

The Yield Curve



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Economic Studies

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Will the Federal Reserve have to resolve to target inflation? The Bank of Canada is a step away from adopting a quantitative policy

HIGHLIGHTS

- The bond market remains concerned about the inflation risks associated with economic recovery operations and the Fed's rapidly expanding balance sheet, as well as about investors' ability to digest the sharp increase in the public debt supply.
- Our approach based on the capital flows identity suggests the deficit can easily be financed, by rising household savings, a decrease in investment and by insatiable appetite for Treasuries from abroad.
- The Fed adopted a "soft" inflation target.
- The Bank of Canada will pursue monetary easing in March.
- It would be in the European central bank's best interest to accelerate monetary easing.

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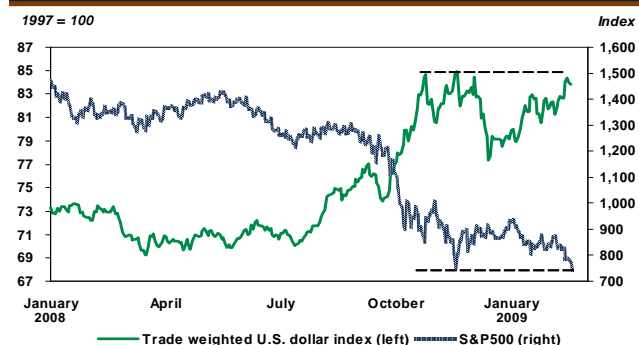
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Summary

The economic recovery plan (US\$787B) had barely been adopted when the Obama administration proposed another plan to save American homeowners. This is in addition to Treasury Secretary Tim Geithner's financial plan—he intends to make good use of the rest of the funds in the Troubled Assets Relief Program (TARP) (US\$350B) to get the financial system back on track. Then there's the Federal Reserve's (Fed) credit facilities, where the amounts committed total almost US\$1,500B since the crisis began.

Yet uncertainty still looms: although the ills that are afflicting the world's economy require a cure with some kick to it, the markets are confused about the amounts being proposed and how the government intends to spend the money. The Geithner plan, ambitious but short on details, was especially disappointing. In his speech to the Senate, the Fed's Chair calmed fears about the need to nationalize the banks, but financial companies' securities are still shaky. With risk aversion front and centre, the stock market closed in on its November 2008 low, and the greenback enjoyed investor favour, which did not keep gold from playing its role as a safe haven security to the hilt (graphs 1 and 2).

Graph 1 – New trough, new top



Sources: Datastream and Desjardins, Economic Studies

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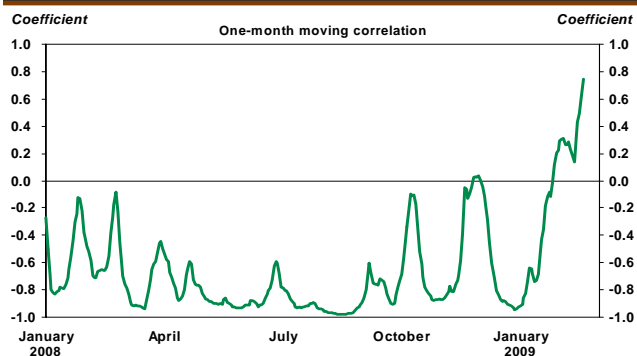
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NOTE TO READERS: The letters **k**, **M** and **B** are used in texts and tables to refer to thousands, millions and billions respectively.

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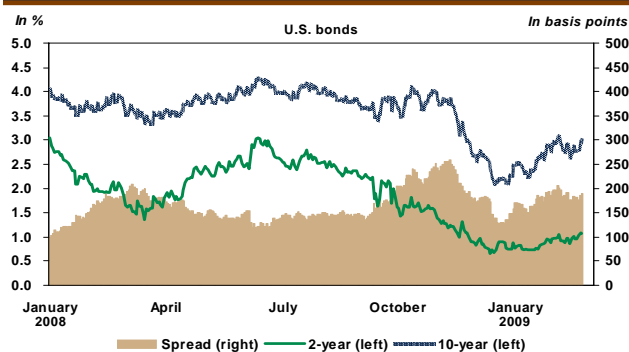
Graph 2 – Gold and the U.S. dollar go hand in hand



Sources: Datastream and Desjardins, Economic Studies

Under these conditions, the bond rally of the last few weeks seems modest. Ten-year Treasuries, which have pulled back by about 30 basis points from their February 9 high of 3.07%, are still nowhere near the 2.03% low set in December 2008 (graph 3).

Graph 3 – Timid bond rallye



Sources: Datastream and Desjardins, Economic Studies

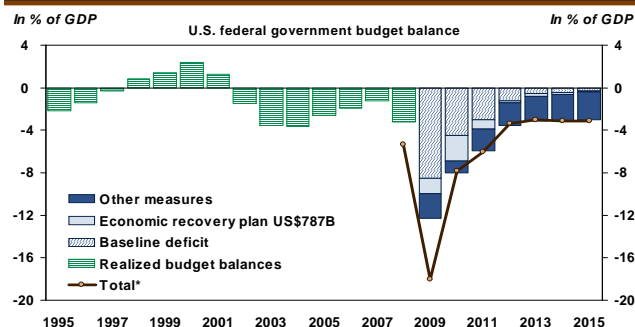
This reflects the market’s concerns about the inflation risks associated with economic recovery operations and the Fed’s rapidly expanding balance sheet, as well as about investors’ ability to digest the sharp increase in the public debt load. The proof is rumours of a US\$1.8T deficit for 2009, that is near 12% of GDP, gradually brought back ten-year rates to the 3.0% mark at the end of the month (graph 4).

A DEFICIT THAT CAN EASILY BE FINANCED...

In a recently released study,¹ we show that the financial markets’ concerns about the upward pressures put on real interest rates by the increase in public debt securities are, in theory, founded. In practice, however, this context, which is characterized by excess production capacity, a major banking

¹ See the *Economic Viewpoint*, “Consequences of high public debt in the United States”, February 25, 2009.

Graph 4 – A deficit of US\$1.8T for the 2009 budget



* Including all financing needs (including Troubled Asset Relief Program – TARP).
Sources: U.S. Treasury, Office of Management and Budget, Congressional Budget Office, and Desjardins, Economic Studies

crisis, severely restricted credit conditions and growing deflation risks, is not compatible with a short-term increase in bond rates. This is because, on one hand, in a situation of economic slack, the government’s expansionist fiscal policy is not inflationary and, on the other, it is going to take low or even negative real interest rates to get the economy into recovery mode.

We must also take financing conditions into account. Beyond the tightened credit conditions that are making retail rates and corporate credit spreads unappealing, the tough economic situation and deflation forces in play are prompting the private sector to limit its debt loads. This context opens the door to more public debt, cheaply: in a way, the Treasury is filling the vacuum left by consumers and business.

