are not inclined to lend funds. Under these circumstances, the money multiplier has plummeted in recent weeks (graph 9).

Graph 9 – The monetary multiplier is decreasing due to an increase in the coefficient of reserve



Sources: Federal Reserve and Desjardins, Economic Studies

STRONG DEMAND FOR TREASURIES

We must also take financing conditions into account. Over the longer range, government debt could have a crowding-out effect on business investment; in the immediate future, however, the Treasury is, in a way, standing in for consumers and business. Beyond the tightened credit conditions that are making retail rates and corporate credit spreads much less appealing, the tough economic situation and deflation forces in play are prompting the private sector (aside from the banks, which are desperately seeking capital) to limit its debt loads. The most concrete example of this is the shrinking credit given to households over the months of October and November 2008.

In a context of strong demand for no-risk securities, U.S. households' return to savings suggests that the government deficit will easily be financed by the domestic economy.

Moreover, the improvement to the current account shows that needs for foreign financing are smaller than they used to be². Yet the expanding budget deficit could quickly turn the recent trend around. It should also be said that, in a context in which the growth of recent years was broadly based on the relationship between the American consumer and Asian manufacturers, it would be hard for emerging nations such as China not to support the greenback. The lightning increase in net purchases of U.S. Treasury securities by Chinese authorities at the centre of the turmoil really underlines this effect (graph 10).

Graph 10 – Demand for American government securities is elevated



* Total over 12 months.
Sources: Datastream and Desjardins, Economic Studies

CANADA: A BUDGET PLAN THAT SHOULD MINIMIZE THE RECESSION

In all likelihood, the Canadian economy went into recession in the fourth quarter of 2008. This can be explained by the sharp worsening of economic conditions among industrialized countries (especially the United States), the harmful effects of the world financial crisis, the weakening of the demand for raw materials and the sharp slowdown of consumption and investment at home.

The budget tabled in January should reach and even exceed the objective of ending the current recession as quickly as possible. The effects of the budgetary measures on economic growth will be significant. According to the Department of Finance, the various measures of budget 2009 will add 1.4%

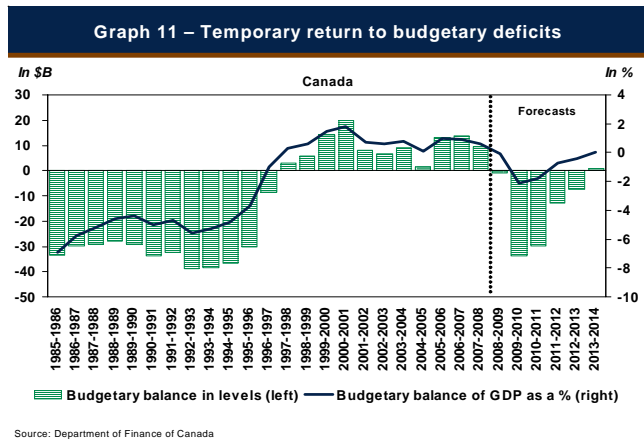
² The trade balance identity states that the current account balance must equal the capital account balance. As a result, the U.S. trade deficit must be financed by net inflows of foreign capital into the United States.

to the annual growth of real GDP by the end of 2010. With the funds raised thanks to the involvement of the provinces and municipalities, the growth of real GDP will be driven up by 1.9% by the end of 2010. Nevertheless note that because of the many constraints, some of the amounts announced today may in the end not be used.

With respect to assumptions concerning the future evolution of interest rates, the Department uses the consensus of forecasters. However, the assumptions include projections that are slightly higher than our own, especially with respect to short term rates. In our view, this could mean additional flexibility in the budgetary balances.

A FIRST INCREASE IN THE DEBT IN 11 YEARS

The debt, which represents the accumulated deficits of the federal government, reached \$457.6B as of March 31, 2008, i.e. a decrease of \$105.2B in comparison to its peak of March 31, 1997. For the first time in over 10 years, this downward trend will be reversed with a slight increase in 2008-2009. The important budgetary deficits anticipated for 2009-2010 and 2010-2011 will amplify the increase of the federal government’s debt over the coming years. It could reach \$542.4B as of March 31, 2013, which is a cumulative increase of \$84.8B (graph 11). A good share of repayments made over the last decade could then be erased.

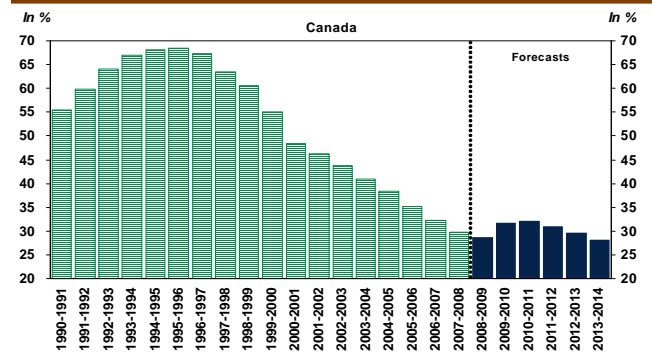


Source: Department of Finance of Canada

That said, the situation is not as catastrophic as it appears. First, it is acceptable that the budgetary balances of a government worsen in periods of crisis, if of course it is a temporary situation, time for economic growth to improve. This helps the government to play its role as an economic stabilizer. By the way, most industrialized countries are currently in the same situation. Second, even of the government’s debt will increase significantly over the coming years, its relative importance will remain fairly limited. The dept-to-GDP ratio will increase to 32.1% in 2010-2011 (a slight

decrease is expected afterwards) compared to 29.8% in 2007-2008. This ratio reached a peak of 68.4% in 1995-1996, a level that showed a much higher debt load relatively speaking (graph 12). In addition, Canada will maintain a favourable variance in comparison to the average of G7 countries with respect to the relative importance of its public debt.

Graph 12 – Federal debt-to-GDP ratio



Sources: Department of Finance of Canada and Desjardins, Economic Studies

FINANCIAL MARKETS WILL EASILY ABSORB THIS ADDITIONAL DEBT

The federal government will easily finance its budgetary deficits and the 100B\$ rise over two years in financial requirements (mainly for its mortgage repurchases) on financial markets by maintaining a relatively favourable balance sheet as far as debt is concerned and by combining it with the attractiveness of federal securities considered without risk. The outstanding debt of Treasury bonds could increase by \$29B between 2008-2009 and 2009-2010. The outstanding debt of marketable bonds should increase by \$54B over the same period. So the share of the fixed-rate debt will significantly decrease, from 63% in 2007-2008 to 56% in 2009-2010. As a result, the government will benefit more from the exceptionally low level of short term interest rates. However, the increase in the number of prime-quality government securities available in financial markets could eventually lead to a slightly higher level in interest rates when the economic recovery will have clearly started.

