

## Has the Federal Reserve done enough? The Bank of Canada: from too much optimism to moderate pessimism

### HIGHLIGHTS

- Renewed optimism is making the bond market slacken, but the predominant deflation risks still favour a further rally.
- The Federal Reserve maintains but does not enhance its quantitative policy.
- According to the Bank of Canada's new scenario, the inflation target could be achieved without resorting to quantitative policy.
- The European Central Bank is hesitant about falling into step with the other central banks.
- Will the Bank of England's action be enough to jump start the economy?

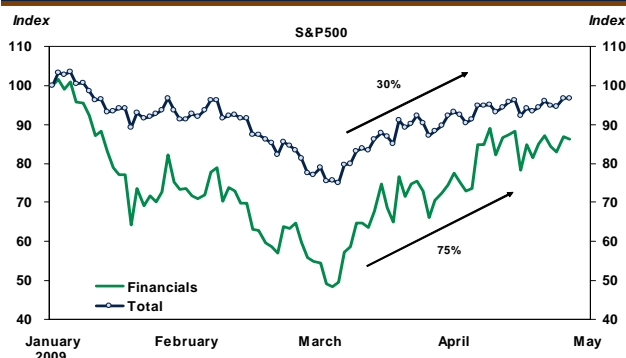
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### Summary

In the last few weeks, the stabilization and even turnaround of some economic and financial indicators has had a soothing effect on investor pessimism and allowed risky securities to stay on the growth track. From its March low, the stock market has gained 30% and commodity prices have rebounded from clearly oversold levels (graph 1).

Graph 1 – Is the stock market rally sustainable?



Sources: Datastream and Desjardins, Economic Studies

The renewed confidence, combined with the efforts made by U.S. monetary and government authorities, has allowed credit spreads to improve. Following the big surge associated with the bankruptcy of the investment firm Lehman Brothers, in the fall of 2008, rate spreads on corporate and agency securities have contracted since the beginning of the year (graph 2 on page 2).

Although these are encouraging developments, prudence is still in order. April's rebound by consumer confidence occurred from levels that demonstrated excessive pessimism; the ISM manufacturing index is still compatible with a sharp contraction in activity in this sector; and the inventory of new homes is still too high for builder optimism to favour a growing real estate market (graph 3 on page 2).

**François Dupuis**  
Vice-President and Chief Economist

**Yves St-Maurice**  
Director and Deputy Chief Economist

**Mathieu D'Anjou**  
Senior Economist

**Francis Généreux**  
Senior Economist

**Martin Lefebvre**  
Senior Economist

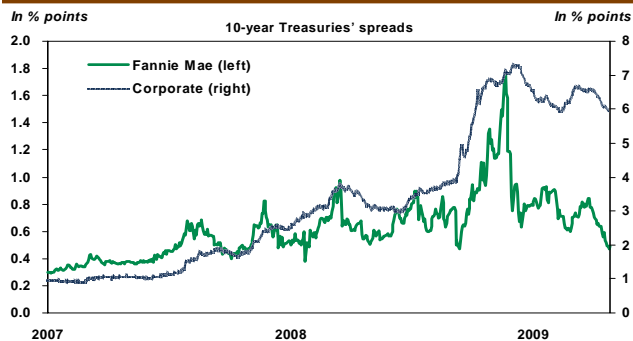
**Hendrix Vachon**  
Economist

514-281-2336 or 1 866 866-7000, ext. 2336  
E-mail: [desjardins.economics@desjardins.com](mailto:desjardins.economics@desjardins.com)

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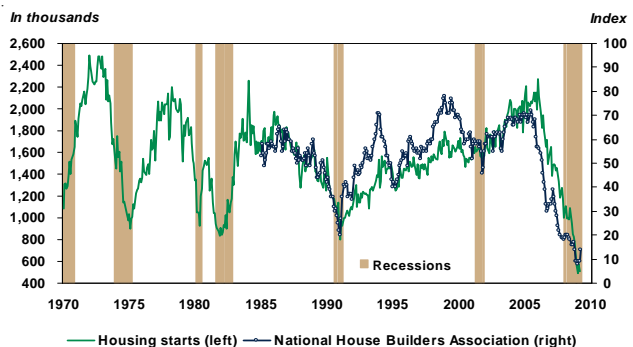
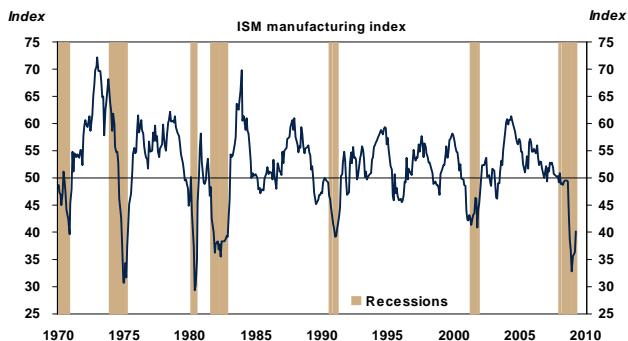
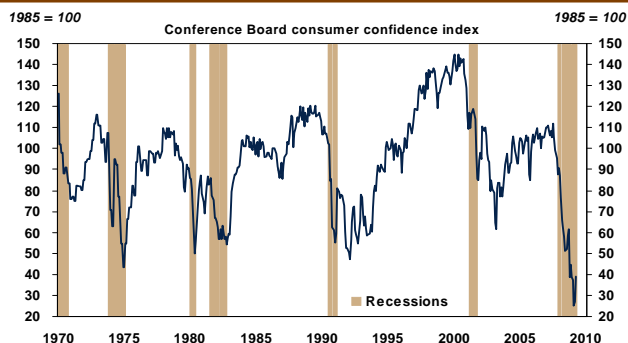
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**Graph 2 – Credit spreads are narrowing**



Sources: Bloomberg and Desjardins, Economic Studies

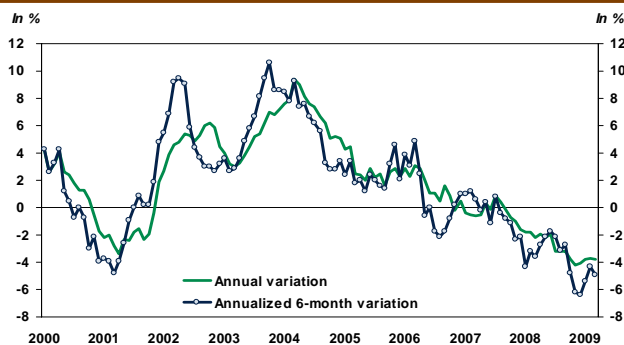
**Graph 3 – Some indexes have rebounded, but are still at very depressed levels**



Sources: Conference Board, Institute for Supply Management, Datastream and Desjardins, Economic Studies

Under these circumstances, the worst of the storm is probably now behind us, but we cannot expect things to get back to normal soon. Among other things, the leading indicator, which is still on a down trend, is not auguring any imminent recovery in the U.S. economy (graph 4). Moreover, there is still a lot of uncertainty. The banks' stress tests are going ahead, delaying the purchase of the toxic securities that are dogging their balance sheets and solvency. The risks of an Influenza A (H1N1) pandemic are not doing anything to help make the financial markets calm (see the box on page 3 for further details).

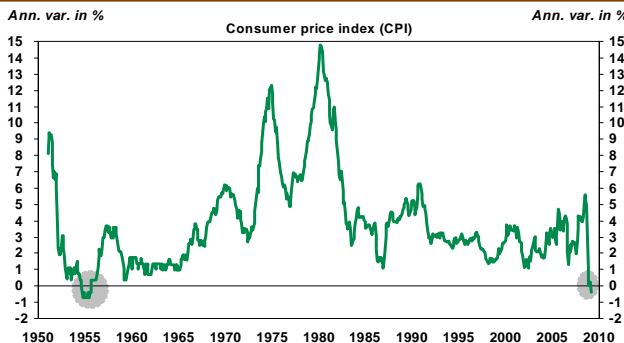
**Graph 4 – The leading indicator does not point to any substantial improvement in the economy**



Sources: Conference Board and Desjardins, Economic Studies

With the Federal Reserve (Fed) at work, and uncertainties that are still very palpable, it is surprising to see how reticent the markets are to drive government bond rates to lower levels. Of course, financing the Obama administration's colossal debt is still a sizeable worry for the bond market. The inflationary impacts of the Fed's quantitative measures are another. Nonetheless, in the short term, the deflation risk is predominant. Already, total inflation has gone into negative territory for the first time since 1955 (graph 5).