...OUT OF A RETURN TO PRIVATE SAVINGS

We see three fundamental reasons connected to the capital² flows identity that should allow the United States to go into debt without putting too much upward pressure on interest rates:

1. Household savings rates are expected to ascend from an average of 0.6 % in 2007 to almost 5% in 2010 in response to the substantial loss of wealth and increased pessimism. This would help free up almost US\$350B in 2009. Every additional percentage point of savings is equal to another US\$100B.
2. Due to the unfavourable economic situation and credit conditions, we are expecting total investment, and thus debt loads, to decline by about 15%, which would make it possible to accumulate US\$300B.

² A rule common to all open economies is that changes in public savings must be equal to the total of net private savings and net inflows of foreign capital.

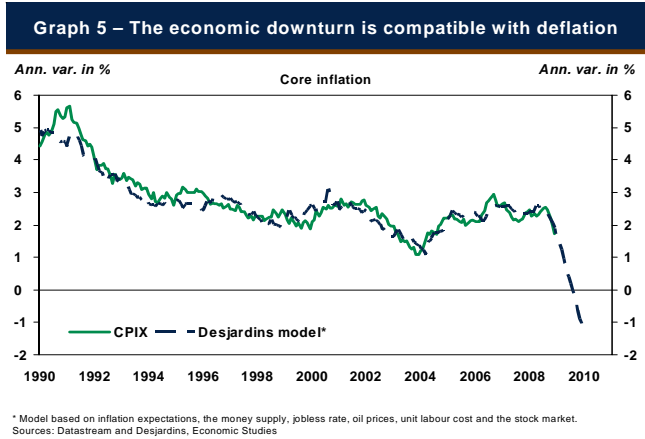
3. A continuous contribution from inflows of foreign capital because of foreign central banks' need to support the greenback will easily offset the shortfall.

DEBT MONETIZATION IS POSSIBLE

In the worst case scenario, in the event the market can no longer absorb the repeated auctions, the Fed could buy back some of the debt (deficit monetization) to keep real interest rates low. However, there are risks of inflation over the longer term, which is why this scenario should only be anticipated in the event of deflation or an overly long contraction by credit (money destruction).

NUMBER ONE SHORT-TERM RISK: DEFLATION

In fact, due to the economic slump and drastic tightening of credit conditions, the situation is potentially deflationary.³ On top of the energy price correction, surplus production capacity is putting downside pressures on consumer prices. The deterioration in the labour market is oppressive, pointing to stagnation in wage growth. A simple forecasting model, essentially based on the relationship between employment and inflation, indicates that there is a compelling risk of widespread deflation (graph 5).

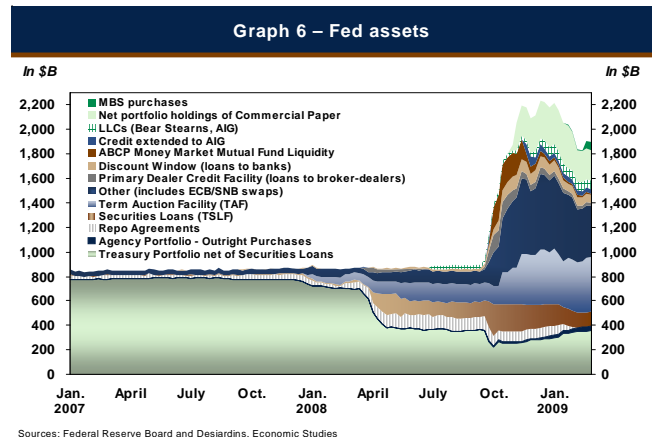


* Model based on inflation expectations, the money supply, jobless rate, oil prices, unit labour cost and the stock market. Sources: Datastream and Desjardins, Economic Studies

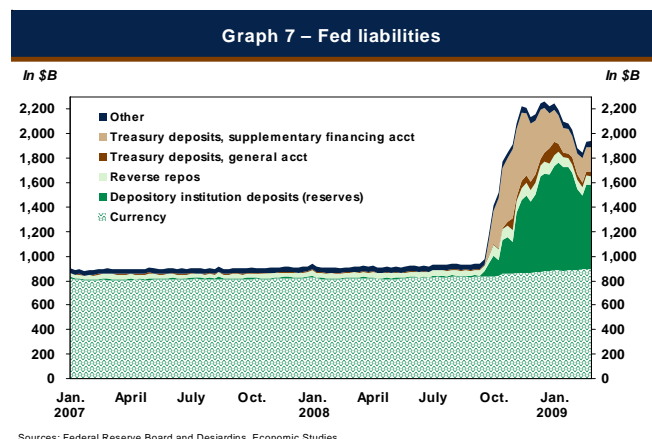
THE FED MUST KEEP EXPANDING ITS BALANCE SHEET

In normal times, to combat the threat of deflation, the tool the Fed would usually use would be lowering interest rates. The “zero” rate policy and weak American economy are forcing it to expand its balance sheet further. The Fed’s credit facilities have already increased its reserves by near 100% since mid-2008 (graphs 6 and 7); the measures instituted recently indicate that the Fed’s balance sheet is poised to expand further. For many, while the tightened credit conditions are currently keeping the money supply from growing too fast,

³ See the *Economic Viewpoint*, “Deflationary forces intensify”, February 18, 2009.



Sources: Federal Reserve Board and Desjardins, Economic Studies



Sources: Federal Reserve Board and Desjardins, Economic Studies

this could inevitably generate inflation pressure over the longer term.

We have always held the view that the Fed’s policies are either not inflationary, or very little. To grasp this, we must separate temporary effects from permanent effects.

The temporary increase in reserves, associated with the Fed’s role as a “lender of last resort”, is not inflationary. The most important components, such as the Commercial Paper Funding Facility (CPFF) (\$251B) and the Term Auction Facility (TAF) (\$413B), are short-term facilities and can easily not be renewed. Moreover, these credit facilities are restrictive and will not be very attractive once the strains in the credit market have resolved, a situation that will automatically make the programs now in place shrink.

To support mortgage and housing markets, and to restart securitization, the Fed has set up more permanent measures, such as the purchase of Mortgage-backed Securities (MBS) on the secondary market and the Term Asset-backed Securities Loan Facility (TALF), which have longer maturities. Currently, these facilities are underused, but their combined limit can total up to US\$1,500B. The problem is that it is hard

to assess the future liquidity of the longer-term components and, as a result, they could provide more permanent support to money supply growth. The inflationary impact of these interventions remains to be demonstrated, but we believe that the Fed will, sooner or later, have to say that it plans to target inflation, the way many other central bank do.

AN EXPLICIT INFLATION TARGET?