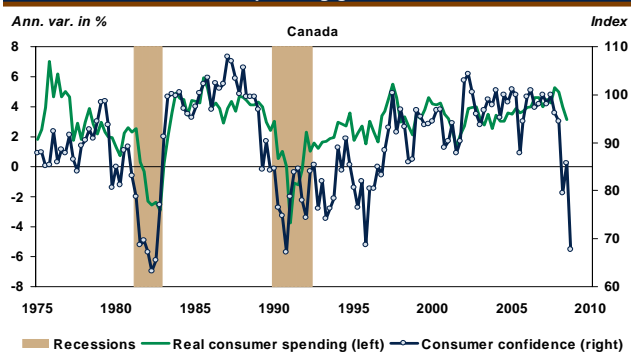
IS THE BANK OF CANADA OPTIMISTIC TOO MUCH?

Like most forecasters, the monetary authorities agree that Canada’s economy entered a period of recession in Q4 of 2008. The Bank of Canada (BoC) diverges in its stance on the recovery to follow the recession. With an average increase of 3.8% in real GDP for 2010 overall, the BoC’s scenario is clearly more optimistic than that of most forecasters in the private sector. According to the BoC, the expected recovery of financial conditions, the stimulus provided by cuts to key interest rates and injections of liquidity, the support provided

by the government’s plan to kick-start the economy and the drop in the loonie should contribute massively to economic growth as of mid-2009.

The BoC expects consumer spending to contribute massively to real GDP growth in 2010. Given the very low level of household confidence noted in Canada at the moment (graph 13), this will require a major reversal of the current situation. Such an improvement will not be possible until the financial markets get back to normal. If the situation has shown some slight improvement in the past few weeks, it is still too soon to hope for a full recovery in the near term.

Graph 13 – Drop in household confidence will rein in consumer spending growth



Sources: Conference Board of Canada, Statistics Canada and Desjardins, Economic Studies

From a monetary policy management point of view, the risks in our opinion remain largely tilted toward the downside. To limit the severity of the recession in Canada and bring core inflation back in line with the mean target in the medium term, it appears obvious that other rate cuts will be made in the months ahead. We anticipate a rate of 0.50% as of March 2009.

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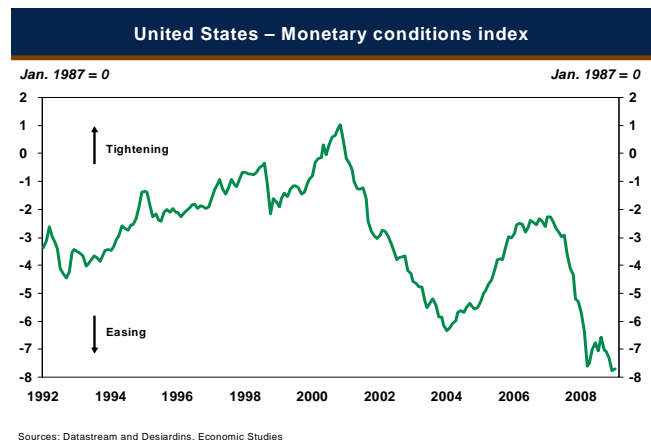
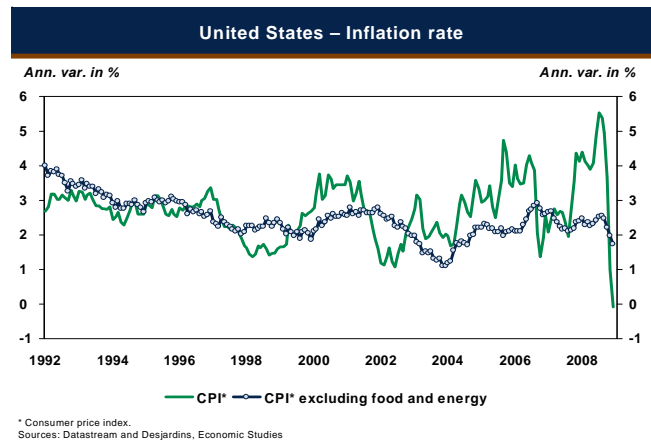
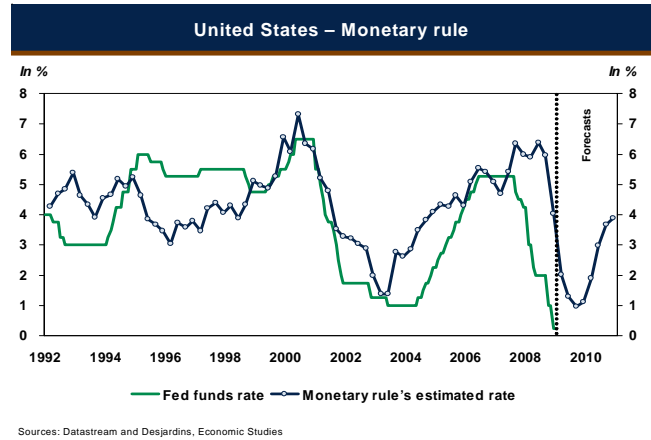
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FEDERAL RESERVE

As key rates are almost zero, the Fed moves ahead with its other actions

- To no one's surprise, the Federal Reserve's (Fed) leaders decided to keep the target interest rate for federal funds in the 0.00% to 0.25% range. As key rates are already at a point at which they can go no lower, traditional monetary policy has been put aside, which does not mean that the Fed is sitting on its hands. It continues to use its balance sheet to provide financial institutions with liquidity and help the most fragile markets.
- The Fed's assets (and liabilities) expanded substantially last fall, in step with the proliferating measures to stabilize the credit market. In the statement that accompanied its January 28 decision, the Fed clearly indicated that its balance sheet remained elevated. It should also continue to buy up agency securities and mortgage-backed securities.
- The Fed will soon expand its presence in the consumer and small business debt-backed securities market to ease the pressures in these markets as well. The Fed also repeated that, if necessary, it intends to buy up long-term government securities to keep market rates low.
- All of the inflation fears that were with us halfway through 2008 have now dissipated. The annual change in the consumer price index (CPI) was just 0.1% in December, the lowest inflation rate since 1955. It could also temporarily go into negative territory in the next few months. Clearly, the main reason for the plunge is the sharp tumble by energy prices. The situation has calmed down since January began, however, especially for gas prices.
- Core inflation has also really moderated as well. In December, the CPI that excludes food and energy recorded an annual change of just 1.8%. The increase in the jobless rate, low production capacity utilization and widespread decline in global demand will continue to limit core inflation. The Fed's leaders even note a risk of inflation that stays too low.