**Graph 5 – Inflation becomes negative for the first time since 1955 in the United States**



Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

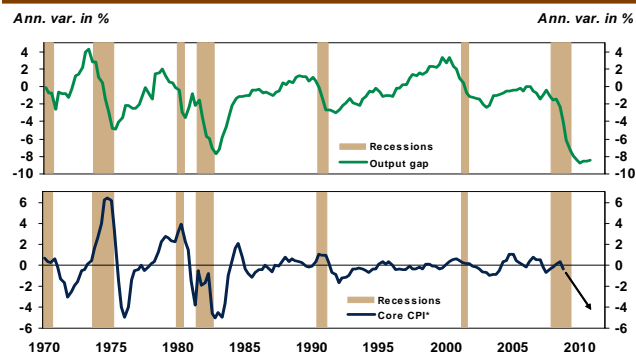
### A new threat: Influenza A (H1N1)

- The swine flu outbreak in Mexico has quickly spread to several other countries in the last few days. The World Health Organization (WHO) has raised the pandemic alert level to 5 out of a possible 6, indicating that it deems that a global pandemic is imminent and that all countries must immediately put their response plans into action.<sup>1</sup>
- To date, the cases reported outside Mexico, where 25 deaths have been confirmed, appear to be fairly benign (at the time of writing, the only death in the United States was a Mexican patient who had contracted the disease in his own country). At first glance, therefore, this flu does not appear to be very deadly. However, it is important to realize that this kind of virus can evolve rapidly and could therefore become more dangerous.
- Overall, the markets' reaction to the news of a potential pandemic has been fairly limited. Following an initial dip, most of the stock indexes quickly went back on the rise. Bond rates have also risen in the last few days, a sign that investor confidence has not been affected much. Even the Mexican stock market has wiped out some of its initial 5% pullback. However, the country's currency has depreciated by around 4%.
- The crisis has affected some sectors more, however. Airline stock has pulled back by about 7% in the United States since the crisis broke out, while a number of corporations in the health care sector have shot up. Although experts are repeatedly saying that eating pork does not pose a danger, the meat's price has fallen by almost 10%. In fact, the connection with pigs is not as clear as it seemed initially, and the WHO has decided to start using the term influenza A (H1N1) rather than calling it swine flu.
- It is much too early to assess the economic impact that Influenza A (H1N1) will have. We can, however, already state that the Mexican economy's contraction will be magnified substantially in the near future, as the government is suggesting that citizens stay home, and asking businesses to shut down for five days. The country's major tourism industry is also being pummelled. A look at the severe acute respiratory syndrome (SARS) epidemic of 2003 provides a glimpse of this pandemic's potential repercussions. SARS appeared in China at the end of 2002 and spread to Hong Kong and Vietnam in February of 2003. It then spread to other countries, including Taiwan and Singapore. In all, the illness infected just over 8,000 people worldwide; 774 deaths were directly associated with SARS. Among the industrialized nations, Canada was one of the most affected, with 438 reported SARS cases, and just over 40 deaths, primarily in the Toronto area.
- Some studies estimate that, in 2003, SARS contributed to real GDP contractions of about 5% in Hong Kong, almost 2% in China and about 1% in Taiwan. The impact in Canada was well below 1% and proved to be quite short lived. In its October 2003 *Monetary Policy Report*, the BoC estimated that the SARS epidemic had caused a 0.60% decline in Canada's GDP in the second quarter of 2003. As of the third quarter, the ebbing of SARS turned this trend around, making a +0.15% contribution to Canada's real GDP.
- For the global economy, the fear is that the pandemic will continue to spread, which could take consumer and investor confidence down. In that case, it would delay the hoped for stabilization of the world's economy.
- Although this possibility seems to be quite slim, given the authorities' quick response and low mortality rate to date, we cannot rule out the possibility of a serious global pandemic. According to research by the World Bank, a pandemic as deadly as the 1918 Spanish Flu epidemic could make the global GDP contract by 4.8%. Much of the loss would stem from efforts made to avoid contamination (reduction in travel and public activities), rather than from the direct impacts of the illness.

<sup>1</sup> Phase 5 was declared because an outbreak had been reported in two countries in the same region (Mexico and the United States), adding a third country in another region would confirm a pandemic (phase 6).

For now, the effects are essentially tied to the sharp correction in energy prices, but underlying inflation will probably be under pressure for the next few quarters. Among other things, the pace at which the U.S. economy is deteriorating will drive the output gap to historic lows, a situation that will take several years to resolve (graph 6). This means that the reflation measures instituted by the Fed will be kept in place for a long time (see the monetary rule on page 7).

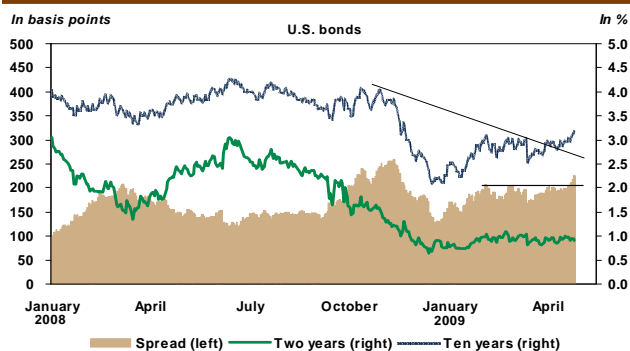
**Graph 6 – Prices will remain under pressure in the United States**



\* Annual change.  
Sources: Datastream and Desjardins, Economic Studies

The bond market seems to have been disappointed with the Fed's April 29 decision (graph 7), but the reaction appears to be exaggerated (see the *Fixed Income Market* section on page 13 for an analysis of rate movements).

**Graph 7 – The bond market was disappointed with the Federal Reserve's decision**



Sources: Datastream and Desjardins, Economic Studies

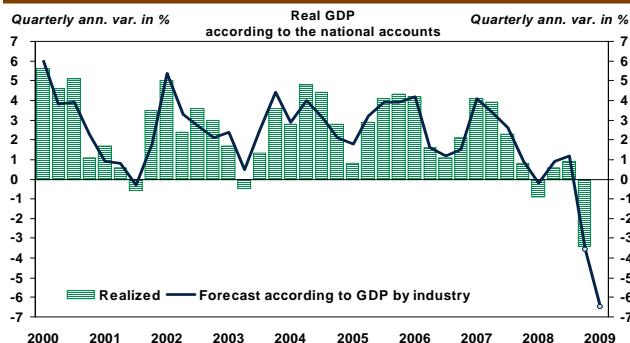
Among other things, the sums that have been generated to date are in line with the Fed's commitments (for example, the pace of the purchases, at almost US\$10B of Treasuries per month, is compatible with the Fed's goal of buying US\$300B by next fall). However, the Fed could have suggested in its statement that, if the economic and financial situation were to deteriorate further, it would be prepared to ratchet up its action or speed up its purchases of public and private

securities. Inflation's movement could eventually force the Fed to make such commitments, in that the increase in real interest rates, triggered by both rising nominal rates and inflation in negative territory, is categorically counter to the Fed's efforts.

**CANADA: QUANTITATIVE POLICY COMING TO A PLACE NEAR YOU?**

Due to a net deterioration in economic activity (graph 8), the Bank of Canada (BoC) has slashed its growth and inflation outlooks for 2009. The BoC is still relatively optimistic about the economic recovery, however. Mark Carney and his colleagues expect Canada's real GDP to grow 2.5% in 2010 (graph 9), growth that is almost twice as fast as our own forecast, and that of the International Monetary Fund (IMF).

**Graph 8 – Heading for a record real GDP contraction in Q1 of 2009**



Sources: Statistics Canada and Desjardins, Economic Studies

**Graph 9 – Comparison of economic forecasts**

Forecasts		2008	2009f	2010f	2011f
Bank of Canada	Real GDP	0.5%	-3.0%	2.5%	4.7%
	Total inflation rate*	2.3%	0.3%	1.7%	1.9%
Desjardins	Real GDP	0.5%	-3.0%	1.4%	3.0%
	Total inflation rate	2.3%	-0.1%	1.3%	2.5%
International Monetary Fund	Real GDP	0.5%	-2.5%	1.2%	n.a.
	Total inflation rate	2.3%	0.0%	0.5%	n.a.