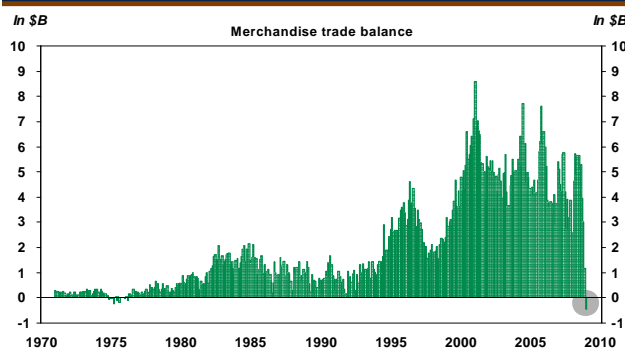
An inflation target would let the Fed kill two birds with one stone: keep inflation expectations well anchored by combating deflation in the short term and money inflation over the longer term. Last week, the Fed took one more step to make sure that inflation expectations don't become unanchored from the average that has been set for the last decade.

The minutes of January's FOMC meeting show that the Fed talked about the possibility of adopting an explicit inflation target in numbers. In the end, members made a slightly more "flexible" commitment, providing a long-term projection that called for long-run inflation ranging from 1.7% to 2.0%.

CANADA: DARKENING ECONOMIC SITUATION

Recently released economic statistics show that Canada's seeming relative advantage eroded substantially in the final months of 2008. In December in particular, manufacturing shipments recorded a monthly decline of 8.0%. Only one out of twenty-one sectors stayed in positive territory. Reflecting the tumble by energy prices and decrease in global demand, the merchandise trade balance went into deficit for the first time since 1976 (graph 8). Retail sales were a disaster, declining 5.4% that month. And the outlook remains grim, with January's loss of 126,000 jobs auguring nothing good.

Graph 8 – First Canadian trade deficit since 1976



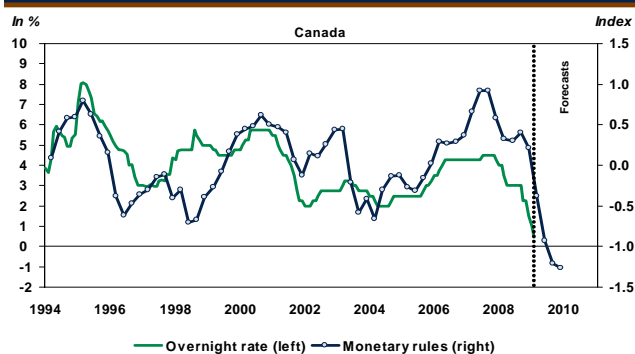
Sources: Statistics Canada and Desjardins, Economic Studies

Under these conditions, and with no inflation pressure, the Bank of Canada (BoC) will certainly continue easing its monetary policy at its March 3 meeting. There is a broad consensus among private sector forecasters for a 50-basis-point cut to key interest rates.

IS A "ZERO" RATE POLICY VIABLE?

What happens after that is a little more nebulous. Because the output gap has widened substantially and expected inflation is lower, our monetary indicator shows that the BoC should adopt a "zero" rate policy as quickly as possible (graph 9).

Graph 9 – Our monetary rule suggest that the BoC as more work to do



Sources: Datastream and Desjardins, Economic Studies

In theory, the BoC could lower its key rate target to 0%. Large Value Transfer System (LVTS) participants are not showing much reticence about exchanging their daily surpluses on the interbank market at the target rate, so the lower limit⁴ of the BoC's operating band could be zero or even negative. In practice, however, the marginal impact of lowering key rates beyond 0.50% seems limited and would do more to create distortions than benefits.

First, a "zero" rate policy could be problematic for monetary funds, with negative returns (due to management charges) making some investors sell off their assets. Then, the structure of Canada's commercial loans calls for prudence. As variable loans are based on the Bank Rate, a "zero" rate would mean that retail loans granted by financial institutions at a discount could result in a negative interest rate. This problem would likely prompt Canadian banks to diverge from the direction set out by the BoC.

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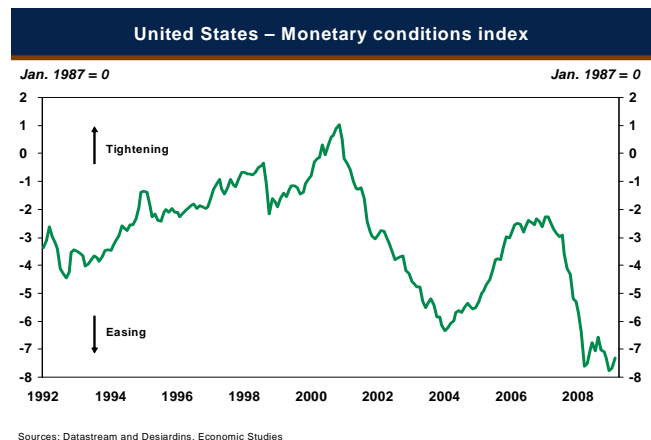
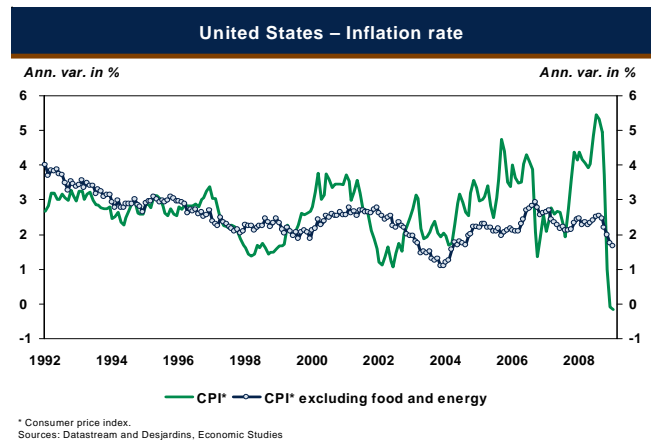
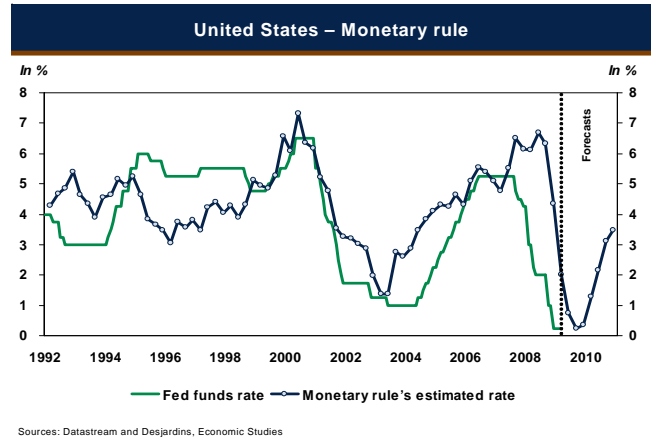
⁴ The bottom of the operating band is the rate paid by the BoC on any LVTS balance held overnight.