Forecasts: It is fairly clear that the Fed will keep the target rate for federal funds at the current level (close to 0%) for some time to come. Given the weak economy and low inflation and the risks of further deterioration, it will maintain an accommodative monetary policy by continuing to take direct action in the markets through its balance sheet. It will thus remain elevated and could even expand further.

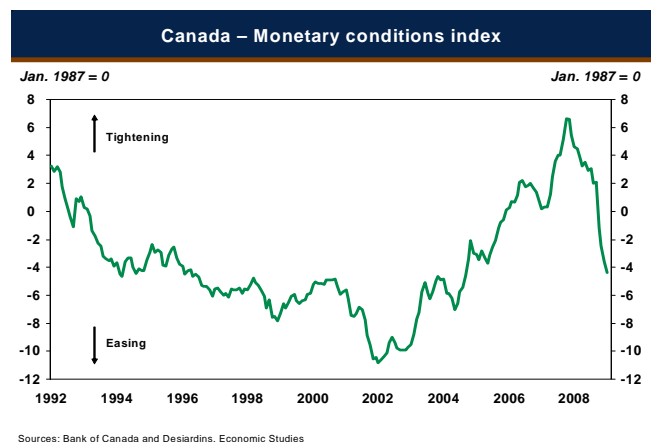
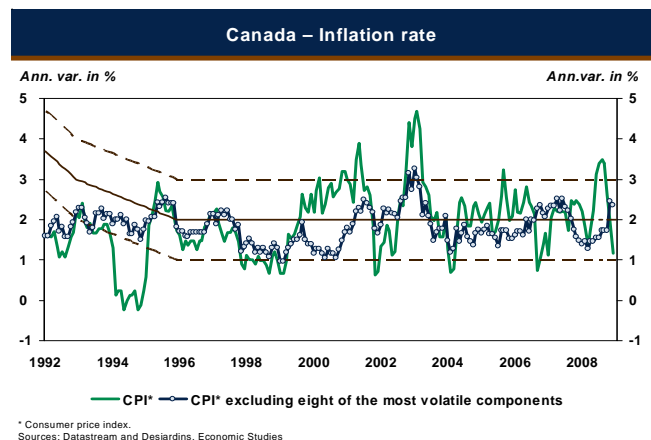
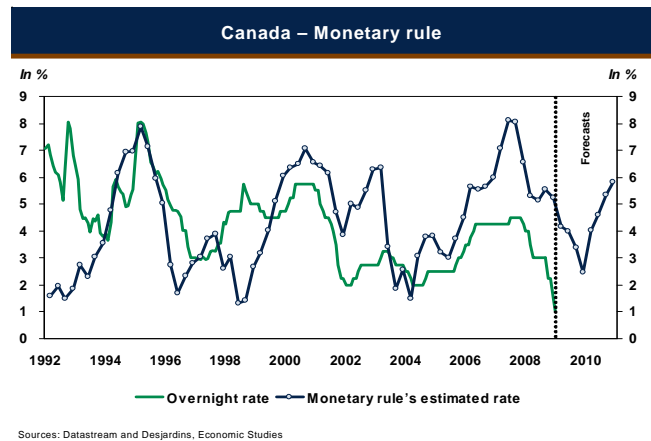


BANK OF CANADA

Monetary easing will continue

- As the broad majority of forecasters had anticipated, the economy's ongoing deterioration prompted the Bank of Canada (BoC) to lower its key rate to 1.00% in January, the lowest level ever recorded in the country. This takes the monetary stimulus ordered since last October to 200 basis points.
- We are at a point where a recession can no longer be avoided, but the impact of public policy will determine how much of a recovery will be seen by year's end. The BoC seems very optimistic about this point. Of course, efforts by monetary authorities (ongoing) and governments (announced) are unprecedented and should eventually lead to a big turnaround, but the tough financial context and rapid deterioration in the economic outlook call for prudence.
- Consumer confidence is nearing historic lows, the labour market is deteriorating quickly and the housing market is correcting in several parts of the country. Due to negative wealth effects, Canadian households are seeing their situations deteriorate and a tough period, characterized by tightening credit conditions, could force them to save more. The recession is now taking hold worldwide, so it is unlikely that demand for commodities will have a positive influence on Canada's economy in 2009.
- Under these circumstances, the Canadian economy's output gap will continue to deepen, completely wiping out inflation pressure in Canada as a result. With the sharp downturn in oil prices and the impacts of the economic downturn, the annual decline in total inflation is likely to hold below the BoC's target range (1% to 3%) until 2010, with an incursion below 0% in the first half of 2009.
- With a monetary policy not as effective as hoped for, given the credit crisis' impacts on retail rates, it has been necessary to lower the target for the key rate further to keep real interest rates as low as possible.

Forecasts: In our opinion, the risks are still broadly tilted to the downside. To limit the severity of the Canadian recession and get core inflation back into line with the mean target over the medium range, it seems clear that further rate cuts will be ordered in the next few months. We are now anticipating a rate of 0.50% as of March of 2009.

