## FIRST QUARTER IN THE CREDIT MARKETS

The first quarter of 2008 witnessed some dramatic developments in the world's bond and credit markets.

The main themes in North America were:

- The significant lowering of key interest rates by the Federal Reserve Board and by the Bank of Canada in response to recessionary fears spawned by the sub-prime mess and the failing housing market
- The sharp steepening of the government yield curve which was in response not only to easing by Central Banks but also to the flight to quality which saw investors plow money into short dated government bonds. Long term government yields barely budged which frustrated those seeking lower mortgage rates
- The blow out in credit yield spreads from government bonds to ALL credits, even the good credits.

Attached you will find graphs highlighting these developments

## OUTLOOK

We do not pretend to know when conditions will improve but there are already tentative signs that the flight to quality is easing as Treasury Bills are becoming more available and the yield curve has flattened somewhat. We do not know when the trend in credit spreads will reverse itself but we do know two things: **1**. It will reverse sometime and: **2**. When it reverses, it will be dramatic.
Our conclusion is that it would be best to be early. In Canada, there is great value in Federal Government Agency bonds as well as in all Provincials and investment grade Corporates.

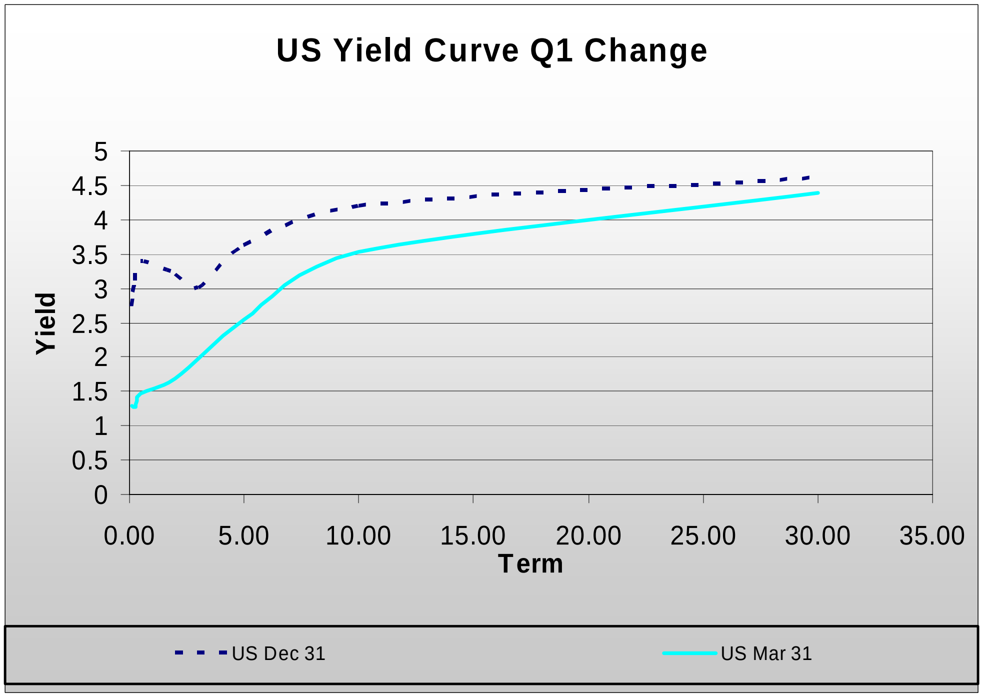
Key things to watch will be: the **TED spread**, which displays the difference between "T", the yield on three month US Treasury Bills and "ED", which is the yield on three month EuroDollar deposits (this is the rate that large financial institutions lend to each other). In normal times, this spread is around 20 but, after the August crunch, it ballooned to 245 and has seesawed its way to a still elevated level of 156.

We are also watching the **US Housing market** for any signs of bottoming. Currently inventory of new and existing homes appear to be far too high for an imminent reversal. Also, there will be another round of write downs when the first quarter earnings of the financials are released which will require close scrutiny for our financial heavy Canadian corporate bond market.