FEDERAL RESERVE

The work is not done

- America's economic problems will be very much with us throughout 2009. This reading, which reflects our latest economic scenario for the United States, matches the Federal Reserve (Fed) reading. Testifying recently before a Senate committee, Ben Bernanke started his speech with the following words: "The U.S. economy is undergoing a severe contraction." As inflation fears have now completely evaporated, the Fed must combat this recession with every tool available to it.
- Since December, the target interest rate for federal funds, the Fed's main instrument, has been sitting in a range of 0.00% to 0.25%. It should stay there throughout 2009. The Fed will thus have to keep the other measures in the foreground of its expansionary strategy. Along with playing its traditional role as a lender to deposit-taking institutions, the Fed has ended up standing in for a deficient supply of funds in the institutional credit market (commercial paper, mortgage bonds, etc.). The measures put forward by the Fed have helped bring some calm back to some credit markets.
- Credit conditions for businesses and consumers remain very tough. In addition to supporting lending, the Fed will soon begin a program to buy up securities backed by consumer loans, business loans and student loans. The financial bailout plan announced by the new Treasury Secretary indicates that these purchases could total US\$1,000B.
- The inflation outlook is still tilted to the downside. Because of the slide in energy prices, the annual change in the consumer price index fell to 0.0% in January. Even though oil and gas prices are stabilizing, inflation will remain anaemic. In fact, it should soon drop into negative territory and, if our outlook for oil prices materializes, inflation could plausibly descend to -2.0% next summer.
- As for core inflation, low industrial capacity utilization, the problems in the labour market, contracting real estate prices and the lagged effect of the decline in energy costs are all factors that will further moderate inflation. Core inflation is not expected to go into negative territory, but this avenue cannot be completely dismissed.

Forecasts: The Fed will keep the target for federal funds at very low levels. It will continue to take direct action in the credit market to ease conditions for households and enterprises while working to stabilize the money market.

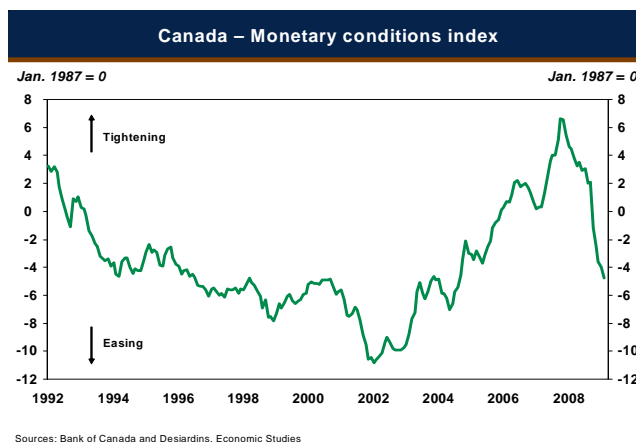
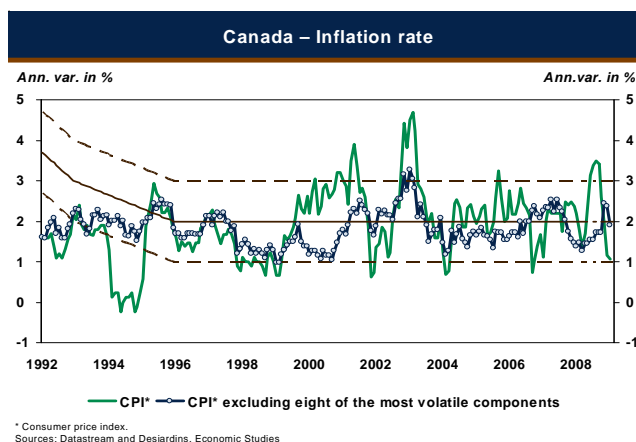
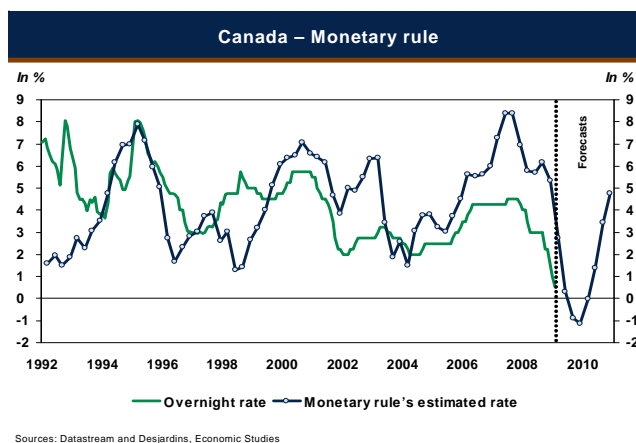


BANK OF CANADA

Another 50-basis-point cut is expected in March

- Over the last few weeks, the bad news has proliferated in Canada's economic landscape. Job losses continued in January, with another 129,000 layoffs; the jobless rate jumped to 7.2%. Manufacturing sales tumbled 8.0% in December, the biggest monthly pullback since this economic indicator began (in 1992). The international merchandise trade balance went into negative territory last December for the first time since March of 1976. Retail sales fell off by 5.4% from November to December.
- After an expected decline of almost 3.2% in the fourth quarter of 2008, the real GDP should continue to contract until next summer. The year 2009 could finish with a decline of about 1.6% in the real GDP. Next year, the economic recovery should bring us 2.3% growth, an outlook that is well below the Bank of Canada's (BoC) (+3.8%). The risks will remain tilted to the downside for the next few months.
- The impact of past energy price increases on the annual change in the total consumer price index (CPI) is gradually fading. The total annual inflation rate should even go into negative territory for a few months as of next summer.
- The annual change in the Bank of Canada's core index (CPIX) will also be under downside pressure from the growing gap between production and full capacity. It could even temporarily go below the Bank of Canada's target range (1%).
- Under these circumstances, the BoC should continue to ease its monetary policy with a 50-basis-point cut at the March 3 meeting. It could then signal that it intends to keep the target rate at 0.50% for some time. A key rate that is lower than that cannot be ruled out, but its marginal impact on economic growth seems limited. Moreover, the distortions generated by a "zero" rate policy, particularly on money market funds and the structure of variable rate retail loans, calls for prudence.

Forecasts: The BoC should cut its key rate by 50 basis points to 0.50% in March and keep it there until 2010.

