



## World Market

- The first quarter had a good performance.
- Despite of the February correction, stocks posted a performance of 2.6%.
- Currencies contributed positively to the return in US dollar for the quarter.
- Commodities, especially oil stirred up by the conflict in Iran, experienced the best performance.

	Global portfolio									
	Weight (%)	Monthly returns (%)			Quarterly returns (%)			Annual returns (%)		
		Mar. 07	Feb. 07	Jan. 07	Mar. 07	Dec. 06	Sep. 06	2006	2005	2004
Equities	50.0	2.1	-0.5	1.0	2.6	9.1	4.6	21.6	11.3	15.8
Nominal bonds	27.5	0.1	2.5	-1.3	1.3	1.7	4.1	5.1	-0.8	9.3
Real bonds	12.5	0.2	2.2	-0.6	1.8	0.1	3.6	4.1	1.6	11.5
Cash	5.0	0.7	1.0	-0.3	1.4	2.5	0.5	8.0	-2.1	5.3
Natural resources	5.0	1.9	4.2	-2.2	3.9	-0.8	-10.3	-1.3	21.7	13.4
<b>Total</b>	<b>100.0</b>	<b>1.2</b>	<b>1.0</b>	<b>-0.1</b>	<b>2.1</b>	<b>5.1</b>	<b>3.4</b>	<b>13.0</b>	<b>6.6</b>	<b>12.8</b>
Currencies	-	0.3	0.6	-0.6	0.3	1.4	-0.5	3.8	-5.0	3.3
Cost of hedging (forward)	-	0.1	0.1	0.1	0.2	0.2	0.3	0.7	-0.3	-0.7

The highlight of the first quarter was the stock market correction which occurred in late February. In spite of being relatively benign in nature, it nevertheless sparked some disproportionate reactions.

This correction was in fact minor and was ineffective to reestablish the relatively high market valuations and consequently, the low long-term expected returns (estimated by our models to be in the range of 6%-7%). For the developed countries as a whole, the E/P ratio went from 5.85% to 6.08% but barely budged for emerging countries. In fact, expressed in monthly terms, the correction was barely noticeable.

The most visible effect of this correction was on implicit market volatility as measured by the VIX index. After fluctuating around 10% for several months, the index nearly hit 20% before stabilizing recently around 14-15%. In our view, this upward reevaluation of stock market risk is an expected return to normal. In light of this, commentaries in regard to this correction have revealed the fact that investors are now used to a low volatility environment.

The correction was however difficult in the United States, since this is where the most important stock market losses occurred in February, with a dip of 1.83%. Among other regions of the world, Europe and the emerging markets also all experienced a negative month. Due to this more marked drop in the United States, the US dollar depreciated against all currencies analyzed in February and March.

Lastly, if the world portfolio turned in a positive performance in February and March in spite of the correction, it was due to nominal and real bonds. These bonds performed remarkably well because of a shift in capital to high quality securities.

## ■ Market review: The subprime meltdown and the Fed

The recent correction has provoked more fear than warranted because it happened at the same time as the difficulties in the subprime market. Subprime mortgages are riskier loans in that they are made to borrowers who do not qualify under traditional, more stringent criteria due to a limited or blemished credit history. These fears appear to us as being overblown. Firstly, the subprime market represents only 6.5% of total mortgages and less than 2% of the total on the entire credit market. Secondly, the American economy is presently being strengthened by an unprecedented credit expansion. Despite a survey of Senior Loan Officers indicating that mortgage financing conditions were getting tighter, the volume of consumer credit issued continued its upward trend, although at a slower pace. The growth rate of consumer credit was 3.2% in January 2007, against an average of 4.8% in 2006, which was slightly lower than the average of 5.2% between 2002 and 2005.

In our view, as long as the volume of credit issued continues to grow, so will the American economy. In the event of a tightening of credit, the Fed will immediately lower its key rates. This would have the usual effect: the banks will be able to finance themselves in the short term and lend in the long term with more advantageous conditions. The argument that the slowing pace of Collateralized Loan Obligation (CLO) issuances could have a significant negative impact on mortgage issuances does not seem as worrisome to us in the medium term. After some lowering of rates, the increasing interest rate slope would give the banks an incentive to lend again, despite having to keep a bigger share of these mortgages in their balance sheets.