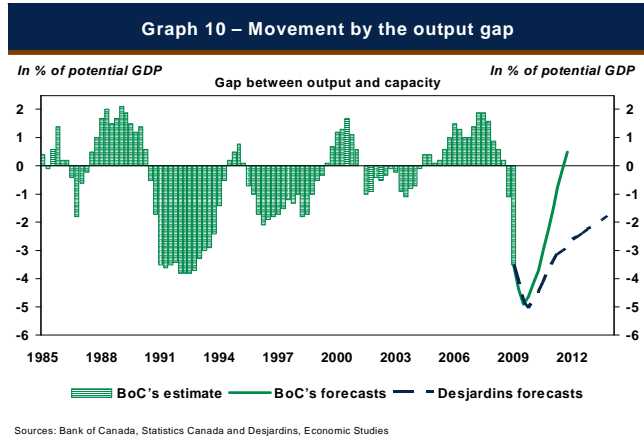
\* Projections based on quarterly and semi-annual forecasts; f: forecasts; n.a.: not available.  
Sources: Bank of Canada, International Monetary Fund and Desjardins, Economic Studies

Profound adjustments are underway in Canada's economy (restructuring auto industry, problems in the forestry industry, increase in household savings rate, decrease in real estate prices, consolidating financial markets, etc.), significantly reducing production's growth potential. According to the BoC's estimates, potential output will grow 1.2% this year,

1.5% in 2010 and 1.9% in 2011. To achieve economic growth of 2.5% in 2010, as the BoC expects, the real GDP will have to go up by about 4% a quarter, on average, all year long, a pace that is well above potential (1.5%). This type of difference is usually associated with a very lively economic recovery. Given the global economy's difficulties and ongoing problems in the financial markets, most forecasters instead think that industrialized countries will see moderate economic recoveries.

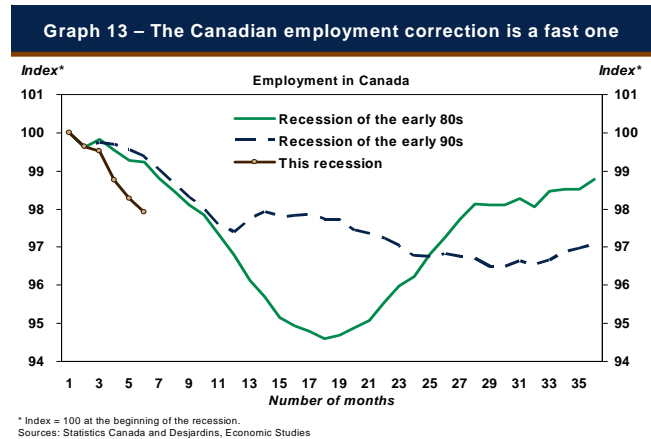
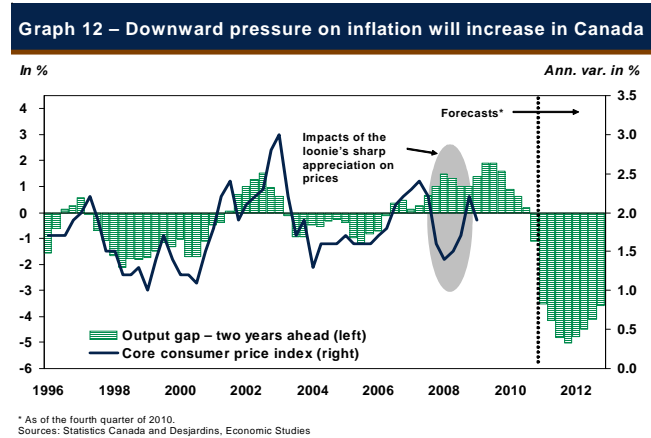
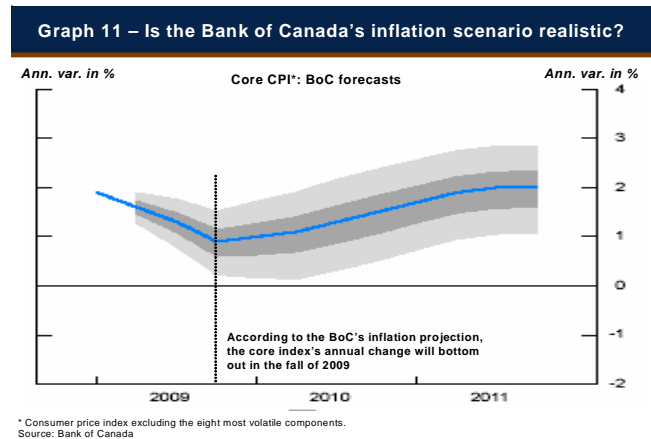
Given these adjustments, the monetary authorities' response has us confused. The key interest rate has been taken to a floor of 0.25%, and, in a spirit of transparency, the BoC has committed to keeping it there until the second quarter of 2010. However, this does not add much to what was already implicit at the meeting in March, i.e. keeping the rates at a low level for a long time.

Our economic scenario shows that more aggressive action will have to be taken as quickly as possible to limit the impact of the drop in activity on underlying inflation. As the BoC has revised the economy's growth potential downward, it will take less growth to mop up excess production capacity, but it would be surprising if this were to happen before 2011 at the earliest (graph 10).

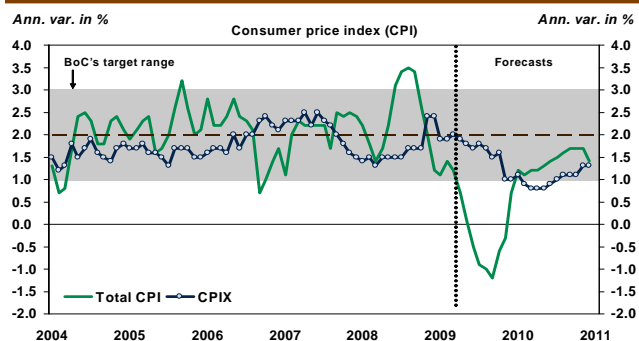


From this perspective, it is surprising to see the BoC's base scenario say that the annual core inflation rate will bottom out at about 1% in the fall of 2009 (graph 11).

The excess supply and the sharp deterioration in the employment market (graphs 12 and 13) will continue to put downside pressure on prices and, although we are not anticipating any deflation outside of energy, there is a sizeable risk that the inflation target will not be achieved over the medium range (graph 14 on page 6).



**Graph 14 – Canada is expected to see a temporary period of deflation**



Sources: Statistics Canada and Desjardins, Economic Studies

Under these circumstances, the change in the BoC's operating framework, with the deposit rate being held at 0.25%, must be seen as an opening to quantitative measures designed to increase banking reserves. The BoC seems to be reticent to take such measures but, if our scenario materializes, it will have to do more to stave off deflation. Buying up private and public securities will inevitably be good news for the bond market in the next few months. Both rate levels and credit spreads should come down.

**François Dupuis**  
Vice-President and Chief Economist

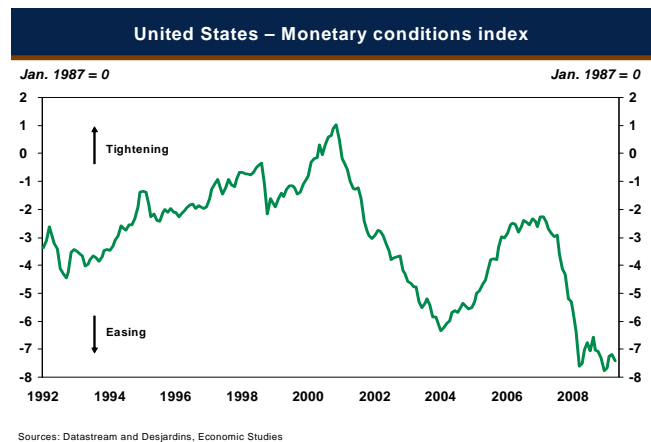
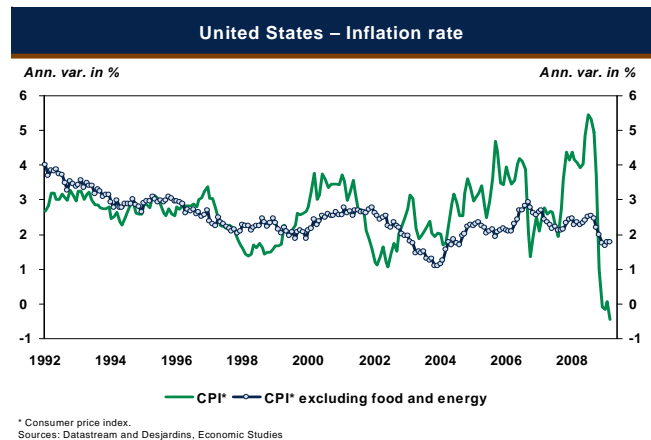
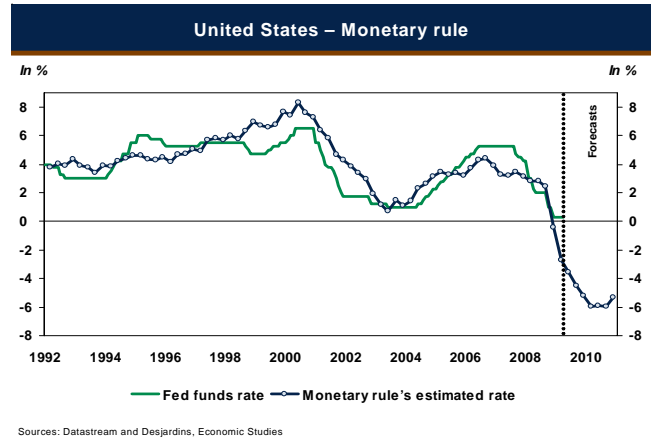
**Martin Lefebvre**  
Senior Economist