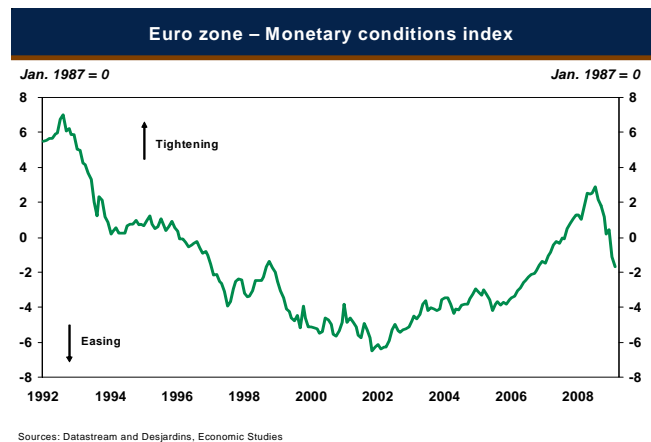
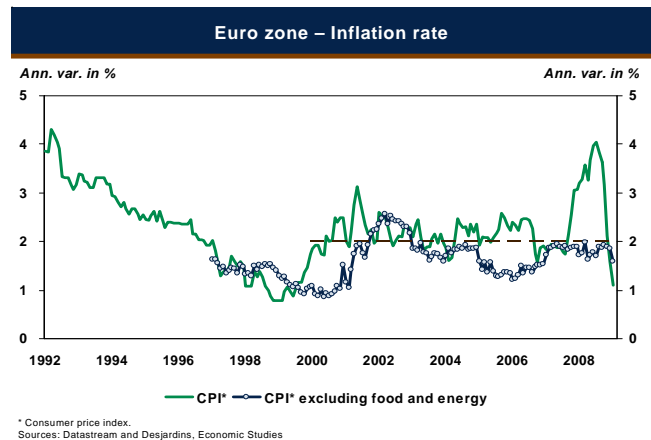
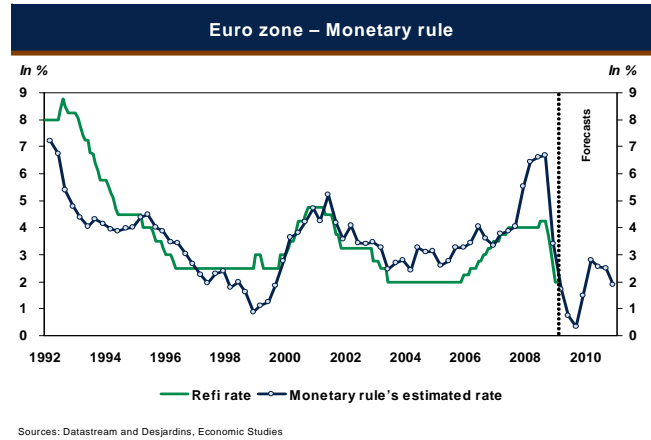


EUROPEAN CENTRAL BANK

Why put off the inevitable?

- As it had previously suggested, the European Central Bank (ECB) decided to take a break in February and keep its key rate at 2.00%. However, the ECB had taken the remark that risks to inflation were balanced out of its statement. President Trichet also opened the door to monetary easing at the March meeting, even suggesting that the cut would probably be closer to 50 basis points than 25 basis points. However, the ECB's leaders continue to assert that: "zero interest rates at the present time is not something that we would consider appropriate."
- In our view, it would be in the ECB's interests to speed up monetary easing. The leaders seem to be well aware of how serious the euro zone's recession is, and of the need to lower key rates further. In this kind of situation, it is better to take rates to an appropriate level as quickly as possible, especially since it takes several months for monetary easing to have an influence on the economy. Moreover, our monetary rule says that the ECB is behind the curve and must quickly take its key rate to 1.00% or lower.
- The 6.0% annualized contraction in the euro zone's real GDP in the final quarter of 2008 confirms that the slight recession that began in the spring of 2008 has taken a much more dramatic turn. Activity has nosedived especially sharply in Germany, where the economy pulled back by 8.2%. The latest statistics appear to show that the situation is still deteriorating, with industrial output and new orders respectively down by an annual 12% and 22% in December of 2008. Moreover, the purchasing manager indexes fell to a new low in February, signalling that activity is contracting even more.
- The ECB's latest monthly report sums the situation up: "The latest economic data and survey information confirm that the euro area and its major trading partners are undergoing an extended period of significant economic downturn, and that accordingly both external and domestic inflationary pressures are diminishing." We would even go so far as to say that inflation pressures seem to have completely vanished as, according to the flash estimate, the annual inflation rate fell to 1.1% in January.

Forecasts: We still expect the ECB to return to monetary easing in March, with the key rate soon to be taken to a low of 1.00%. The rate could even go a little lower if Euroland's economy does not show signs of stabilizing soon. The ECB has not ruled out adding other, unconventional measures for supporting the financial system, but the euro zone's structure could limit its capacity to act.

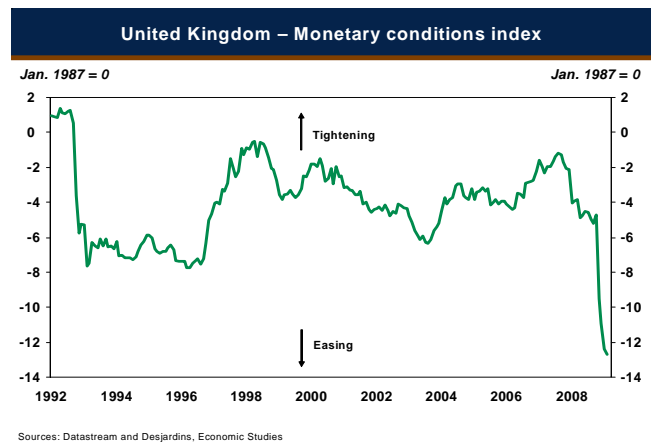
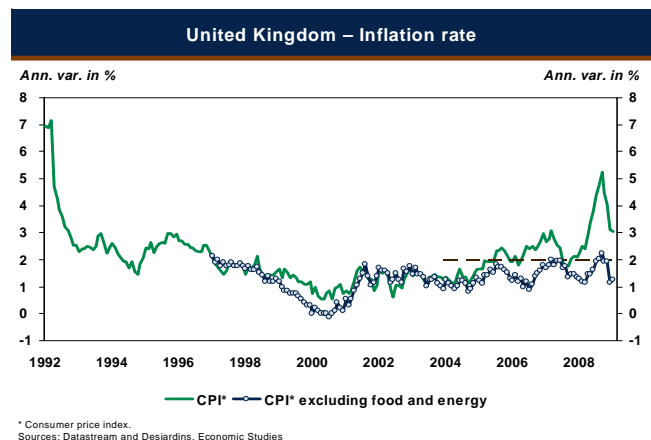
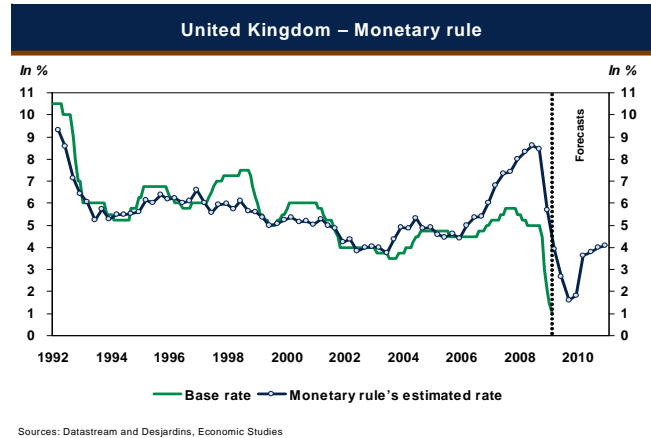