The main macroeconomic risk could come from a weakening in aggregate demand caused by the reversal of the positive wealth effect which has been happening for several years, or by layoffs in the construction sector. However, in the United States, we have been observing a permanent efficiency gain in residential financing in recent years. With the possibility of a temporary tightening in the credit market, in the long term, the new instruments for mortgage financing will permit consumers to choose their financing term more easily than before. This will enable them to take greater advantage of the opportunities offered by the shape of the interest rate slope.

## ■ Canada

Canada (3.23%)										
	Weight (%)	Monthly returns (%)			Quarterly returns (%)			Annual returns (%)		
		Mar. 07	Feb. 07	Jan. 07	Mar. 07	Dec. 06	Sep. 06	2006	2005	2004
Equities	52.6	2.8	0.7	-0.0	3.3	7.1	1.3	18.4	28.9	22.8
Nominal bonds	28.9	1.2	2.4	-2.0	1.6	-4.0	5.7	3.8	9.6	16.1
Real bonds	13.2	1.8	1.5	-1.5	1.7	-5.7	3.7	-2.0	17.6	26.9
Cash	5.3	2.0	1.0	-1.1	2.0	-3.1	0.8	4.6	5.5	10.6
<b>Total</b>	<b>100.0</b>	<b>2.2</b>	<b>1.3</b>	<b>-1.0</b>	<b>2.5</b>	<b>1.7</b>	<b>2.9</b>	<b>10.7</b>	<b>20.6</b>	<b>20.8</b>
Currencies	-	1.6	0.7	-1.4	0.9	-4.1	-0.3	0.4	2.6	7.9
Cost of hedging (forward)	-	0.1	0.1	0.1	0.2	0.2	0.2	0.7	-0.5	-1.9

- The underlying tendency of the Canadian dollar became positive again following the lead of commodities.
- Problems observed in the US on the subprime market as well as on the MBS market and stocks, had no repercussions in Canada.

## ■ Market review: The effects of recent turbulence on the interest rate slope

During the month of March, fears of credit tightening contributed to a greater inversion of the U.S. Treasury Bonds curve between the 2 year rate and the overnight rate. While this slope had oscillated between  $-0.3\%$  and  $-0.4\%$  since August 2006, recent events have increased the inversion to  $-0.65\%$ , which translates into a 2-year rate of  $4.6\%$ . Assuming that the Fed maintains its key rate at its current level until June, it would take a quarterly drop of  $0.25\%$  until the Fed rate reached  $4.25\%$  in March 2008 in order for the overnight rate to provide a return similar to the current 2-year rate.

Even if we generally agree with market expectations that a level of  $4.25\%$  in the key rates would be closer to the neutral level, we consider that it would be justifiable only in the case of lower inflation volatility than we are presently seeing. In other words, a level of  $4.25\%$  for the short rate with expected long-term inflation of close to  $2.4\%$ , as presently discounted by real bonds, would translate into a real return of  $1.85\%$ . This scenario would, in our view, be fairly reasonable. However, given the current volatility of the inflation rate caused by oil price fluctuations, the Fed would need to come up with a very good reason before lowering the interest rate. In short, this vision appears to us as a little too pessimistic. It is more probable that the 2-year rate will revert to its pre-correction level.

## ■ United States

United States (43.85%)										
	Weight (%)	Monthly returns (%)			Quarterly returns (%)			Annual returns (%)		
		Mar. 07	Feb. 07	Jan. 07	Mar. 07	Dec. 06	Sep. 06	2006	2005	2004
Equities	52.6	1.1	-1.8	1.8	1.0	6.8	5.4	15.3	5.7	10.7
Nominal bonds	28.9	-0.3	2.6	-0.6	1.7	0.6	5.3	2.2	3.0	4.5
Real bonds	13.2	0.2	2.1	0.1	2.4	-1.3	3.6	0.5	2.7	8.7
Cash	5.3	0.4	0.4	0.4	1.3	1.3	1.3	4.9	3.1	1.3
<b>Total</b>	<b>100.0</b>	<b>0.5</b>	<b>0.1</b>	<b>0.8</b>	<b>1.4</b>	<b>3.6</b>	<b>4.9</b>	<b>9.0</b>	<b>4.4</b>	<b>8.1</b>
Currencies	-	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Cost of hedging (forward)	-	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

- The US market had the weakest performance in the world in the first quarter due to the subprime crisis.
- The stock market hasn't recovered its peak prior to the February 27th correction.
- Rising inflation caused by the recent rise in the price of oil, has favored real return bonds over nominal bonds.