# FEDERAL RESERVE

## Quantitative policy continues, but does not expand

- Although still shaky, the U.S. economy no longer seems to be contracting at such a frightening pace as it was at the end of 2008 or in early 2009. In this context, the Federal Reserve (Fed) opted to keep its monetary policy unchanged at its meeting on April 28 and 29. Key interest rates remain in a target range of 0.00% to 0.25%.
- In its quantitative policy, the Fed is maintaining its targets for security purchases. Here, it still has a long way to go before it exhausts its tools. The purchase of government bonds is occurring fairly slowly, as the Fed has only bought US\$68.3B of the target US\$300B. It has only amassed US\$367.7B in mortgage-backed securities, compared with the target of US\$1,250B, and US\$45B in agency debt securities out of a potential US\$200B. Maintaining the targets announced in March gives the Fed the possibility of taking a lot more action in the markets. Moreover, the program designed to extend consumer and business credit, TALF (Term Asset-Backed Securities Loan Facility) is still in its infancy, with barely US\$6.4B outstanding. The federal government's financial rescue plan states that this program could go as high as US\$1,000B outstanding.
- Underuse of production capacity and the increase in joblessness are fuelling the risks of deflation, which are still dominant. In March, for the first time since 1955, inflation was negative in the United States. The consumer price index was 0.4% lower than it was in March 2008. However, this is not a generalized phenomenon: the CPI's decline over 12 months stems solely from the 23% drop in energy prices, while food prices are up 4.4% and core inflation (which excludes food and energy) is at 1.8%. The impact of the annual drop in energy prices should take total inflation to a low of about -2.0% this summer. Core inflation should also moderate, although the latest monthly figures were more stable than expected. Core CPI should slow over the next few quarters, reaching an annual change of 0.5% in mid-2010.

**Forecasts:** We cannot expect many changes in American monetary policy in the next few months. Instead, the Fed will continue to implement the quantitative measures that are already in place, which will keep expanding its balance sheet.

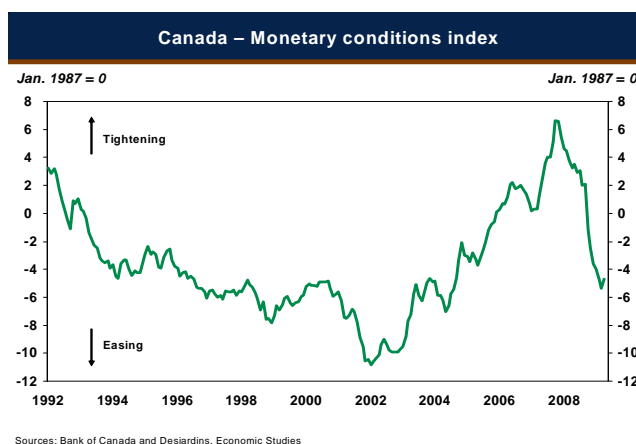
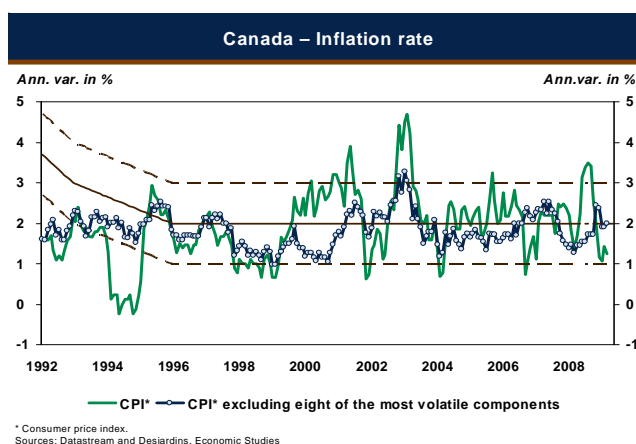
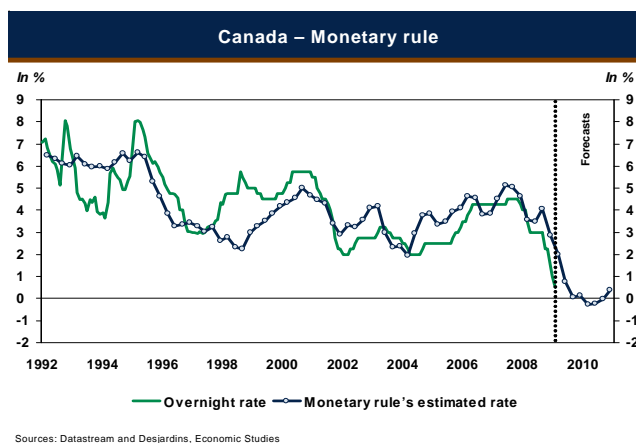


# BANK OF CANADA

## The BoC is hesitant about resorting to quantitative policy

- In April, the Bank of Canada (BoC) opted to tighten its monetary policy one more notch by lowering its key rate by 25 basis points, to a historic low of 0.25%. This floor marks the end of 425 basis points in monetary easing since December 2007.
- According to the BoC, it has taken more time than usual for monetary policy to take effect and Canada's recession will be deeper than first thought. To no one's surprise, the BoC revised its outlooks for growth and inflation. It is now expecting real GDP to contract by about 3% in 2009 with, among other things, a record contraction in the first quarter (-7.3%).
- Our growth estimates for Canada's economy (similar to the BoC's for 2009, but more negative for 2010) are compatible with a significant widening of the output gap, which could reach almost 6% by the end of 2009, and will be hard to mop up over the next few years. The excess supply will continue to put downside pressure on prices and, although we are not anticipating any deflation outside of energy, there is a sizeable risk that the inflation target may not be achieved over the medium range.
- A period of deflation (negative annual change in prices) should begin by June. This will be a temporary phenomenon, however, as it is expected to swing back into positive territory at the end of 2009. The decrease essentially reflects the drop in energy prices, so the annual change in the core index (CPIX) should meanwhile remain positive, although an incursion below the lower target (1%) cannot be ruled out for several months.
- In its Monetary Policy Report, the BoC set out the framework for implementing the future monetary easing tools that will be used if needed. Conditional upon its inflation scenario, it thus committed to keeping the key rate at 0.25% until the second quarter of 2010. If there are further shocks, the BoC intends to resort to credit and further quantitative easing.

**Forecasts:** As traditional monetary policy has reached a floor, the door is now open to quantitative easing. The BoC seems to be trying to buy time, but the risk that inflation will move substantially below the 2% target over the next few months signals that its work is not over.

