Quarterly Market Review

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Desjardins Asset Management

Markets were taken by surprise on Monday, March 17, when the U.S. Federal Reserve (Fed) and JPMorgan bailed out Bear Stearns despite the fact that the corporation's financing problems were already known the previous week. While the Fed's intervention on behalf of an investment bank was a surprise in itself, the US$2 per share buyout price offered by JPMorgan also greatly contributed to the market reaction. Although JPMorgan substantially revised its offer in the following weeks, the idea that the fifth-largest investment bank in the United States could succumb to financing problems in the short-term sent shock waves through the markets.

Meanwhile, stock markets recorded a decrease of more than 9% in U.S. dollars in Q1. That decrease reached nearly 11% in emerging countries, which showed the strongest downslide, and just under 6% in Canada, where energy prices supported the market. In local currencies, the Pacific market is down by more than 17% and the Canadian market by nearly 10%.

During the quarter, major long-term rate decreases, fuelled by fears of recession, produced returns of nearly 6% for bonds. This effect was explained by the dominant weight of the U.S. market, as rates were only slightly down in Europe and Canada and on the upswing in the Pacific region.

Strong appreciation of the euro and the yen made a positive contribution to the currency portfolio, while the Canadian dollar lost nearly 4% of its value and the currencies of emerging countries remained relatively stable. Commodities also experienced strong appreciation, with major contributions from both energy and food.

World market

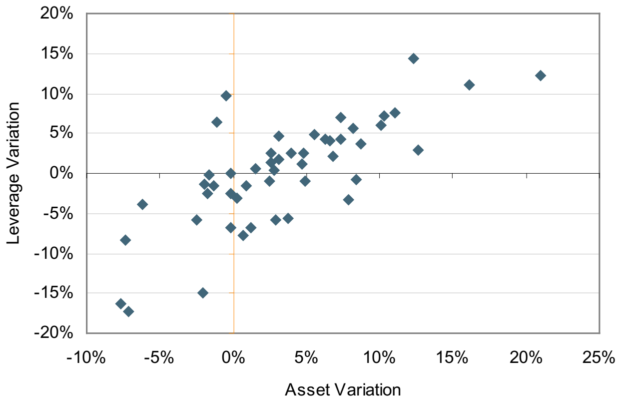
	Global portfolio									
	Weight (%)	Monthly returns (%)			Quarterly returns (%)			Annual returns (%)		
		Mar 08	Feb 08	Jan 08	Mar 08	Dec 07	Sept 07	2007	2006	2005
Equities	50.0	-1.4	0.3	-8.2	-9.2	-1.7	3.6	12.0	21.5	11.3
Nominal bonds – local currencies *	25.9	1.2	1.9	3.3	5.9	4.3	6.4	10.2	5.1	-1.0
Nominal bonds – USD	1.6	0.2	0.2	1.0	1.4	2.1	2.2	5.5	5.5	5.3
Real bonds	12.5	0.6	1.8	3.1	5.5	4.4	5.6	12.2	4.1	1.6
Cash	5.0	1.3	1.5	1.1	4.1	1.8	3.7	8.8	8.0	-2.1
Natural resources	5.0	-3.7	11.3	2.1	9.2	7.4	11.3	26.7	-1.3	21.7
Total	**100.0**	**-0.4**	**1.5**	**-2.7**	**-1.7**	**1.3**	**4.9**	**12.0**	**13.0**	**6.7**
Currencies		0.9	1.1	0.7	2.9	0.7	2.5	4.1	3.8	-5.0
Cost of hedging (forward)		-0.1	-0.1	-0.0	-0.0	0.1	0.1	0.8	0.7	-0.3

- Global portfolio down 1.68% in Q1 2008, mostly due to a drop in stock market performance throughout the world.
- Positive contribution of nearly 3% by foreign currencies.
- Solid performance of natural resources despite the economic slowdown.

Leverage being reduced throughout the financial sector

Higher risk aversion levels observed since last summer have generally driven investors to demand higher risk premiums. By repositioning their portfolios, these investors have caused prices to fall, which has taken a considerable bite out of brokers' balance sheets. First of all, lower liquidity levels put a sudden end to securitization, leaving a certain quantity of securities on their balance sheets. Then, the drop in prices – a direct consequence of the risk re-evaluation – reduced their equity because of major losses incurred. Finally, the insolvency of certain off balance sheet funds forced several brokers to consolidate them on their balance sheets in order to maintain their credibility with investors (e.g.: Bear Stearns speculative hedge funds).