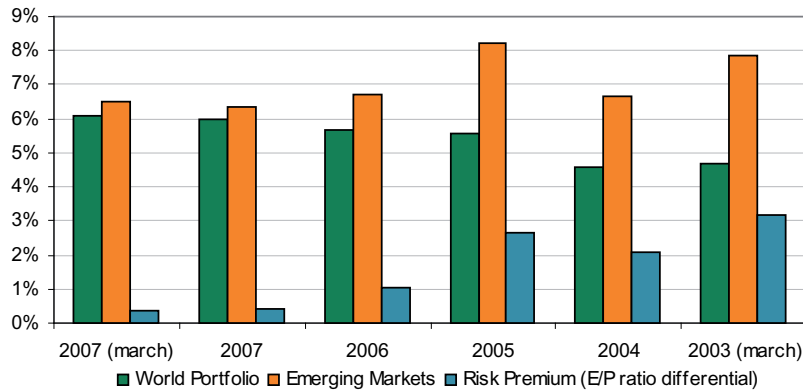


## Market review: Emerging markets are looking increasingly expensive

Despite the recent market correction, the relative value of emerging markets compared to the world portfolio continued its decline during the first quarter. Even though this decline was somewhat slowed by the February correction, we would like to take a closer look at the evolution of relative value since the beginning of the stock market cycle in March 2003.

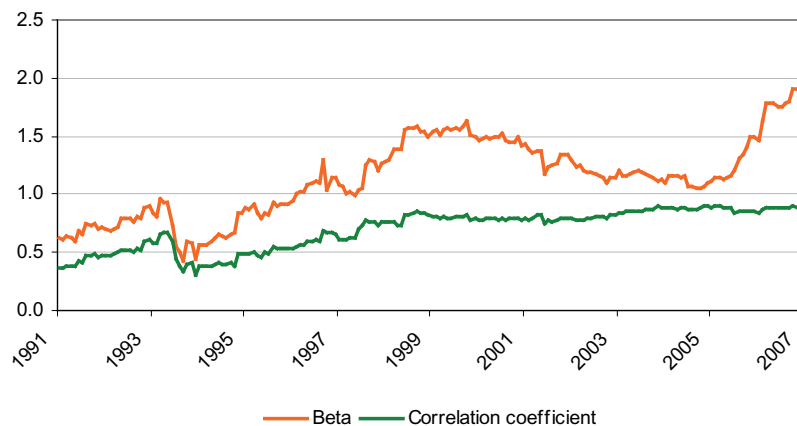
As the chart shows, the world market, dominated by the United States at around 50%, has seen its E/P ratio rise from 4.8% to a little over 6%. This increase in the E/P ratio has taken approximately 30% away from the price appreciation during this period even though corporate profits have risen by more than 100%. This negative correlation between earnings and the fluctuation of the E/P ratio is typical. Investors try to smooth out price fluctuations during periods of falling profits (decreasing E/P ratio) and inversely when they are rising.

Evolution of the E/P ratio during the current stock market cycle



The situation is somewhat different for the emerging countries, owing more to the speculative behavior than to the typical cycle. While earnings were growing at roughly the same rate as in the world portfolio, the E/P ratio of close to 8% in March 2003 has dropped to about 6.5% today. Thus, expected earnings from this market have decreased in parallel with the drop in the E/P ratio.

Another concern regarding emerging markets is the fact that during the increasing allocations to this region, not only is the expected return decreasing, but so is the potential for diversification that the region offers. The following chart presents the emerging market beta compared to the world portfolio and the correlation coefficient between emerging market returns and the world portfolio return. These two measures illustrate the fact that there is a downward tendency in the benefits of diversification in the emerging markets.



## ■ Market review: The potential for profit growth in the medium term

Our last point concerns the future growth of stock market profits, particularly in the developed countries. According to our statistical models, profits are overshooting their cyclical trend by a wide margin, as determined by the GDP growth rate. By analyzing some numbers on corporate profits in the national accounts, we can add a more fundamental aspect to this statistical analysis.

Corporate profits, as measured in percentage of national income, recently reached 9.8%, their highest recorded level. Previously, a level of 8.7% was reached in the first quarter of 1966 and again in the third quarter of 1997. This makes the recent level all the more extraordinary.