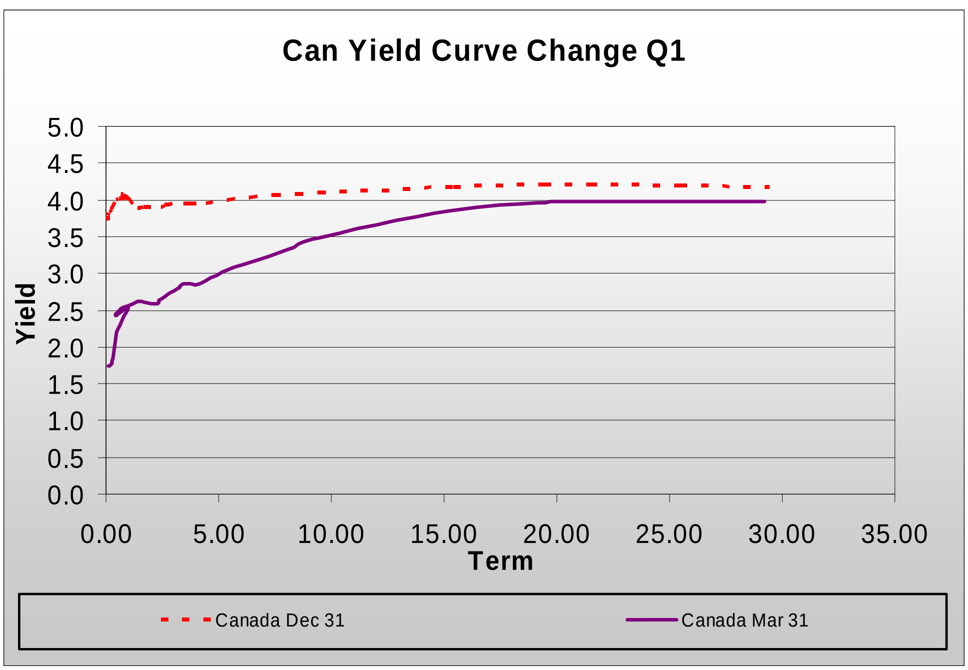
The TED spread is produced daily in the *Daily FI Snapshot* (contact Jamie Price to subscribe), as are charts of the yield curve for Canada and the US government bonds.

Snapshots and general market comments are posted here:
http://ideashare/C1/Fixed%20Income/default.aspx