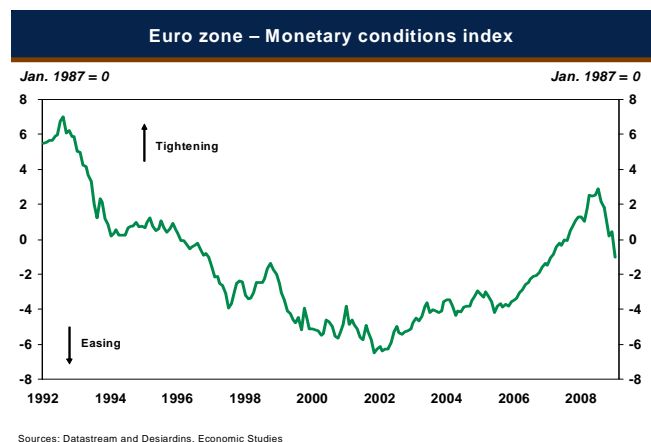
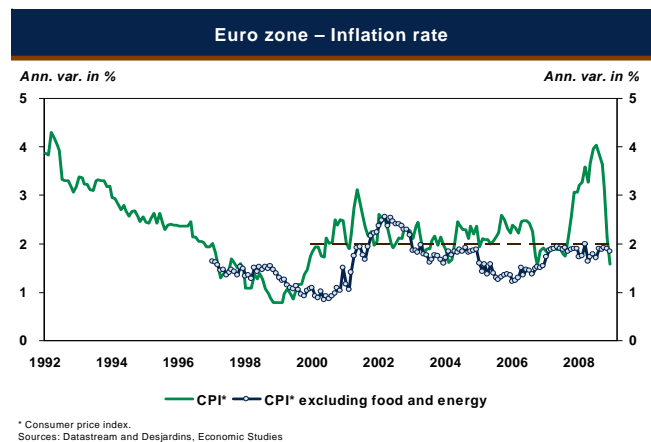
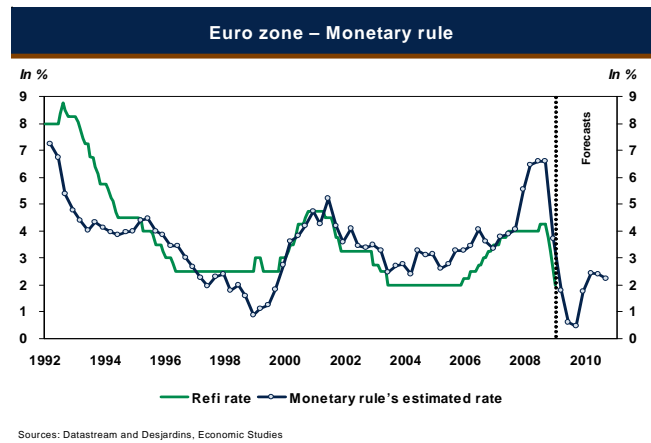


EUROPEAN CENTRAL BANK

A pause is possible in February, but more monetary stimulus is on the way

- To no one's surprise, the European Central Bank (ECB) eased its monetary policy further in January, lowering its key rate by 50 basis points to 2.00%. Although he never makes any definite promises for future meetings, President Trichet sent the markets a clear message. "Given that our decision-making meeting in February is only three weeks away, we do not deem it an important meeting for policy-making. The next important meeting will be in March." The ECB also judges that, after the latest rate cut, the risks to price stability are broadly balanced. Our monetary rule, however, indicates that the easing should continue.
- The latest statistics confirm that the recession, which began in the spring of 2008, will be painful. There is nothing to show that activity has stopped contracting: the consumer and business confidence indexes fell to historic lows in December. Despite a slight comeback in November, retail sales are still down on an annual basis and new car registrations continue to slump. Businesses are also hard hit, with production and new industrial orders sliding more steeply last November. In Germany, January's slight rebound of the IFO index is not enough to augur better days.
- Unlike the ECB, we do not think that the risks to price stability are balanced over the medium range. The risks of overly soft price growth are clearly dominant. The total annual inflation already fell to 1.1% in January, according to the flash estimate, and the commodities price correction indicates that the trend will continue until at least mid-2009. The strong wage growth recorded in the euro zone through much of 2008 should slow steeply now that the recession is impacting the job market. The jobless rate therefore went from 7.2% to 8.0% from March to December 2008. If the economic situation does not start to stabilize soon, ECB leaders will have to stop insisting that there is no deflation risk in the euro zone.

Forecasts: The ECB is now in a tough situation. On one hand, it cannot ignore the very serious difficulties that are pummeling the European economic and financial system. On the other, it is worried about taking its key rate too low, a move that could, in its view, introduce substantial economic distortions. The importance of this latter concern will dwindle as the risks of deflation grow. The ECB's dogmatism could make it take a break in February, but the deterioration in Euroland's economy should eventually force it to lower its key rate to 1.00%.



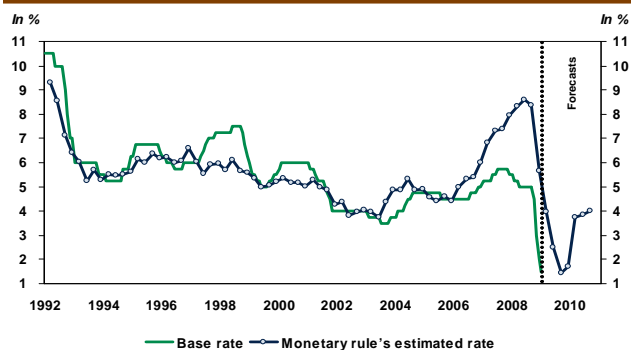
BANK OF ENGLAND

Heading for a key rate close to zero

- The Bank of England (BoE) lowered its key rate by 50 basis points in January, which put it at 1.50%, the lowest it has been since the BoE was founded in 1694. The huge 350 basis point drop in the key rate since early October and the pound sterling's collapse has led to a substantial decline in the monetary conditions index. However, this does not yet seem to be enough to stabilize Britain's economy.
- Our scenario of a severe recession in the United Kingdom is shaping up. The non-annualized 1.5% decline in real GDP in the fourth quarter is the biggest contraction in activity since the severe recession of the early 80s. The real estate sector, consumption and financial services are particularly hard hit by the crisis. Except for December's surprise—and unsustainable—jump in retail sales, all economic statistics are promising further substantial declines for the GDP in the first half of 2009.
- Britain's authorities are especially worried about the health of the financial sector. The government has thus just set up a second plan to support the banks, among other things by guaranteeing some asset-backed securities. The stock market did not receive the plan very well at first, as it tries to force participating banks to increase their lending and, for many people, confirms that more British financial institutions will have to be nationalized. The new measures, which also allow the BoE to buy several types of financial assets, have the backing of Governor Mervyn King, who believes that: "The first priority for policy is to fix the banking system so that it can resume its normal lending function."
- Inflation is still moderating in the United Kingdom. A third straight monthly pullback of the price index took the annual inflation rate to 3.1% in December, compared with a peak of 5.2% in September. Along with the collapse of commodity prices, inflation's decline reflects the temporary 2.5% cut to the sales tax. The pressure on prices will remain to the downside over the coming months and some surveys show that a number of businesses plan to freeze wages, or even cut them in some cases. Despite the rapid drop of Britain's key rate, the BoE's Governor recently confirmed that: "There remains a risk that inflation will fall below 2%."