Nevertheless, these results were due in large part to the weakness of corporate investment. In particular, depreciation of capital, instead of reducing earnings, recently made a positive contribution to the increase in corporate profits. Normally, depreciation lowers profits by 10% to 20%. However, since the first quarter of 2005, depreciation has contributed \$150 billion per year to profits totaling \$1,150 billion. (It is important to note that the definition of profits by NIPA (National Income and Products Accounts) add to them the spread between depreciation and investment. This implies that, if corporations invest less than depreciation, this amount adds to profits. This definition is thus more akin to the one for cash flows).

This exceptional situation has happened only twice before since 1950. The first time occurred at the beginning of the sampling, from 1951 to the end of 1954, and the second was from the end of 1975 to the end of 1980. The question is whether these three episodes have anything in common.

We know that at the beginning of the 1950s, the American economy was in full transition from military production to civilian production. At the time, there was excess production capacity, which contributed to a low level of investment. The second episode, from 1975 to 1980, consisted in a reorientation of production in the automobile and oil sectors in particular. In fact, although the level of investment was not particularly low during this period, it had changed in nature since production capacity could no longer be increased without considering energy costs.

## ■ Europe

Europe (30.61%)										
	Weight (%)	Monthly returns (%)			Quarterly returns (%)			Annual returns (%)		
		Mar. 07	Feb. 07	Jan. 07	Mar. 07	Dec. 06	Sep. 06	2006	2005	2004
Equities	52.6	3.7	-0.4	0.6	3.9	11.5	5.7	34.3	9.9	21.3
Nominal bonds	28.9	0.3	2.5	-2.3	0.4	3.6	3.4	11.1	-6.2	16.9
Real bonds	13.2	-0.6	2.3	-2.0	-0.3	4.6	3.7	14.7	-4.4	17.4
Cash	5.3	0.8	1.4	-0.7	1.5	5.2	0.4	16.0	-9.9	10.6
<b>Total</b>	<b>100.0</b>	<b>2.0</b>	<b>0.9</b>	<b>-0.6</b>	<b>2.2</b>	<b>8.0</b>	<b>4.5</b>	<b>24.1</b>	<b>2.3</b>	<b>18.9</b>
Currencies	-	0.4	1.1	-1.0	0.5	4.3	-0.5	12.3	-12.4	7.7
Cost of hedging (forward)	-	0.1	0.1	0.1	0.3	0.4	0.5	1.3	-0.6	-1.4

- The recent forecast for improving growth in Europe has positively influenced the stock market.
- Nominal bonds posted a weak performance. Real return bonds were affected negatively by a pickup in growth causing higher real interest rates.
- The Bank of England has maintained its rate at 5.25% despite indications by the European central bank that they will continue their upward trend beyond 4%.



## ■ Market review: The potential for profit growth in the medium term (cont.)

The emerging countries have a number of advantages in terms of cost of production and technology that make them more efficient than developed countries in several respects. Might the disinvestment observed in industrialized countries be indicative of a reorientation of the U.S. economy toward higher value sectors and the services sector?

Whatever the exact cause, we at least know that it cannot go on forever. When depreciation exceeds corporate investment, this tends to increase profits in the short term but damages future prospects. If this continues on for some time, job creation and future economic growth will suffer. However, given a reversal of this situation, the end of capital depreciation's contribution to profits would shave off about 30% from them (going from a 15% positive contribution to a negative 15%). Spread out over several years, the underlying growth rate of profits would offset part of this effect but at the cost of a lower growth rate in the future.

Consequently, we consider that this argument makes us all the more skeptical in the face of current market valuations. The record level of profits is being caused by temporary factors that could prove short-lived.