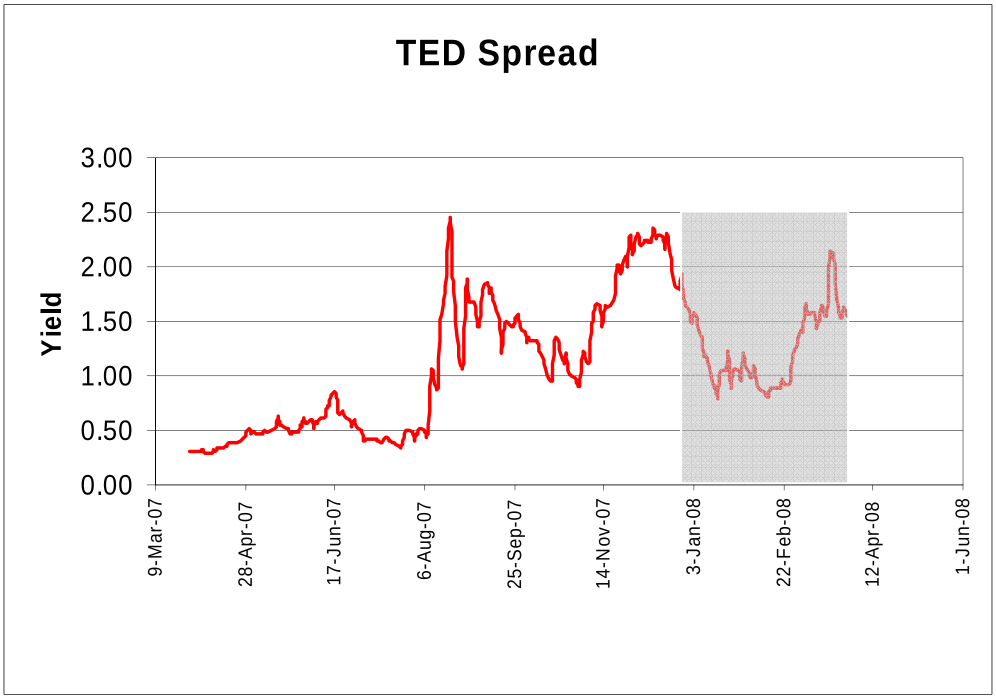
Hank Cunningham and James Price




The US yield curve steepening took place entirely on the short end.