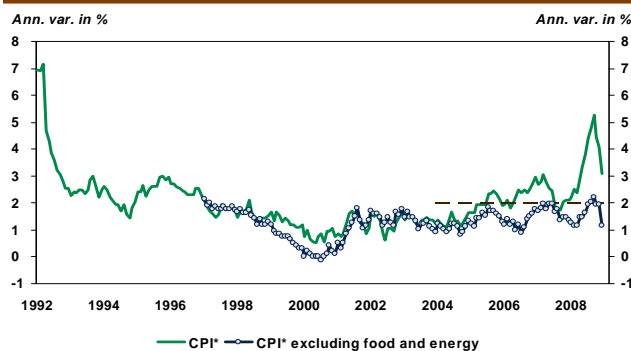
Forecasts: Monetary easing will move forward in the United Kingdom as the BoE wants to continue to support the economy and the financial system. As in the United States, Britain's monetary authorities acknowledge that they are preparing to use non-conventional measures once they can no longer use the key rate tool. The key rate should therefore be lowered to almost zero over the months to come.

United Kingdom – Monetary rule



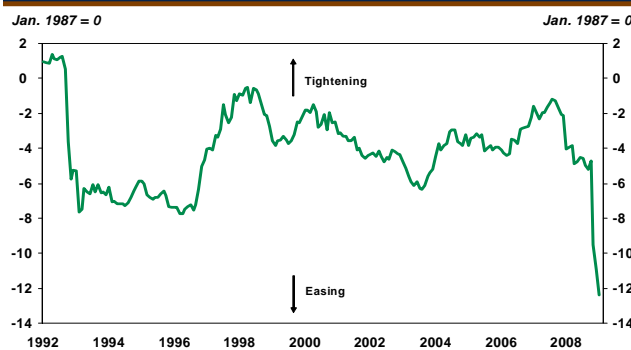
Sources: Datastream and Desjardins, Economic Studies

United Kingdom – Inflation rate



* Consumer price index.
Sources: Datastream and Desjardins, Economic Studies

United Kingdom – Monetary conditions index



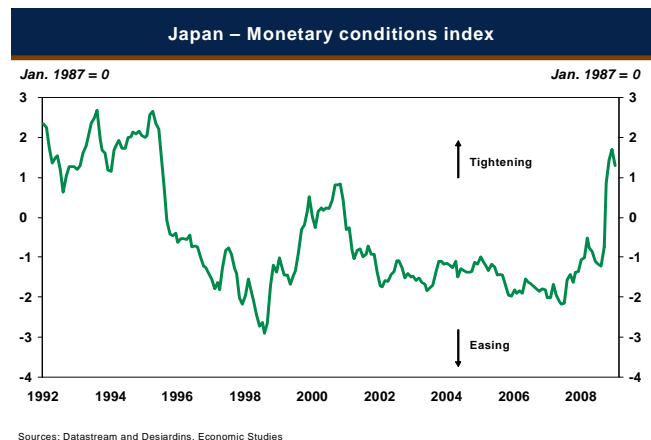
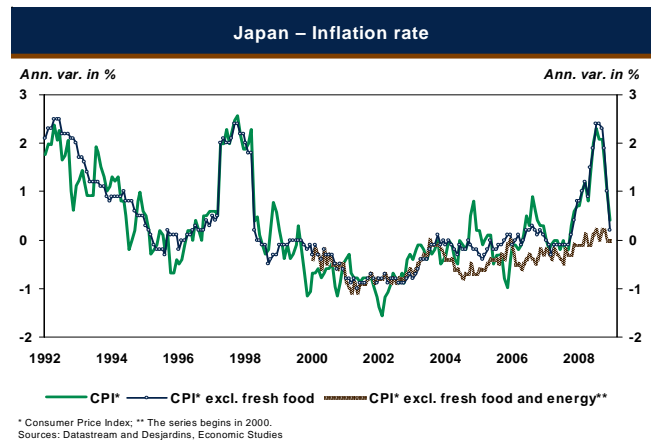
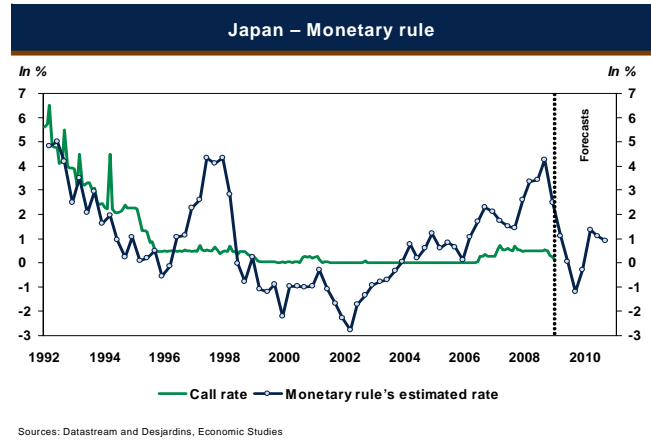
Sources: Datastream and Desjardins, Economic Studies

BANK OF JAPAN

Deflation is once again on the horizon

- Japan's economic problems are getting worse, and the risks of deflation are resurfacing. The Bank of Japan (BoJ) decided to lower its key interest rate by 40 basis points to 0.10%, as well as adopting measures to facilitate business financing, such as buying up commercial paper and accepting a broader range of corporate debt securities as collateral. A little like the Federal Reserve, the BoJ is falling back on its balance sheet in an attempt to stem the crisis.
- Japan has been in recession since last spring, and should be there until at least next summer. The combined effect of its currency's appreciation and the drop in global demand is rapidly driving down the value of Japan's exports. Even exports to Asia, which had been holding up well against the movement until recently, are no longer going unscathed. Industrial production is, of course, hard hit, recording a decline of 9.6% in December alone. Lastly, the outlooks for consumption and investment are still being overshadowed by weak consumer and business confidence.
- The tough economic times and drop in energy and commodity prices are encouraging Japan's inflation rate to go down; it was 0.4% last December. It is at 0.0% if we exclude the change in energy and fresh food prices. Deflation looms over Japan's economy in the short term, but it would be astounding if the BoJ decides to take its key interest rate to 0%, for all that. Its current strategy differs from quantitative easing adopted at the end of the 90s; it involves extending the required credit without setting a precise target for the surplus liquidity that could end up in the market. Moreover, a rate of 0% would make the recent deposit facility obsolete—the facility makes it easier for the central bank's balance sheet to expand by absorbing financial institutions' excess reserves.
- Despite the drop in the interest rate, the monetary conditions index reached a 15-year peak on the yen's strength. This situation, characterized by the unwinding of carry trades due to the resurgence of risk, should last for some time yet. Everything suggests that an overly strong yen could justify intervention in the exchanges.