BANK OF ENGLAND

Quantitative policy has started

- To no one's surprise, the Bank of England (BoE) lowered its key rate by 50 basis points this morning, putting it at 1.00%. One committee member was even in favour of a more aggressive cut. The minutes of the meeting also show that the BoE is aware that the impact of further key rate cuts would probably not be enough: "It seemed unlikely that the inflation target could be met solely by cutting the Bank Rate." As a result, the BoE has recently started to use quantitative measures, buying up commercial paper.
- Despite the efforts that British authorities have made over the last several months, the economic situation is still dire. As BoE Governor Mervyn King recently stated: "The UK economy is in a deep recession." After an annualized decline of 6.0% in the last quarter of 2008, everything suggests that the real GDP will continue to nosedive in the first half of 2009. Note, however, that retail trade once again surprised, recording solid growth in January. The rebound by sales could be temporary as, in our view, it is mainly due to the recent cut to the sales tax. For the year underway, the real GDP could pull back by almost 3.0% in the United Kingdom.
- The pullback by inflation is still not as sharp in the United Kingdom as in most other countries. The annual inflation rate only fell by 0.1% in January and, at 3.0%, is still well over the BoE's 2% target. Substantial depreciation by the pound, which is putting upside pressure on prices for imported products, is helping to keep inflation relatively high. However, we are still convinced that the many other disinflationary pressures will win out and quickly take inflation below the target. The BoE's latest projections, tabled in February's Inflation Report, show that the annual inflation rate could slide well below the 2% target over the medium range. This confirms that further monetary easing will be needed.

Forecasts: The BoE will keep using every tool it has to support Britain's financial system and economy. The key rate will be brought down to almost zero. Technical reasons could convince the BoE to keep it at 0.25% or 0.50%, however. In any event, British monetary authorities will now primarily be using quantitative policies. The U.K.'s government will also continue intervening to try to kick start the credit market.



BANK OF JAPAN

The economy sinks further

- Japan is being hard hit by the global economic problems; a return to deflation seems imminent. The Bank of Japan (BoJ) will have no choice but to keep interest rates low for the coming quarters. Like the Federal Reserve, the BoJ is also focusing on using unconventional tools to facilitate credit and lessen strains in the financial markets.
- Japan's economy sank back into recession in the fourth quarter of 2008, posting the worst results recorded since 1974. On an annualized basis, the real GDP contracted by 12.7%, which was in keeping with the signal sent by the tumble in industrial output. The drop in global demand and strong yen are doing a lot of damage to Japan's economy, whose growth has relied extensively on the contribution from foreign trade for several years. Economic recovery seems unimaginable in Japan until the global economy has shown new signs of life. Moreover, there is a risk that soft foreign demand may further contaminate domestic demand. The job market has started a worrisome trend and consumer and business confidence remains low.
- Due to the economic slump and drop in energy and food prices, deflationary pressures are coming more and more to the fore in Japan. Continuing its descent of the last few months, the annual inflation rate was 0.4% in December; it was just 0% if energy and fresh food prices are excluded. All the ingredients are once again in place for interest rates to be close to 0% for a long time. Unlike the last period of deflation, the BoJ did not opt for traditional quantitative policy. In addition to putting together a temporary deposit facility and widening the array of securities accepted as collateral, it announced a series of measures to facilitate business credit. These include buying commercial paper and corporate bonds.
- Despite low interest rates, Japan's monetary conditions index remains high, due to the yen's strength. Still, the currency's recent tendency to depreciate to better reflect the weakness of Japan's economy should ease monetary pressures.

Forecasts: Japan's economy is contracting sharply; it is unthinkable that it will see an economic recovery without the rest of the planet's economy. With deflation expected to return in Japan, monetary authorities will have no choice but to keep their primary interest rate at 0.1% until at least the end of this year.

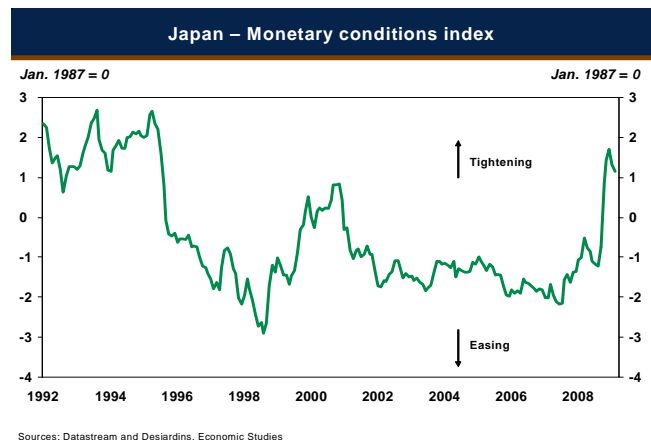
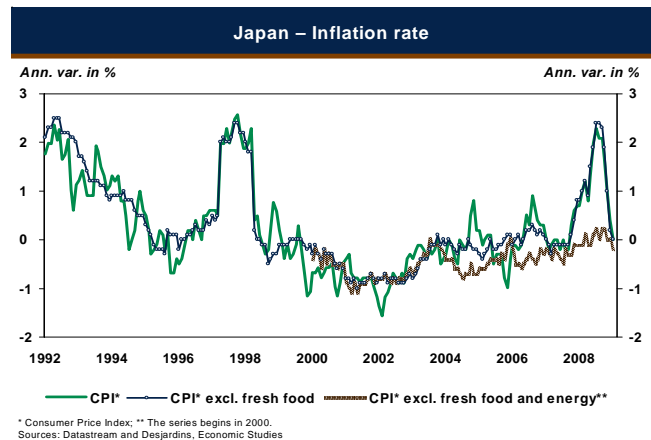
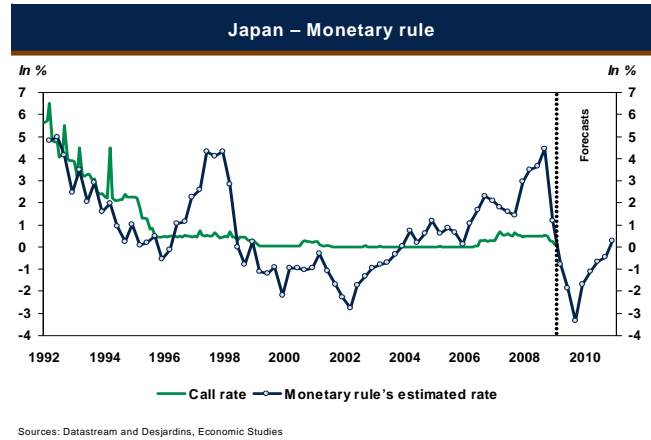