## ■ The Pacific region

The Pacific region (13.96%)										
	Weight (%)	Monthly returns (%)			Quarterly returns (%)			Annual returns (%)		
		Mar. 07	Feb. 07	Jan. 07	Mar. 07	Dec. 06	Sep. 06	2006	2005	2004
Equities	52.6	0.3	3.4	0.9	4.7	8.0	0.5	12.7	22.8	19.6
Nominal bonds	28.9	0.5	3.0	-1.7	2.1	0.6	1.0	1.2	-9.4	7.1
Real bonds	13.2	2.2	4.0	-1.4	4.8	3.4	4.2	9.5	3.2	17.0
Cash	5.3	0.9	2.0	-1.3	1.6	0.8	-1.9	2.2	-9.6	5.5
<b>Total</b>	<b>100.0</b>	<b>0.7</b>	<b>3.3</b>	<b>-0.3</b>	<b>3.8</b>	<b>4.9</b>	<b>1.0</b>	<b>8.4</b>	<b>9.2</b>	<b>14.9</b>
Currencies	-	0.7	1.9	-1.4	1.1	0.4	-2.3	0.7	-10.9	4.3
Cost of hedging (forward)	-	0.3	0.3	0.3	0.8	0.9	0.9	2.9	1.0	-0.1

- The Pacific region experienced the best performance in the world for the first quarter.
- On the 3.76% of portfolio returns, more than 1.3% came from stronger currencies.
- The Yen in particular, consisting in approximately 80% of the weight in the index, was the cause of this appreciation.

## ■ Investment conclusion

What can we learn from the subprime crisis? In the worst-case scenario, job losses in the housing sector and tighter credit will force the Fed to lower its interest rate. Global economic growth could stay positive but on the low side, hovering between 1% and 2%, due to the contraction in residential investment but relatively solid growth in consumption. Bank profits, particularly among the small banks, which are fairly numerous in the United States (and often more dependent on the mortgage sector) would be reduced. The growing number of homes repossessed by financial institutions would drive prices down. Also, if consumer demand continued, the current account balance would deteriorate given the weak contribution of residential investment to imports.

The consequences for the financial sector would be numerous. The US dollar would be the first victim of this scenario. A second wave of depreciation against the major currencies of the developed countries could reverse the value of US/Japan carry trade. As for interest rates, the slope would become steeper with the lowering of the short rate and possibly stable or rising long rates.

Finally, the stock market could be penalized by the earnings correction. Historically, the depreciation of the US dollar and the liquidity provided by the lowering of interest rates have carried the stock market upwards.

At the international level, inflationary pressures seem to have continued unabated in emerging countries. The Indian central bank tightened its rate on April 2 to quell growing inflationary pressures in the country following increases in the Euro zone, Denmark and Norway. In Argentina, the government's recent intervention in the calculation of the CPI did nothing to help the country's lack of credibility. Overall, after a drop to less than 3% in October 2006, following a drop in the price of oil, the aggregate inflation rate of the emerging countries has returned to above 4.0%.

This rebound in inflation is critical for these countries. Short term real rates are either nil or negative in emerging markets. The reason for this is a profound conviction on the part of monetary authorities and the private sector that the underutilization of the work force justifies a major monetary stimulation. Therefore, in absence of a cushion created by a positive real interest rate, a pickup in inflation has to at least force short rates to grow in pace with inflation. However, the good performance of the emerging countries owes a lot to the worldwide deflationary environment caused in part by the emergence of these countries into the world economy. We will know soon enough if the monetary authorities will have the necessary discipline to tighten their rates despite the protests that this may generate.

Consequently, given this view and backed by our analysis of the Mexican debt in dollars and pesos (see Focus Latin America), we would tend to recommend a limited tactical exposure to emerging countries in stocks as well as debt denominated in national currencies. However, the currencies of these countries could benefit from the tightening of short-term rates.

## ■ Emerging market countries

Emerging market countries (8.36%)										
	Weight (%)	Monthly returns (%)			Quarterly returns (%)			Annual returns (%)		
		Mar. 07	Feb. 07	Jan. 07	Mar. 07	Dec. 06	Sep. 06	2006	2005	2004
Equities	60.6	4.0	-0.6	-1.1	2.4	17.5	5.2	32.6	35.7	26.1
Nominal bonds	33.3	1.2	0.9	-1.2	0.5	6.3	4.9	11.1	7.6	20.1
Cash	6.1	1.2	0.6	-0.3	1.6	4.3	1.0	9.7	5.9	14.8
<b>Total</b>	<b>100.0</b>	<b>2.9</b>	<b>0.0</b>	<b>-1.0</b>	<b>1.7</b>	<b>13.0</b>	<b>4.9</b>	<b>24.0</b>	<b>24.5</b>	<b>23.4</b>
Currencies	-	0.7	0.1	-0.8	-0.0	2.6	-0.6	2.9	-0.7	8.0
Cost of hedging (forward)	-	-0.1	-0.1	-0.1	-0.4	-0.4	-0.3	-2.3	-3.7	-4.9

- Emerging market currencies have stabilized during the first quarter.
- Tightening monetary conditions in several countries, penalized return on nominal bonds.