Forecasts: Japan's economy is not doing well and a period of slight deflation seems inevitable. The BoJ's strategy differs from quantitative easing and it should keep its key rate at 0.10% until the end of this year.



**Table 1
Key interest rates**

End of period in %	2008				2009				2010			
	Q1	Q2	Q3	Q4	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
United States												
Federal funds	2.25	2.00	2.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50
Canada												
Overnight funds	3.50	3.00	3.00	1.50	0.50	0.50	0.50	0.50	0.50	0.50	1.00	1.50
Euro zone												
Refinancing rate	4.00	4.00	4.25	2.50	1.50	1.00	1.00	1.00	1.00	1.00	1.00	1.50
United Kingdom												
Base rate	5.25	5.00	5.00	2.00	0.50	0.00	0.00	0.00	0.00	0.00	0.50	1.00
Japan												
Overnight funds	0.50	0.50	0.50	0.30	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.50

f: forecasts

Sources: Datastream and Desjardins, Economic Studies

**Table 2
Schedule and key rates**

Date	Central Bank	Decision	Rate
November 2008			
6	European Central Bank	-50 b.p.	3.25
6	Swiss National Bank	-50 b.p.	2.00
20	Bank of Japan	s.q.	0.30
20	Swiss National Bank	-100 b.p.	1.00
28	Bank of Mexico	s.q.	8.25
December 2008			
1	Reserve Bank of Australia	-100 b.p.	4.25
1	Bank of Japan	s.q.	0.30
3	Reserve Bank of New Zealand	-150 b.p.	5.00
4	Bank of England	-100 b.p.	2.00
4	European Central Bank	-75 b.p.	2.50
4	Bank of Sweden	-175 b.p.	2.00
9	Bank of Canada	-75 b.p.	1.50
10	Bank of Brazil	s.q.	13.75
11	Swiss National Bank	-50 b.p.	0.50
16	Federal Reserve	-100 b.p. / -75 b.p.	0.00 / 0.25
17	Bank of Norway	-175 b.p.	3.00
18	Bank of Japan	-20 b.p.	0.10
January 2009			
8	Bank of England	-50 b.p.	1.50
15	European Central Bank	-50 b.p.	2.00
16	Bank of Mexico	-50 b.p.	7.75
20	Bank of Canada	-50 b.p.	1.00
21	Bank of Brazil	-100 b.p.	12.75
21	Bank of Japan	s.q.	0.10
28	Reserve Bank of New Zealand	-150 b.p.	3.50
28	Federal Reserve	s.q.	0.00 / 0.25
February 2008			
3	Reserve Bank of Australia	-100 b.p.	3.25

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

Source: Desjardins, Economic Studies

**Table 3
Coming soon**

Date	Central Bank
February 2009	
4	Bank of Norway
5	Bank of England
5	European Central Bank
10	Bank of Sweden
19	Bank of Japan
12	Bank of Mexico
March 2009	
3	Reserve Bank of Australia
3	Bank of Canada
5	Bank of England
5	European Central Bank
11	Bank of Brazil
12	Reserve Bank of New Zealand
12	Swiss National Bank
17	Bank of Japan
17	Federal Reserve
20	Bank of Mexico
25	Bank of Norway
April 2009	
2	European Central Bank
7	Reserve Bank of Australia
7	Bank of Japan
9	Bank of England
17	Bank of Mexico
20	Bank of Sweden
21	Bank of Canada
28	Bank of Japan
29	Bank of Brazil
29	Federal Reserve

Source: Desjardins, Economic Studies

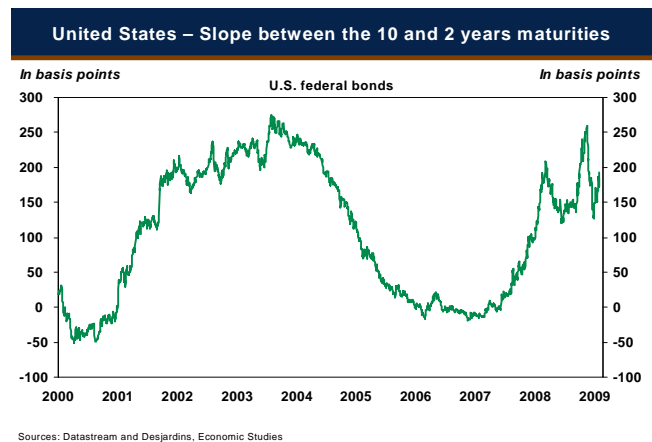
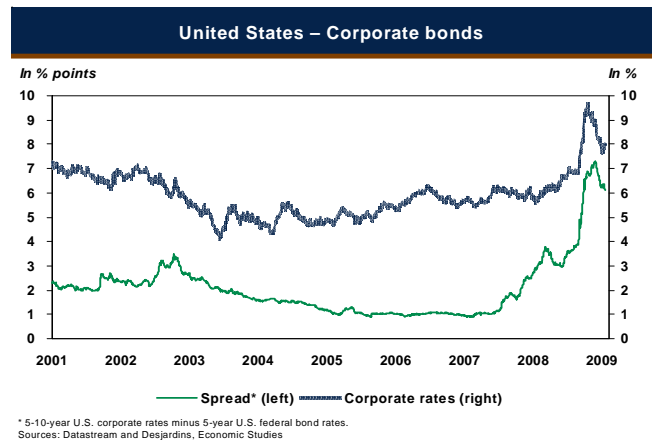
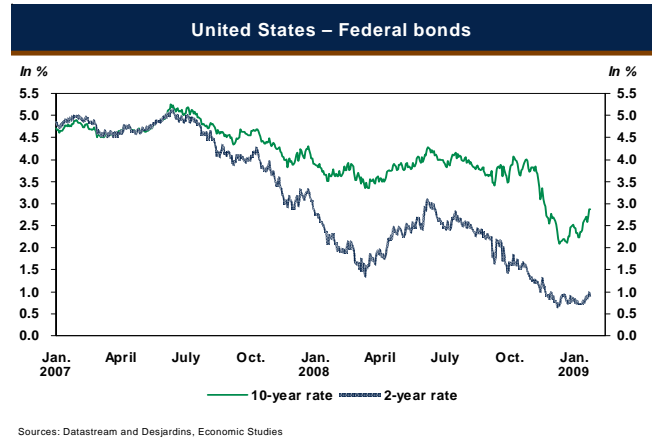
FIXED INCOME MARKET