Table 1
Key interest rates

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
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
4	Bank of Norway	-50 b.p.	2.50
5	Bank of England	-50 b.p.	1.00
5	European Central Bank	s.q.	2.00
11	Bank of Sweden	-100 b.p.	1.00
18	Bank of Japan	s.q.	0.10
20	Bank of Mexico	-25 b.p.	7.50

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

Source: Desjardins, Economic Studies

Table 3
Coming soon

Date	Central Bank
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
30	Reserve Bank of New Zealand
May 2009	
5	Reserve Bank of Australia
6	Bank of Norway
7	Bank of England
12	European Central Bank
12	Bank of Mexico

Source: Desjardins, Economic Studies

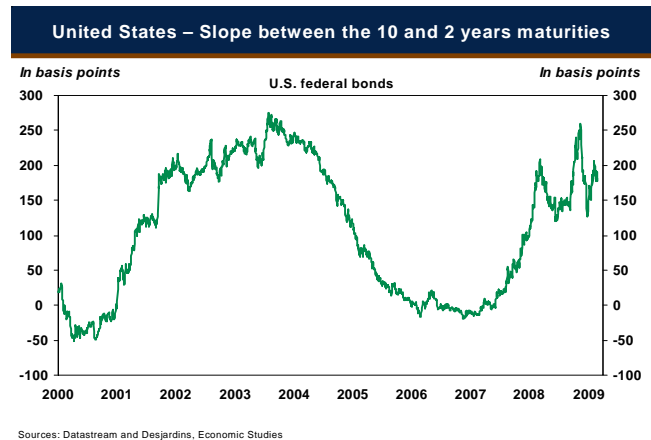
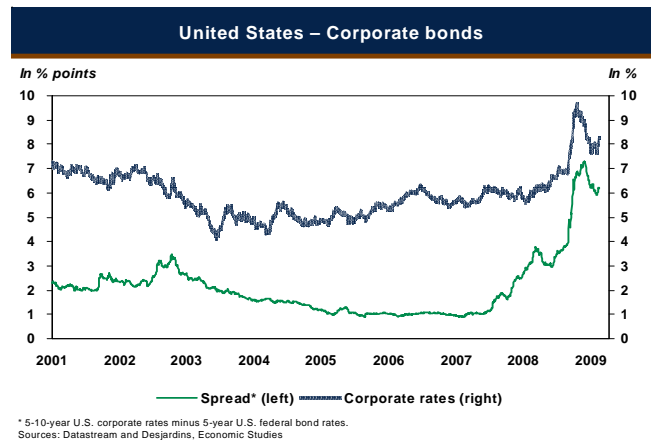
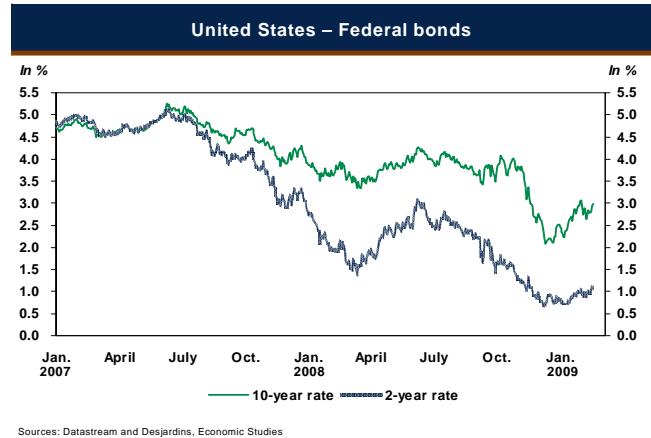
FIXED INCOME MARKET

The supply of debt securities is still the main source of concern

U.S. FEDERAL BONDS

- The economic and financial problems are still with us, but the bond market is still unmoving due to concerns about financing the American government's budget deficit.
- The short end of the yield curve is still under pressure. After remaining fairly stable around 0.75% in December, two-year rates stayed on the ascent that began at the end of January to go back over 1.00%.
- The markets fears about financing the U.S. debt continued to put downside pressure on the longer maturities, driving 10-year bond rates up to a recent peak close to 3.05% on February 9. The banks' problems and renewed risk aversion, however, helped rates to come down slightly, but the pullback seems timid.
- For now, the bond market is reticent due to the repeated auctions, but the risks associated with the economic downturn and possibility of deflation should make rates for the longer maturities converge on historic lows in the first half of 2009.
- Moreover, financing conditions are still appealing. The increase in the household and business savings rate is allowing the government to get inexpensive financing easily. Moreover, judging from demand from indirect bidders (48.9%) at the February 25 auction of US\$30B in five-year bonds, the shortfall is largely being offset by the insatiable appetite for Treasuries from abroad.

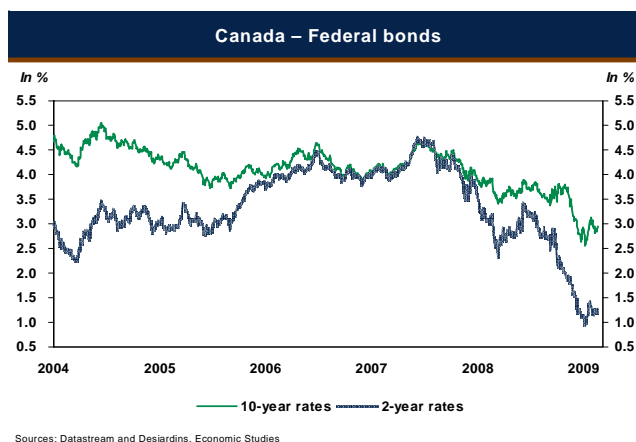
Forecasts: Caution is in order, given the pace at which the Treasury is holding auctions. However, the themes of a severe recession, potential deflation risk, strong comeback by savings and the Fed's potential intervention in the secondary market, continue to favour the bond market.



CANADIAN FEDERAL BONDS

- Another wave of pessimism in the financial markets on the disappointment created by the plan to stabilize the U.S. financial system also favoured Canadian federal bonds. As we had expected, fears surrounding the economic and financial situation won out over concerns regarding the deteriorating public finances worldwide. The latter have not completely vanished and are now helping keep rates above the lows set in mid-January.
- The latest Canadian economic statistics were especially bad, confirming that the Bank of Canada (BoC) should to move ahead with monetary easing. This, combined with heightened demand for safe haven securities, has taken the Canadian two-year rate from over 1.40% at the end of January to around 1.15% today. The ten-year rate followed a similar trend, going from almost 3.15% to about 2.80% in the last few weeks. After reaching 190 basis points at the start of February, the slope of Canada's curve fell to slightly below 170 points, similar to where it was in recent months.
- The spreads between Canadian and U.S. bond rates have narrowed in recent weeks. Note that Canada's economic situation has deteriorated a lot recently, and is increasingly similar to the situation seen south of the border. The growing likelihood that Canada's key rates will be lowered to almost zero and that the BoC will also have to resort to more quantitative action also justify bond rates that are similar to U.S. bond rates.
- Canada's corporate bond market responded much better than the stock market to the recent wave of market pessimism. In general, corporate rates have moved parallel to rates for federal securities in the last few weeks. Rate spreads have even closed slightly since mid-January. The fact that major international firms have recently succeeded in issuing bonds could be behind the corporate market's good performance.