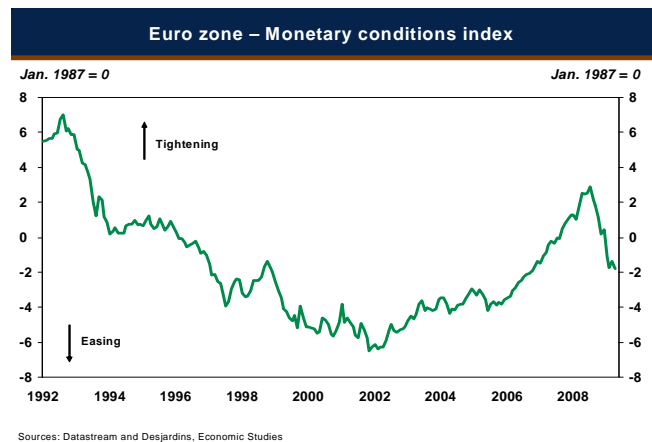
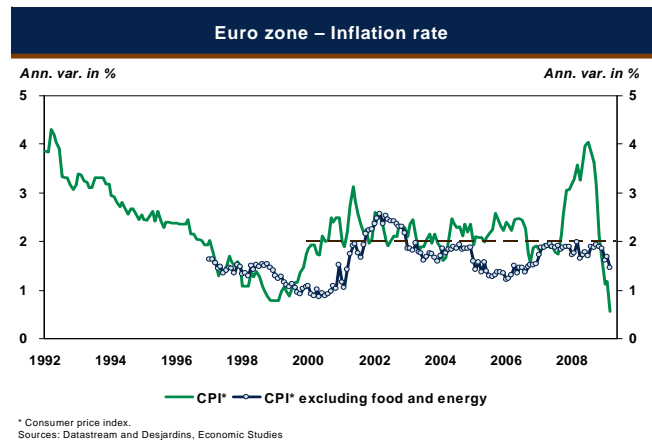
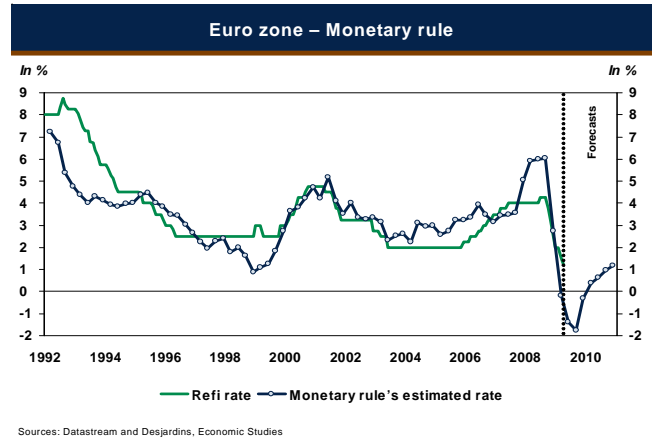


# EUROPEAN CENTRAL BANK

## The ECB is hesitant to fall into step with the other central banks

- The European Central Bank's (ECB) lag widened further in April. Unlike the other monetary authorities, which have already taken their key rates to a floor that is very close to zero and, in most cases, instituted some form of quantitative easing, the ECB took its foot off the gas, lowering its key rate by only 25 basis points in April, to 1.25%. Analysts had been anticipating a more aggressive 50 point cut. At the press conference that followed the decision, President Trichet confirmed that another rate cut could happen on May 7, and that the decision as to whether to proceed with non-traditional measures would also be announced at that meeting.
- The relatively disappointing outcome of April's meeting seems to reflect uncertainty and dissent within the ECB as to the monetary policy to adopt given an exceptionally difficult economic and financial environment. Comments from members of the Governing Council confirm that there are some conflicting opinions. Some, including Axel Weber, believe it would be inappropriate to take the key rate below 1%, and that additional measures should continue to focus on financing the banking sector: "Direct interventions, such as the purchase of corporate debt, shouldn't take priority." Others think the Council should consider bringing its key rate closer to zero and proceeding with asset purchases.
- Given the euro zone's economic situation, it is hard to understand the ECB's reticence about doing everything in its power to stimulate activity. The real GDP's sharp downturn should continue, as confidence indicators hit new lows in March, and the pullback by retail sales picked up speed in February, reaching a year-over-year change of -4.0%. Although the purchasing manager (PMI) and IFO indexes edged up in April, it seems certain that the recession will last for several more months. The annual inflation rate, at just 0.6% in April, should slide into negative territory this summer and subsequently remain very low, given how soft the economy is. Some ECB members are even acknowledging that deflation risks have risen somewhat.

**Forecasts:** Another 25 basis point key rate cut seems certain in May, when the ECB should also announce new efforts to support the credit market, without necessarily starting to buy assets. Like the Federal Reserve and the Bank of Canada, the ECB should also send a clear signal that rates will not be brought up for several months. After that, we could think that Euroland authorities will try to keep the key rate at 1.00%, a psychological threshold for some Bank leaders. However, economic problems could force them to return to monetary easing this summer.

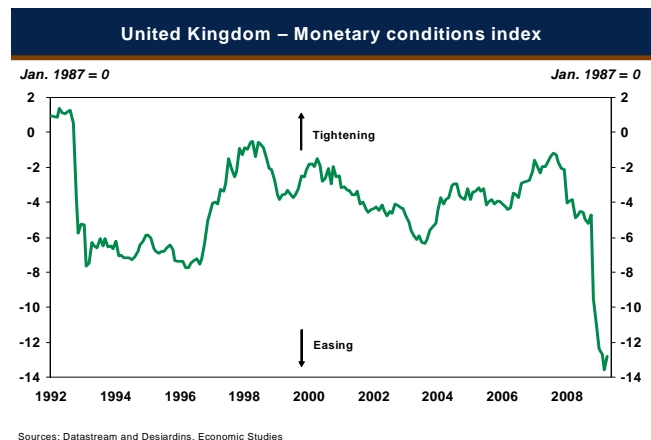
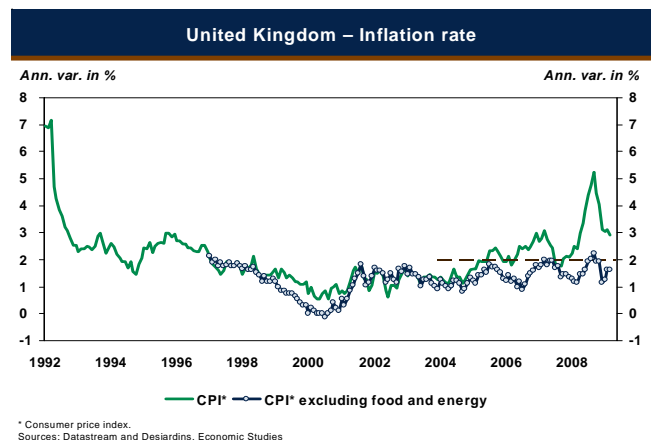
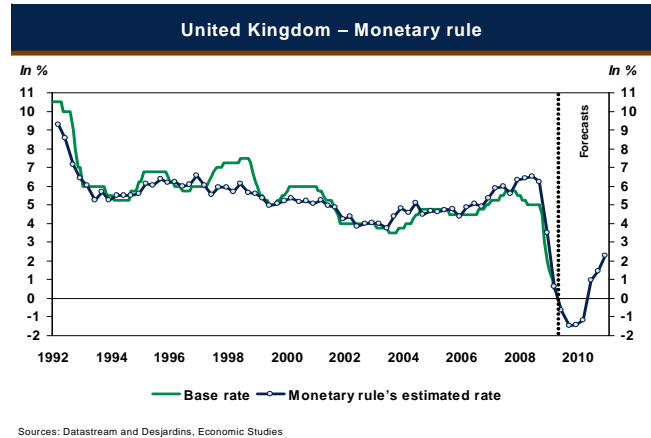


# BANK OF ENGLAND

## Will the BoE's actions be enough to kick start the economy?

- Unlike the European Central Bank, the Bank of England (BoE) has taken an aggressive approach to help get Britain's economy out of recession. Note that it instituted a quantitative policy as early as February, starting with buying commercial paper. It went further still in March, lowering its key rate to 0.50%, which, for technical reasons, should be a floor, and announcing a new £75B (US\$110B) quantitative easing program designed to increase the money supply by buying private securities and even British government bonds. The BoE's work is therefore well underway and no further action was taken at the April meeting.
- The BoE's readiness to use all of its ammunition is justified by the British economy's brutal contraction over the last few months. After plunging by an annualized 6.1% in the last quarter of 2008, the real GDP's contraction totalled 7.4% in the first quarter of 2009. A ray of hope recently dawned, as the actions taken by the BoE and government seem to be starting to have a positive impact on the economy. Credit conditions did not tighten as sharply in Q1 of 2009, and financing is now expected to ease somewhat this spring. Moreover, we are beginning to see a promising stabilization in the housing market. It is much too early to be able to hope for renewed growth in the United Kingdom but, as the BoE noted at its last meeting: "... the rate of contraction in output might be starting to moderate in Q2." The spectacular erosion of the public finances still constitutes a major risk for Britain's economy and could offset the BoE's efforts to keep bond rates low.
- Given the magnitude of the recession that is pummeling Britain's economy, inflation's resilience is still surprising analysts and the BoE. Yearly CPI is still high at 2.9% in March. This rapid price increase primarily seems to be a reflection of a bigger pass-through effect on UK prices of the pound sterling's depreciation. Given the weak domestic inflation pressures and the pound's recent stabilization, inflation should slow substantially over the next few months. The BoE acknowledges that, in the near term, inflation may not be as low as it had anticipated, but it still expects it to drop below the 2% target in the second half of the year.