Bond market concerned about financing of the deficit

U.S. FEDERAL BONDS

- Despite the economic and financial difficulties, the bond market is continuing to show concern about financing the American government's budget deficit.
- After having remained relatively stable in December, the short end of the yield curve edged down in recent weeks. Two-year rates thus went from an average of 0.75% in early January to close to 0.95% at the end of the month. This situation appears temporary, however. Due to the tough economic conditions, the Federal Reserve (Fed) should keep its key interest rate at zero for longer than the markets had expected, a situation that will take two-year rates back to test December 2008's lows soon.
- The markets' fears about financing the American debt have had bearish impacts for the longest terms, driving rates on ten-year bonds up by about 75 basis points, from a low of 2.00% in December to over 2.75% at the end of January.
- For now, the bond market is reticent, but the risks associated with the economic downturn and lack of inflation pressure should make the rates for the longest terms converge toward historic lows in the first half of 2009. The Fed has even reiterated that, if necessary, it intends to buy long-term government securities to keep market rates low.
- The spread between two-year rates and ten-year rates widened in the last few weeks. After hitting a recent low of about 130 basis points, the sharper rise by ten-year rates than two-year rates took the spread above 175 basis points. At these levels, the economic and financial context seems to be compatible with a flattening yield curve.

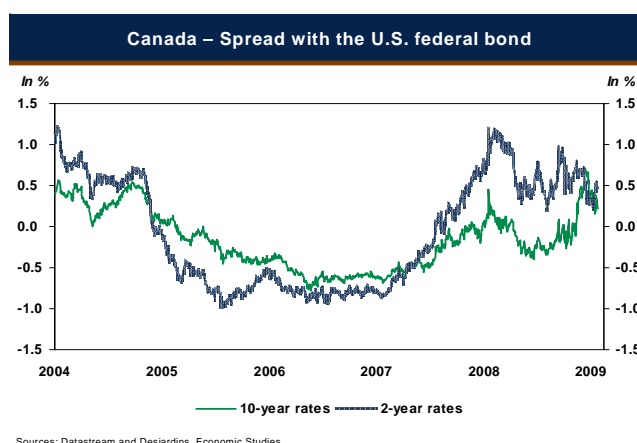
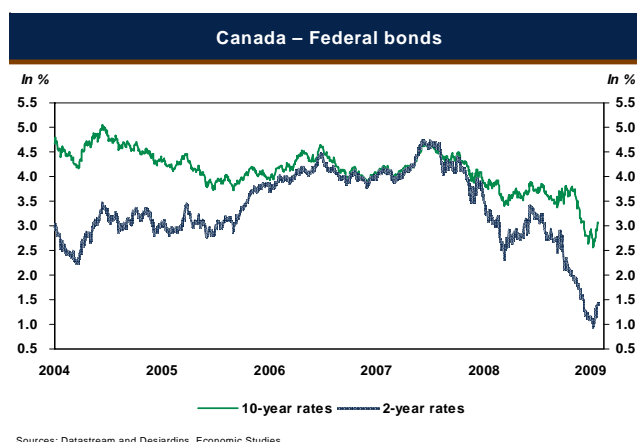
Forecasts: The deteriorating economic outlook and deflation risks should quickly win out over concerns about the growing budget deficit. We continue to look for bond rates to converge toward historic lows in the first half of 2009.



CANADIAN FEDERAL BONDS

- Canadian federal bonds made further large gains at the end of 2008 and at the beginning of the new year. These securities have benefited from the steadily darkening economic outlook and further financial strains associated with the problems facing major international banks. However, the Canadian curve has risen by about 40 basis points in the last few weeks, as the deterioration in public finances almost worldwide seems to be worrying investors. After the last few months' spectacular performance, technical factors also fully justified a slight correction.
- Expecting more Canadian key rate cuts, the yield on two-year federal bonds fell to a low of 0.91% during trading on January 15, before coming back to just over 1.30% now. During the same time, the ten-year rate went from 2.52% to about 2.90%. After last fall's steep ascent took it over 180 points, the slope of the Canadian curve has been oscillating between 1.55% and 1.75% since mid-November.
- Now that the U.S. key rate is almost zero, ongoing monetary easing in Canada should make the rate spreads between American and Canadian short-term bonds narrow. For two-year bonds, the spread has gone from over 70 points in mid-December to just 21 points on January 14, when the problems in Canada's economy appeared to be worsening. However, the Bank of Canada's new and highly optimistic outlook, which calls for growth of 3.8% in 2010, has made the spread widen to more than 50 points. True, if this scenario materializes, which is unlikely, in our opinion, it would limit the need to keep key rates very low for a long time. The spread between 10-year rates has also narrowed somewhat since mid-December. American long rates rose more, perhaps reflecting the American government's much greater financing needs.
- The budget tabled by Finance Minister Jim Flaherty on January 27 to stimulate Canada's economy confirmed that Canada will see large deficits in the next few years. The rapid deterioration in Canada's budget situation should bring on an increase of just over \$50B in federal bonds outstanding over the next fiscal year. An increase in supply is never a positive thing for the bond market but, given the current appeal of federal securities and Canada's low debt levels compared to the other G7 nations, the market should be able to absorb the new issues with no trouble.

Forecasts: The deteriorating economic outlook and deflation risks should quickly win out over concerns about the deterioration in the public finances. As a result, we are still expecting Canadian bond rates to come down in the next few months, perhaps even testing mid-January lows.