Forecasts: The recessionary, deflationary environment should keep downside pressures on Canadian rates for the next few months. The markets' persistent fears about the increase in debt issues planet wide could limit the pullback by long-term rates, however.

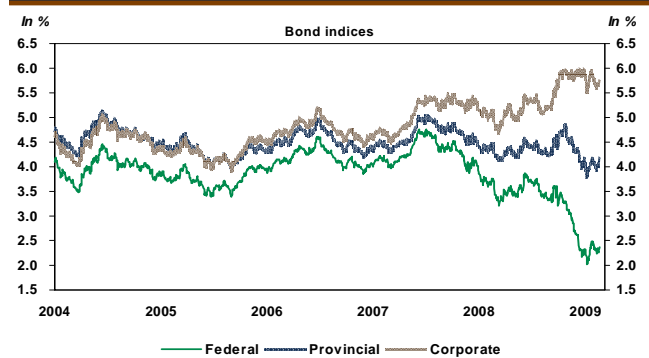


PROVINCIAL BONDS

- Provincial bonds have been fairly volatile in the last few weeks. After shooting up at the end of January, provincial rates have fallen off slightly in the last few weeks. They are still higher than they were in mid-January. Rate spreads between most provinces' ten-year securities and federal bonds have gone up by about 20 basis points since the month started. The deterioration in provincial public finances could be behind the sector's mixed performance. In a study, Moody's recently said that the provinces were, in general, in good position to cope with the crisis. However, there were risks of a downgrade if policies were not instituted to lighten the debt load once the economic downturn was over, or if the recession was much deeper than forecast.
- Québec and Ontario's serious economic problems have long been known, and the situation will continue to deteriorate. Both provinces' budgets, slated for March, will surely post substantial deficits. The last few months have confirmed that the other provinces were also being hard hit by the downturn. British Columbia recently tabled a deficit budget and Alberta's government is anticipating a severe recession, there again accompanied by renewed deficits.

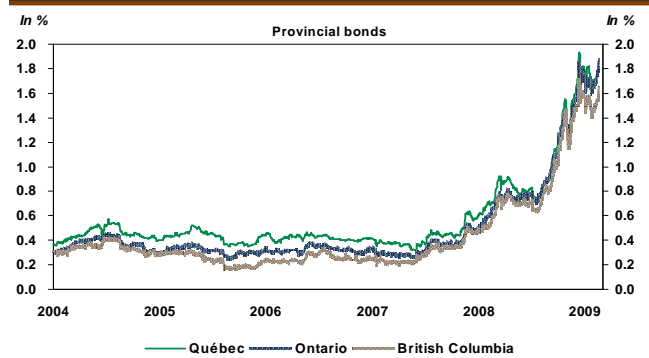
Forecasts: In our opinion, provincial rate spreads should continue to oscillate near current levels for several months, until Canada's economy starts to show some signs of recovery. For now, the likelihood that the provinces will be downgraded seems slim, but the risk cannot be ignored.

Evolution of the Canadian bond indices



Sources: Datastream and Desjardins, Economic Studies

Spreads with Canadian federal bond rates



Sources: Datastream and Desjardins, Economic Studies

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

	<i>Surplus (deficit) (1) in \$M</i>		<i>Budget surplus (deficit) in % of GDP</i>	<i>Total debt (2) in % of GDP</i>	<i>Credit rating</i>	
	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	0.20	0.15	0.20	0.25	0.25	0.25	0.30	0.70
Federal bonds												
2-year	1.62	2.61	1.99	0.76	0.80	0.75	0.75	0.75	1.00	1.25	1.50	1.75
5-year	2.47	3.33	2.98	1.55	1.60	1.20	1.30	1.40	1.60	1.85	2.10	2.60
10-year	3.43	3.98	3.82	2.25	2.25	2.00	2.10	2.25	2.55	2.80	3.10	3.50
30-year	4.30	4.53	4.30	2.69	3.25	3.00	3.10	3.20	3.40	3.60	3.80	4.00
Yield curve												
5-year - 3-month	1.09	1.43	2.06	1.44	1.40	1.05	1.10	1.15	1.35	1.60	1.80	1.90
10-year - 2-year	1.81	1.36	1.84	1.49	1.45	1.25	1.35	1.50	1.55	1.55	1.60	1.75
30-year - 3-month	2.92	2.63	3.38	2.58	3.05	2.85	2.90	2.95	3.15	3.35	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	0.50	0.90	1.50	1.90
Federal bonds												
2-year	2.63	3.25	2.79	1.09	1.10	1.00	1.10	1.35	1.70	2.15	2.40	2.75
5-year	2.91	3.46	3.17	1.70	1.85	1.60	1.70	1.80	1.90	2.15	2.50	3.10
10-year	3.43	3.74	3.76	2.69	2.65	2.45	2.50	2.70	2.75	3.05	3.40	3.85
30-year	3.94	4.08	4.23	3.46	3.50	3.30	3.40	3.70	3.90	4.00	4.10	4.20
Yield curve												
5-year - 3-month	1.03	0.96	1.27	0.81	1.40	1.15	1.25	1.35	1.40	1.25	1.00	1.20
10-year - 2-year	0.80	0.49	0.97	1.60	1.55	1.45	1.40	1.35	1.05	0.90	1.00	1.10
30-year - 3-month	2.06	1.58	2.33	2.57	3.05	2.85	2.95	3.25	3.40	3.10	2.60	2.30
Spreads (Canada - U.S.)												
3-month	0.50	0.60	0.98	0.78	0.25	0.30	0.25	0.20	0.25	0.65	1.20	1.20
2-year	1.01	0.63	0.80	0.32	0.30	0.25	0.35	0.60	0.70	0.90	0.90	1.00
5-year	0.44	0.13	0.19	0.15	0.25	0.40	0.40	0.40	0.30	0.30	0.40	0.50
10-year	0.00	-0.24	-0.07	0.44	0.40	0.45	0.40	0.45	0.20	0.25	0.30	0.35
30-year	-0.36	-0.45	-0.07	0.76	0.25	0.30	0.30	0.50	0.50	0.40	0.30	0.20

f: forecasts

Sources: Datastream and Desjardins, Economic Studies