**Forecasts:** Despite some encouraging signs, the British economy is still in serious difficulties. The BoE will maintain highly expansionary policies for several quarters and the scope of the quantitative easing program could potentially be increased. However, inflation's resilience will allow the BoE to wait a while before announcing new programs.

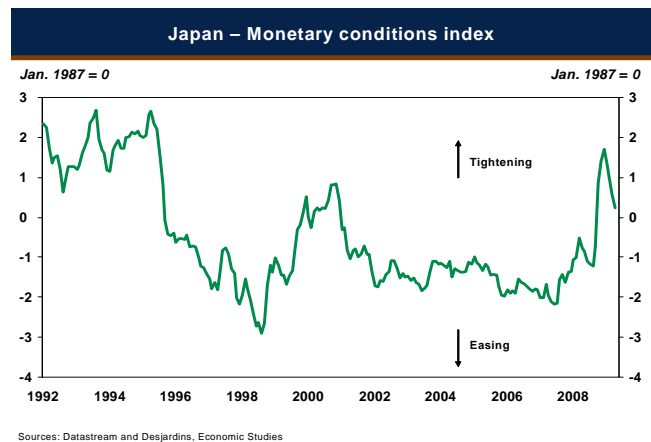
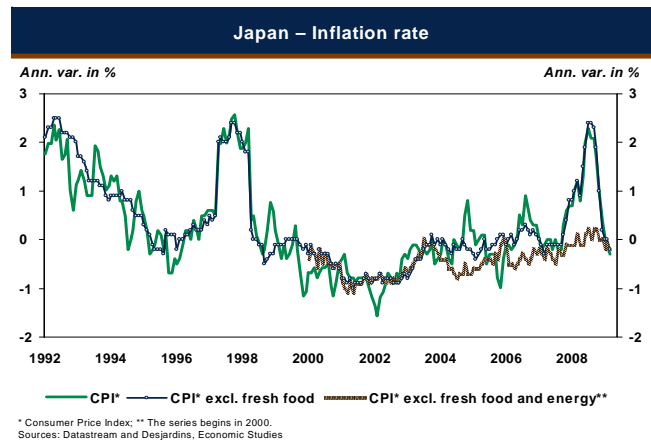
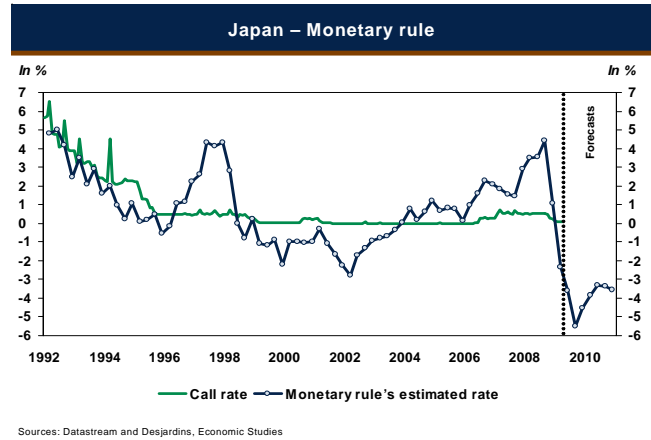


# BANK OF JAPAN

## The BoJ is not skimping on means

- Japan has slid into a recession which, combined with the drop in commodity prices, has revived deflation. It is therefore not surprising to witness the extent of the Bank of Japan's (BoJ) monetary easing. Its primary key interest rate has now been close to 0.1% since last December and, like other central banks, it has deployed an array of unconventional measures.
- Japan's economy is in dismal condition. Exports have fallen off considerably, due to the deterioration in economic conditions worldwide. The haemorrhage did stop in March, when shipments abroad went up for the first time in ten months. However, there is no guarantee that the improvement will last. Japan's economy is also being slammed by a drop in domestic demand, hurt by the decline in corporate profits, more precarious job market and contraction in household incomes. In addition, credit conditions are still tight, hurting recovery efforts.
- The situation seems more problematic in corporate financing, which is, moreover, why the BoJ has been buying commercial paper and corporate bonds for some time. The monetary authorities are noting that some improvements have been generated by the measures taken, but they believe they must still keep their feet on the accelerator. The limit on the central bank's annual purchase of Japanese government bonds was raised to 21.6 trillion yen in March, to make sure that the financial markets have sufficient liquidity. On April 10, the BoJ also announced the terms and conditions of a new line of credit making it possible to extend long-term loans to Japanese banks, to ensure they have a big enough capital base to keep operating.
- Backing the central bank's actions, the Japanese government is not stinting on its efforts to stay the crisis. Despite an already heavy public debt load, it announced a US\$150B economic stimulus plan in early April. Moreover, the yen's depreciation in the last few weeks has helped to ease monetary conditions, which had remained tight despite the interest rate cuts. The currency's value is now more in line with the economy's softness.

**Forecasts:** In Japan, the recession is a severe one that has brought deflation back. To support a recovery, the rest of the planet's economy will have to get back on its feet first. Monetary authorities will have no other choice but to keep the main key rate close to 0.1% for several quarters, and continue with monetary easing using unconventional measures.



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

End of period in %	2008				2009				2010			
	Q1	Q2	Q3	Q4	Q1	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
<b>United States</b>												
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
<b>Canada</b>												
Overnight funds	3.50	3.00	3.00	1.50	0.50	0.25	0.25	0.25	0.25	0.25	0.25	0.50
<b>Euro zone</b>												
Refinancing rate	4.00	4.00	4.25	2.50	1.50	1.00	0.50	0.50	0.50	0.50	1.00	1.50
<b>United Kingdom</b>												
Base rate	5.25	5.00	5.00	2.00	0.50	0.50	0.50	0.50	0.50	0.50	0.50	1.00
<b>Japan</b>												
Overnight funds	0.50	0.50	0.50	0.30	1.30	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
<b>February 2008</b>			
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
<b>March 2008</b>			
2	Reserve Bank of Australia	s.q.	3.25
3	Bank of Canada	-50 b.p.	0.50
5	Bank of England	-50 b.p.	0.50
5	European Central Bank	-50 b.p.	1.50
11	Reserve Bank of New Zealand	-50 b.p.	3.00
11	Bank of Brazil	-150 b.p.	11.25
12	Swiss National Bank	-25 b.p.	0.25
17	Bank of Japan	s.q.	0.10
18	Federal Reserve	s.q.	0,00 / 0,25
20	Bank of Mexico	-75 b.p.	6.75
25	Bank of Norway	-50 b.p.	2.00
<b>April 2008</b>			
2	European Central Bank	-25 b.p.	1.25
6	Bank of Japan	s.q.	0.10
7	Reserve Bank of Australia	-25 b.p.	3.00
9	Bank of England	s.q.	0.50
17	Bank of Mexico	-75 b.p.	6.00
21	Bank of Sweden	-50 b.p.	0.50
21	Bank of Canada	-25 b.p.	0.25
29	Reserve Bank of New Zealand	-50 b.p.	2.50
29	Bank of Brazil	-100 b.p.	10.25
29	Bank of Japan	s.q.	0.10
29	Federal Reserve	s.q.	0,00 / 0,25

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

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

Date	Central Bank
<b>May 2009</b>	
5	Reserve Bank of Australia
6	Bank of Norway
7	Bank of England
7	European Central Bank
15	Bank of Mexico
21	Bank of Japan
<b>June 2009</b>	
2	Reserve Bank of Australia
4	Bank of England
4	European Central Bank
4	Bank of Canada
10	Reserve Bank of New Zealand
10	Bank of Brazil
15	Bank of Japan
17	Bank of Norway
18	Swiss National Bank
19	Bank of Mexico
24	Federal Reserve
<b>July 2009</b>	
2	European Central Bank
2	Bank of Sweden
7	Reserve Bank of Australia
9	Bank of England
14	Bank of Japan
17	Bank of Mexico
21	Bank of Canada
22	Bank of Brazil
29	Reserve Bank of New Zealand