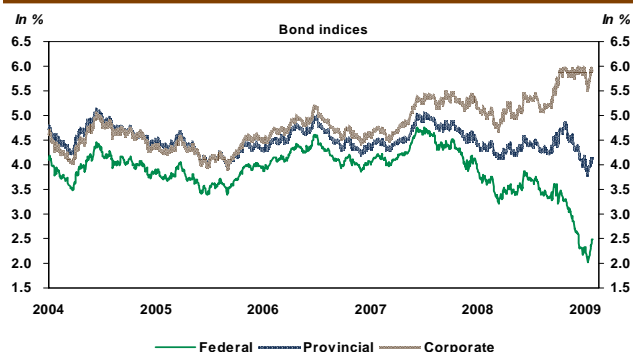


PROVINCIAL BONDS

- The bond market's evolution, marked by a big premium for liquidity and security, continues to favour federal securities over corporate securities. After having dipped somewhat at the beginning of the year, the rates demanded on corporate bonds have thus recently come back to almost their mid-December peak. Spreads between rates on federal and corporate bonds remain very large, near 3.5%, which is partially justified by the very poor economic context for Canadian business.
- Provincial bonds have done well in the last few weeks. Unlike what we saw throughout 2008, provincial rates even pulled back more sharply than rates on federal securities, for example, taking the rate spread for a 10-year Ontario bond from 185 basis points in mid-December to about 160 points now. Ontario's economy, especially hard hit by the recession, will get substantial aid from the federal government to support the auto sector. Conversely, the latest federal budget does not seem as good for Québec, confirming a new way of calculating equalization payments which will leave the province with a substantial shortfall. Overall, the deterioration in the provinces' budget situations is, to date, not nearly as spectacular as the deterioration at the federal level.

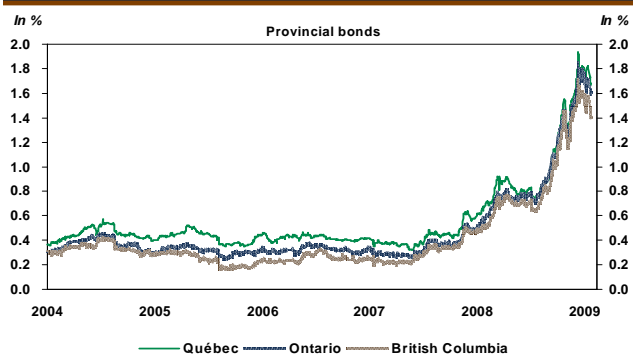
Forecasts: The economic and financial difficulties will persist in the near term, keeping premiums on corporate and provincial bonds very high in relation to federal securities. The spreads should begin a down trend, however, as soon as the economy starts to show signs of stabilizing.

Evolution of the Canadian bond indices



Sources: Datastream and Desjardins, Economic Studies

Spreads with Canadian federal bond rates



Sources: Datastream and Desjardins, Economic Studies

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

	<i>Surplus (deficit) (1)</i> <i>in \$M</i>		<i>Budget surplus (deficit)</i> <i>in % of GDP</i>	<i>Total debt (2)</i> <i>in % of GDP</i>	<i>Credit rating</i>	
	2007-2008	2008f-2009f	2008f-2009f	2007f-2008f	S&P	Moody's
Federal government	9,597	-1,100	-0.1	34.9	AAA	Aaa
Newfoundland	1,377	544	1.8	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	-300	-0.1	26.4	AA	Aa1
Manitoba	576	96	0.2	30.4	AA	Aa1
Saskatchewan	1,282	3,020	5.8	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 %	2008				2009				2010			
	Q1	Q2	Q3	Q4	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Key rate												
Federal funds	2.25	2.00	2.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50
Treasury bills												
3-month	1.38	1.90	0.92	0.11	0.10	0.10	0.10	0.20	0.20	0.20	0.30	0.70
Federal bonds												
2-year	1.62	2.61	1.99	0.76	0.60	0.60	0.65	0.70	0.75	0.85	1.00	1.50
5-year	2.47	3.33	2.98	1.55	1.20	1.20	1.30	1.40	1.60	1.85	2.10	2.60
10-year	3.43	3.98	3.82	2.25	1.80	1.75	1.95	2.25	2.55	2.80	3.10	3.50
30-year	4.30	4.53	4.30	2.69	2.60	2.50	2.70	3.00	3.40	3.60	3.80	4.00
Yield curve												
5-year - 3-month	1.09	1.43	2.06	1.44	1.10	1.10	1.20	1.20	1.40	1.65	1.80	1.90
10-year - 2-year	1.81	1.36	1.84	1.49	1.20	1.15	1.30	1.55	1.80	1.95	2.10	2.00
30-year - 3-month	2.92	2.63	3.38	2.58	2.50	2.40	2.60	2.80	3.20	3.40	3.50	3.30

f: forecasts

Sources: Datastream and Desjardins, Economic Studies

Table 6
Canada: fixed income market

End of period in %	2008				2009				2010			
	Q1	Q2	Q3	Q4	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Key rate												
Overnight funds	3.50	3.00	3.00	1.50	0.50	0.50	0.50	0.50	0.50	0.50	1.00	1.50
Treasury bills												
3-month	1.88	2.50	1.90	0.89	0.45	0.45	0.45	0.45	0.45	0.90	1.50	1.90
Federal bonds												
2-year	2.63	3.25	2.79	1.09	1.10	1.15	1.25	1.30	1.45	1.75	1.90	2.50
5-year	2.91	3.46	3.17	1.70	1.65	1.60	1.60	1.70	1.90	2.15	2.50	3.10
10-year	3.43	3.74	3.76	2.69	2.40	2.35	2.45	2.65	2.75	3.05	3.40	3.85
30-year	3.94	4.08	4.23	3.46	3.30	3.25	3.40	3.65	3.90	4.00	4.10	4.20
Yield curve												
5-year - 3-month	1.03	0.96	1.27	0.81	1.20	1.15	1.15	1.25	1.45	1.25	1.00	1.20
10-year - 2-year	0.80	0.49	0.97	1.60	1.30	1.20	1.20	1.35	1.30	1.30	1.50	1.35
30-year - 3-month	2.06	1.58	2.33	2.57	2.85	2.80	2.95	3.20	3.45	3.10	2.60	2.30
Spreads (Canada - U.S.)												
3-month	0.50	0.60	0.98	0.78	0.35	0.35	0.35	0.25	0.25	0.70	1.20	1.20
2-year	1.01	0.63	0.80	0.32	0.50	0.55	0.60	0.60	0.70	0.90	0.90	1.00
5-year	0.44	0.13	0.19	0.15	0.45	0.40	0.30	0.30	0.30	0.30	0.40	0.50
10-year	0.00	-0.24	-0.07	0.44	0.60	0.60	0.50	0.40	0.20	0.25	0.30	0.35
30-year	-0.36	-0.45	-0.07	0.76	0.70	0.75	0.70	0.65	0.50	0.40	0.30	0.20

f: forecasts

Sources: Datastream and Desjardins, Economic Studies