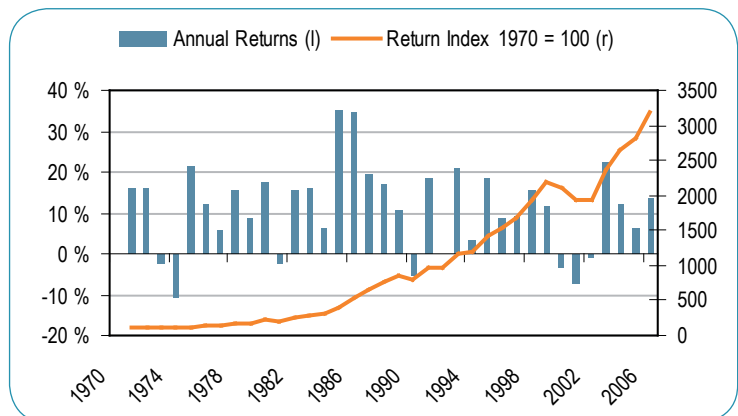
## Global portfolio

The global portfolio is diversified across key asset classes: equities, nominal bonds, real return bonds, cash and commodities. Their weightings in the portfolio correspond to the weightings in the Global Market Performance Table. Each asset class is structured using the local indexes of the countries that comprise the MSCI All Country World Index (ACWI). The weightings of these local indexes in the asset classes considered is equal to the market capitalization of these same countries in the MSCI ACWI Index (see table opposite). However, for real return bonds, the local indexes of seven countries are our only benchmark. Thus, the weightings of countries applied to this asset class differ from the other classes.

The global portfolio returned 11% from 1970 to 2005, with a same level standard deviation. Despite this relatively solid performance and major diversification, such a portfolio generated negative returns for several years following major macroeconomic shocks. The years 1973, 1974 and 1981 were marked by negative returns in the wake of the oil shocks, as were 2000 and 2002 in the wake of the equity market bubble. Inversely, 1985, 1986 and 1987 were particularly good, stimulated by the U.S. dollar's depreciation.

\* At the time of publication, a certain number of data may not be available for a few countries. Therefore, the updated results could be somewhat different. For example, if the data for 90% of the countries are available, the results are aggregated in proportion by making the hypothesis that the data for the remaining 10% are identical to the available ones.

World portfolio weights *			
Aggregats / regions / countries	relative %	Aggregats / regions / countries	relative %
<b>World</b>	<b>100,00</b>	<b>Emerging Countries</b>	<b>8,36</b>
<b>Developed countries</b>	<b>91,64</b>	<b>Latin America</b>	<b>1,69</b>
<b>North America</b>	<b>47,08</b>	Argentina	0,06
Canada	3,23	Brasil	0,90
United States	43,85	Chile	0,13
<b>Europe, Australia, Far East</b>	<b>44,56</b>	Colombia	0,02
<b>Western Europe</b>	<b>30,61</b>	Mexico	0,52
Austria	0,29	Peru	0,05
Belgium	0,56	Venezuela	0,01
Switzerland	3,01	<b>Eastern Europe</b>	<b>1,33</b>
Germany	3,43	Czech Republic	0,07
Denmark	0,38	Hungary	0,08
Spain	1,80	Poland	0,15
Finland	0,67	Russia	0,89
France	4,47	Turkey	0,13
United-Kingdom	10,33	<b>Asia</b>	<b>4,28</b>
Greece	0,30	China	0,95
Ireland	0,38	Indonesia	0,13
Italie	1,68	India	0,51
Netherlands	1,57	South Korea	1,27
Norway	0,42	Malaysia	0,25
Portugal	0,16	Philippines	0,05
Sweden	1,17	Tailand	0,12
<b>Pacific</b>	<b>13,96</b>	Taiwan, Province of China	1,01
Australia	2,63	<b>Africa, Near East</b>	<b>1,06</b>
Hong-Kong	0,77	Egypt	0,07
Japan	10,03	Israël	0,20
New-Zealand	0,07	Jordan	0,01
Singapor	0,45	Morocco	0,03
		Pakistan	0,02
		South Africa	0,72



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