Source: Desjardins, Economic Studies

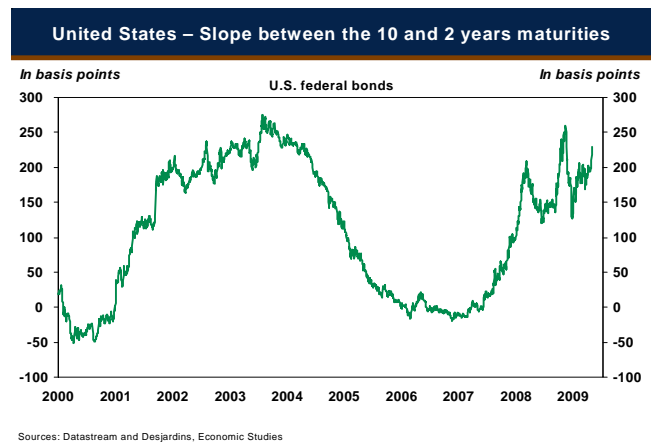
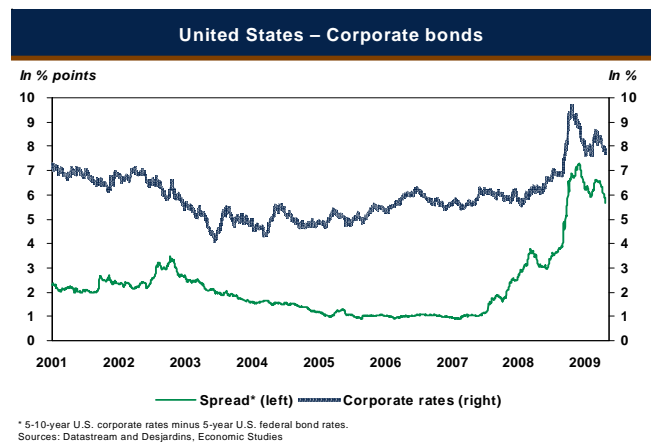
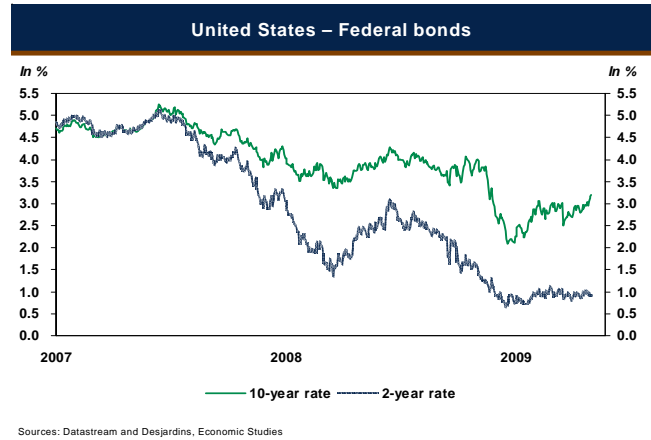
# FIXED INCOME MARKET

## Renewed optimism makes the bond market slacken

### U.S. FEDERAL BONDS

- The economic and financial problems are still with us, but the bond market is made of stone due to concerns regarding the financing of the American government's budget deficit.
- The short part of the yield curve remains under pressure. After reaching a low of 0.80% at the end of March, two-year rates began a slight up trend, closing in on 0.95%.
- Markets' fears about financing the U.S. debt have kept downside pressure on the longer maturities. After benefiting from the Federal Reserve's (Fed) policy to buy US\$300B in Treasuries, ten-year bond rates moved upward, going from a mid-March low of 2.50% to a recent peak over 3.10% on April 29. Note that the bond markets reacted strongly to the latest Fed statement; the Fed did not expand its quantitative action and showed some optimism about the future recovery.
- The markets' reaction seems overblown. For one thing, the stock market rally (+30% since March) is still very shaky and subject to a correction at any time. For another, the deflation risk remains dominant. Even if the economic situation improved slightly over the next few quarters, the output gap would continue to widen which, combined with the lags that have already been amassed, would wipe out inflation pressure for several quarters to come. As a result, the steepening of the interest rate curve, at its steepest since November of 2008, should correct. The spread between two-year and ten-year rates went from 169 basis points at the time of the Fed's March meeting to 225 basis points at the time of the April meeting, an increase of 56 basis points.
- If bond rates stay at current levels, we can expect further intervention from the Fed. Clearly, the recent increase in rates goes against the Fed's efforts. In particular, it remains to be seen how comfortable it will be with ten-year rates over 3.25%. The need for low nominal rates to jump start the economy will be even greater if deflation intensifies.

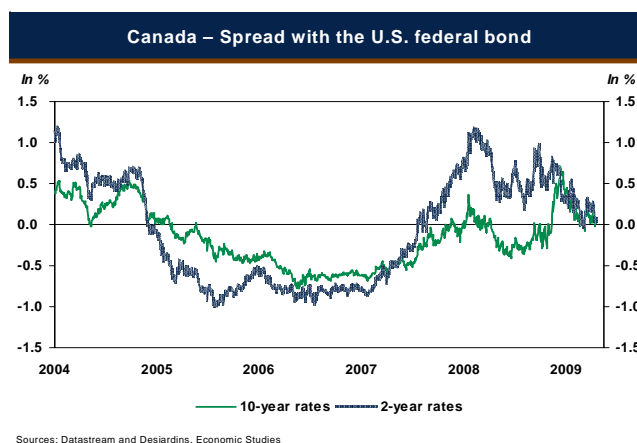
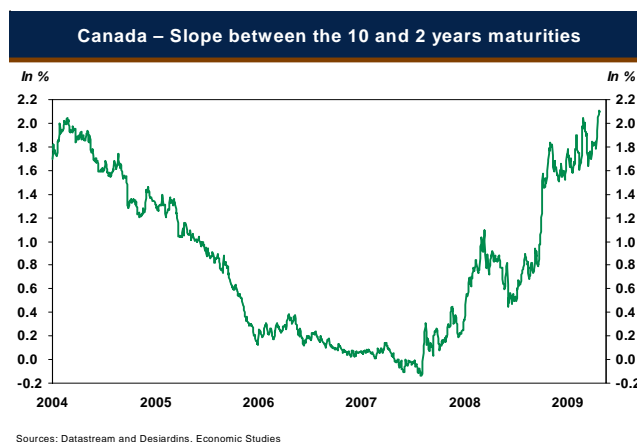
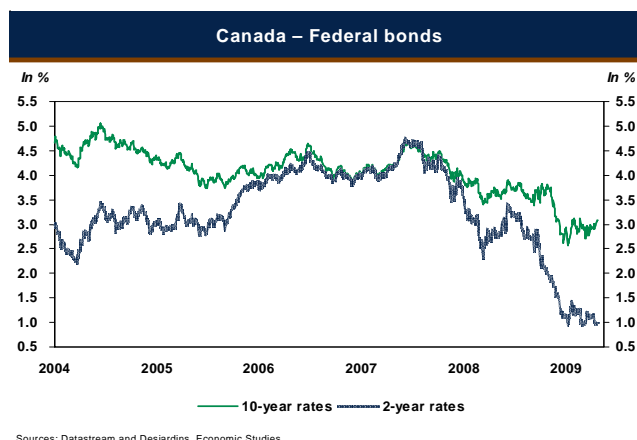
**Forecasts:** At the pace at which the U.S. Treasury is holding auctions, prudence is in order. However, our themes of economic downturn, widening output gap, potential deflation risk, forced return to savings, and potential additional intervention by the Fed in the secondary market are favourable to an eventual bond market rally.



### CANADIAN FEDERAL BONDS

- After recording large changes at the end of 2008 and in early 2009, Canadian bond rates have shown signs of stabilizing in the last few weeks. On one hand, the weak economy and inflation pressures, as well as the central banks' efforts, are reining in rate increases. On the other, massive issues of new bonds to finance public deficits worldwide are worrying investors and preventing rates from going any lower.
- The rate on two-year Canadian federal bonds edged just under 1% following the last 25 basis point cut to Canadian key rates on April 21, which had not been fully priced in. Despite the Bank of Canada's (BoC) commitment to keep its rate at this floor until mid-2010, the cut's impact on long-term rates did not last. The ten-year rate even went over 3.00% after the Monetary Policy Report was released, which said that quantitative monetary policy was not imminent in Canada. As a result, the Canadian curve's slope steepened to 207 points, a peak that dates back to August of 2002.
- The spreads between Canadian and U.S. bond rates are now very small, as the economic situation appears to be fairly similar on both sides of the border. Firstly, key rates are at almost zero in Canada and the United States. Secondly, the recessionary climate and lack of inflation pressures are affecting both economies, justifying similar long-term rates. The absence of quantitative policy in Canada, however, should keep Canadian rates just above rates on American securities.
- Investors' renewed confidence, as well as renewed demand for riskier assets, have really helped Canadian corporate bonds. The improvement in the financial environment has allowed some companies to start issuing securities again, and has brought down their financing costs. The yield rate demanded on Canadian corporate bonds has declined by about 80 basis points since the year began, and the spread between corporate and federal securities has declined from 3.65% to just under 3%.