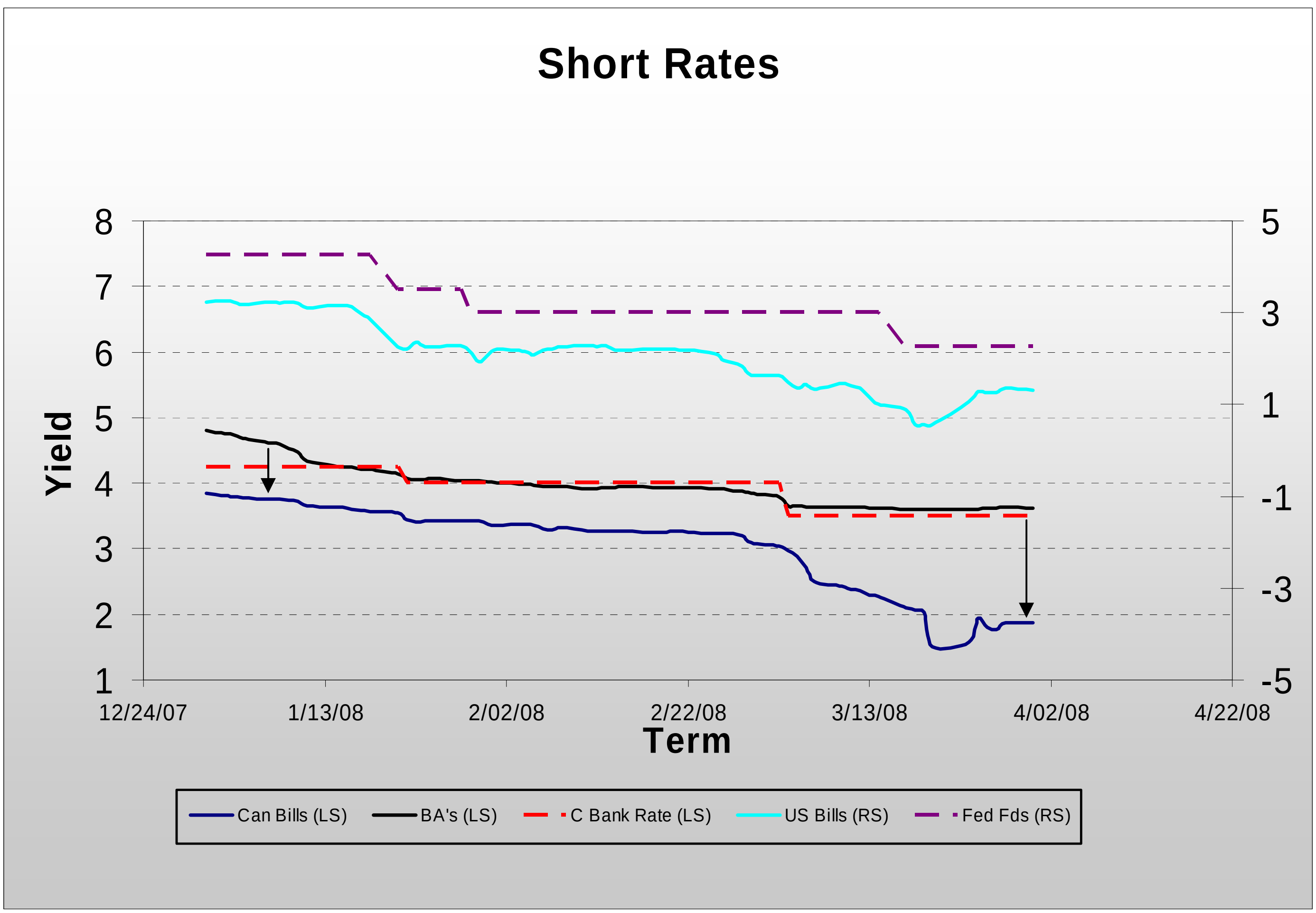

Same story in Canada. Very little change in long bond yields.




TED spread
(shaded area Q1 '08)

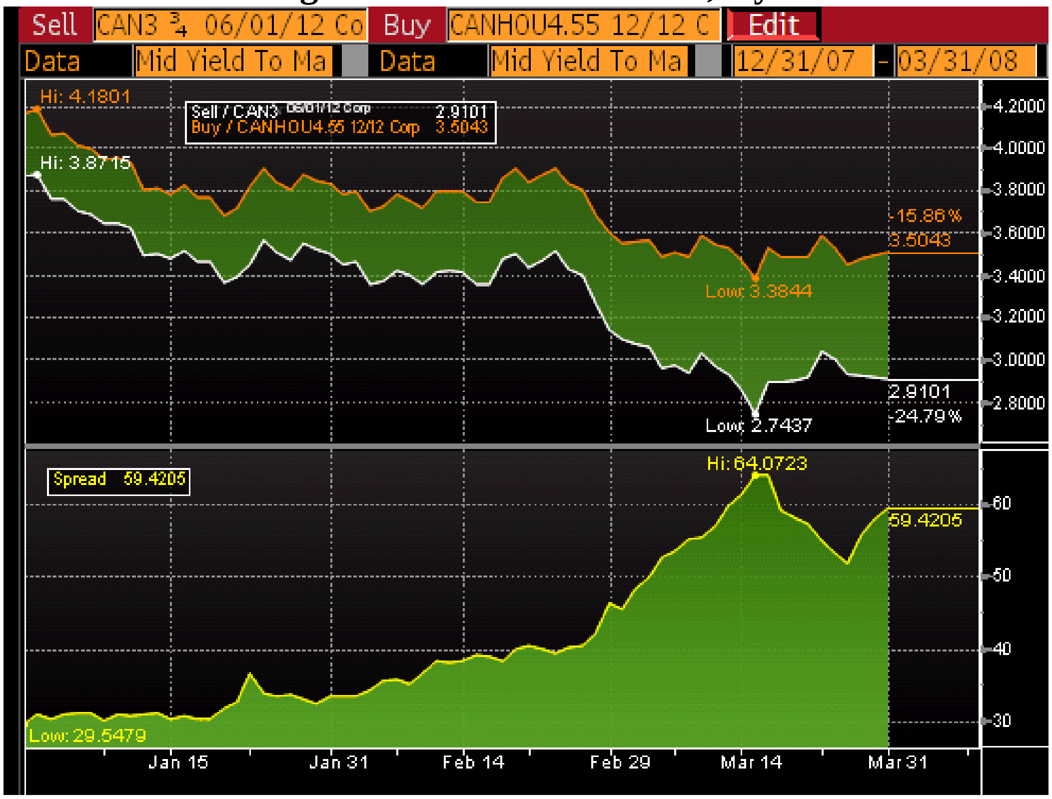
Risk aversion was volatile.

"Normal" for this series is 20 to 30




The spread between Canadian BA's and Bills (black and dark blue) widened significantly. Short rates in general fell precipitously.

# Canada Housing Trust vs. Canada bonds, 5 year term




The top panel shows the outright yield of these two instruments over the quarter (brown line CHT's, white line Canadas). Both have had significant quarterly returns.

The bottom panel shows the difference in yield.

Keep in mind, these both carry the same Government of Canada guarantee.