**Forecasts:** Although the substantial increase in the supply of bonds will keep investors worried, we believe that Canadian rates could come down somewhat in the next few months. The economic and financial context is still very difficult, and the dominant deflation risk will test the markets' optimism. We therefore recommend banking on the curve flattening slightly. The next easing measures could focus on buying private securities, which would help corporate spreads to narrow further.

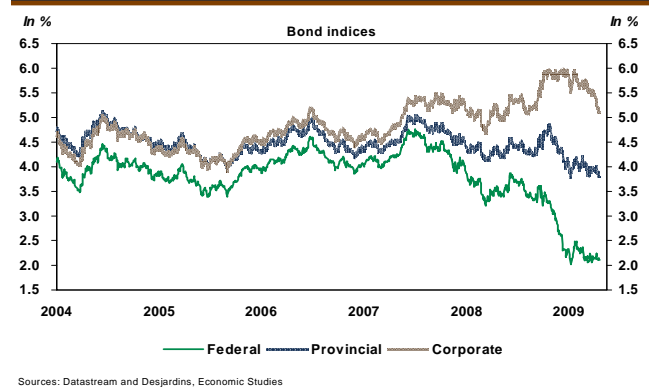


**PROVINCIAL BONDS**

- Provincial bonds have done well recently, with spreads for federal securities narrowing by about 25 basis points since March began. This confirms that the dominant factor for rate spreads is currently the evolution of financial strains. The recent drop in risk aversion therefore more than offset the sharp deterioration in a number of provinces' budget situations and the large issues of new bonds needed to finance the increase in provincial debt.
- The last few months have shown that this recession is not sparing any part of the country. Ontario is especially hard hit, and western Canada is affected as well, with Alberta and British Columbia seeing their economies contract in 2008. For 2009, we expect real GDP to contract in every province. The recession's impact on the public purse is a concern, as most provinces, including Alberta, announced sizeable deficits when they tabled their budgets. In Québec and Ontario, the return to a balanced budget promises to be a long, arduous process.

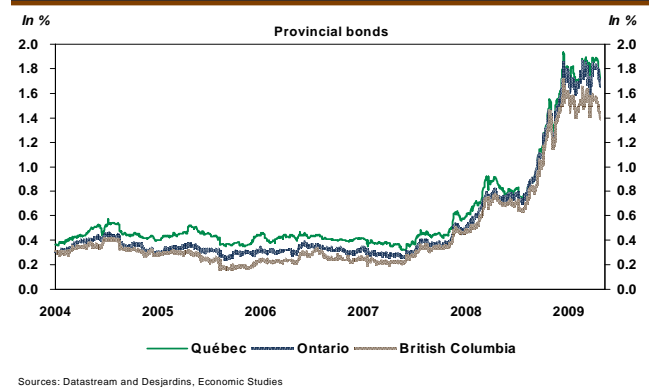
**Forecasts:** Rate spreads between provincial and federal government securities are still very wide, historically. They could therefore continue to shrink over the coming quarters, if investors' risk aversion keeps dwindling. Huge issues of new bonds to finance deficits could slow down the narrowing of the spreads, however. Once the recession is over, the provinces will have to quickly take steps to eliminate their deficits in order to maintain their credit ratings. The spreads could narrow further if the Bank of Canada decides to buy provincial securities. Such an action does not seem to be imminent, however.

**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>Net fin. debt (2) in % of GDP</i>	<i>Credit rating</i>	
	2008-2009f	2009-2010f	2009-2010f	2007	S&P	Moody's
Federal government	-1,100	-33,700	-2.1	38.5	AAA	Aaa
Newfoundland	2,400	-750	-2.5	47.5	A	Aa2
Prince Edward Island	-41	-85	-2.0	30.7	A	Aa2
Nova Scotia	-170	n.a.	n.a.	37.8	A+	Aa2
New Brunswick	-265	-741	-2.7	24.0	AA-	Aa1
Québec	0	-3,946	-1.3	39.4	A+	Aa2
Ontario	-3,900	-14,100	-2.5	21.0	AA	Aa1
Manitoba	96	48	0.1	27.2	AA	Aa1
Saskatchewan	2,318	425	0.8	20.8	AA+	Aa1
Alberta	-1,426	-4,714	-2.5	-18.6	AAA	Aaa
British Columbia	50	-495	-0.3	8.0	AAA	Aaa

n.a.: not available, those budgets had not been released; f: forecasts; (1) Include contingency reserves for some governments, (2) Adjusted based on the Financial Management System of Statistics Canada.

Sources: Federal and provincial departments of Finance, Statistics Canada and Desjardins, Economic Studies

**Table 5**  
**United States: fixed income market**

End of period in %	2008				2009				2010			
	Q1	Q2	Q3	Q4	Q1	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
<b>Key rate</b>												
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
<b>Treasury bills</b>												
3-month	1.38	1.90	0.92	0.11	0.21	0.15	0.20	0.25	0.25	0.30	0.40	0.70
<b>Federal bonds</b>												
2-year	1.62	2.61	1.99	0.76	0.81	0.75	0.75	0.75	1.00	1.25	1.50	1.75
5-year	2.47	3.33	2.98	1.55	1.68	1.50	1.40	1.40	1.60	1.85	2.10	2.60
10-year	3.43	3.98	3.82	2.25	2.69	2.50	2.40	2.40	2.60	2.80	3.10	3.50
30-year	4.30	4.53	4.30	2.69	3.57	3.40	3.30	3.30	3.40	3.60	3.80	4.00
<b>Yield curve</b>												
5-year - 3-month	1.09	1.43	2.06	1.44	1.47	1.35	1.20	1.15	1.35	1.55	1.70	1.90
10-year - 2-year	1.81	1.36	1.84	1.49	1.88	1.75	1.65	1.65	1.60	1.55	1.60	1.75
30-year - 3-month	2.92	2.63	3.38	2.58	3.36	3.25	3.10	3.05	3.15	3.30	3.40	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	Q1	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
<b>Key rate</b>												
Overnight funds	3.50	3.00	3.00	1.50	0.50	0.25	0.25	0.25	0.25	0.25	0.25	0.50
<b>Treasury bills</b>												
3-month	1.88	2.50	1.90	0.89	0.40	0.20	0.20	0.20	0.30	0.35	0.40	0.70
<b>Federal bonds</b>												
2-year	2.63	3.25	2.79	1.09	1.07	0.85	0.85	0.85	1.10	1.40	1.65	1.85
5-year	2.91	3.46	3.17	1.70	1.75	1.75	1.65	1.65	1.85	2.15	2.30	2.70
10-year	3.43	3.74	3.76	2.69	2.78	2.75	2.65	2.65	2.80	3.05	3.40	3.80
30-year	3.94	4.08	4.23	3.46	3.56	3.50	3.40	3.50	3.60	3.80	4.00	4.10
<b>Yield curve</b>												
5-year - 3-month	1.03	0.96	1.27	0.81	1.35	1.55	1.45	1.45	1.55	1.80	1.90	2.00
10-year - 2-year	0.80	0.49	0.97	1.60	1.71	1.90	1.80	1.80	1.70	1.65	1.75	1.95
30-year - 3-month	2.06	1.58	2.33	2.57	3.16	3.30	3.20	3.30	3.30	3.45	3.60	3.40
<b>Spreads (Canada - U.S.)</b>												
3-month	0.50	0.60	0.98	0.78	0.19	0.05	0.00	-0.05	0.05	0.05	0.00	0.00
2-year	1.01	0.63	0.80	0.32	0.27	0.10	0.10	0.10	0.10	0.15	0.15	0.10
5-year	0.44	0.13	0.19	0.15	0.07	0.25	0.25	0.25	0.25	0.30	0.20	0.10
10-year	0.00	-0.24	-0.07	0.44	0.09	0.25	0.25	0.25	0.20	0.25	0.30	0.30
30-year	-0.36	-0.45	-0.07	0.76	0.00	0.10	0.10	0.20	0.20	0.20	0.20	0.10

f: forecasts

Sources: Datastream and Desjardins, Economic Studies