Financial institutions reacted, simultaneously attempting to reduce leverage levels. Keep in mind that brokers such as Bear Stearns generally maintain leverage levels between 30 and 40, meaning that its assets represent 30 to 40 times shareholder equity. The following graph shows the variation in Bear Stearns leverage in relation to the variation in assets on the balance sheet. We can see that this broker's behaviour is pro-cyclical. Here we are using Bear Stearns as an example, but several studies show that this behaviour is typical of brokers in general. It would seem that when asset prices go up, brokers increase their leverage. In those conditions, the value-at-risk (VAR) goes down, influenced by the recent positive performance, which justifies higher leverage. However, when the markets deteriorate, causing an increase in VAR, leverage mut be quickly reduced so as to keep risk levels constant.



Canada

Canada 3.8%										
	Weight (%)	Monthly returns (%)			Quarterly returns (%)			Annual returns (%)		
		mars 08	févr 08	janv 08	mars 08	déc 07	sept 07	2007	2006	2005
Equities	52.6	-5.5	6.2	-6.4	-6.0	-0.0	9.6	30.2	18.4	28.9
Nominal bonds	28.9	-2.4	3.5	-1.7	-0.7	4.4	9.0	22.4	4.1	14.4
Real bonds	13.2	-0.5	4.8	-2.4	1.9	3.4	8.2	20.0	-2.0	17.6
Cash	5.3	-4.2	3.3	-1.7	-2.8	1.9	8.3	23.3	4.6	5.5
Total	**100.0**	**-3.9**	**5.1**	**-4.2**	**-3.2**	**1.8**	**9.2**	**26.3**	**10.8**	**22.0**
Currencies		-4.5	2.9	-2.1	-3.8	0.7	7.0	17.9	0.4	2.6
Cost of hedging (forward)		-0.1	-0.1	-0.0	-0.1	0.0	0.2	0.7	0.7	-0.5

- The Canadian stock market, supported by energy prices, was down only 2.3% in local currency.
- The dollar lost nearly 4%.
- Long-term rates down 0.3%; strong performance of real return bonds.

When considered on the scale of a single firm, this behaviour seems to be rational. But, as we have seen, this strategy is very sensitive to variations in liquidity levels. If assets cannot be quickly liquidated, the low cushion provided by equity – around 2.5% to 3.3% of assets – can quickly evaporate. Furthermore, this behaviour, when generalized to all market stakeholders, becomes nonsensical, because when a risk re-evaluation occurs, everyone wants to simultaneously sell the same assets.

The reaction of securities holders was therefore to limit the number of transactions. This situation led to uncertainty in the value of these securities, since low prices in a relatively non-liquid market implies that prices could go even lower if major volumes are liquidated. Reassurance that the crisis is over will only come when credit market liquidity is fully restored. Only then will we be certain that no investors are holding securities “against their will” and that no major inventories of credit securities are sitting around waiting for a rebound in prices in order to be liquidated.

Following this reasoning, we have no choice but to conclude that the crisis is still far from over, as volumes remain very low on all structured products.

United States

United States 41.4%										
	Weight (%)	Monthly returns (%)			Quarterly returns (%)			Annual returns (%)		
		Mar 08	Feb 08	Jan 08	Mar 08	Dec 07	Sept 07	2007	2006	2005
Equities	52.6	-0.4	-3.1	-6.1	-9.3	-3.2	2.1	6.0	15.3	5.7
Nominal bonds	28.9	1.1	1.2	3.6	6.1	5.6	4.9	10.5	2.3	2.8
Real bonds	13.2	0.0	1.3	3.7	5.1	5.1	4.5	11.8	0.5	2.7
Cash	5.3	0.2	0.2	0.3	0.8	1.1	1.3	5.1	4.9	3.1
Total	**100.0**	**0.1**	**-1.1**	**-1.6**	**-2.4**	**0.7**	**3.2**	**8.0**	**9.0**	**4.3**
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

- Strong bond market performance, driven upward by recession fears.
- U.S. stock market down by over 9%.

Housing prices: Any stabilization in sight?

Given the problem that institutional investors are currently facing, we might wonder whether the situation is any better for individual consumers. Increased leverage for households has translated into housing purchases and a high level of mortgage debt. This debt level was justifiable when interest rates were low, especially for variable rate loans. In terms of payment as a percentage of income, household debt remained constant during the real estate bubble.

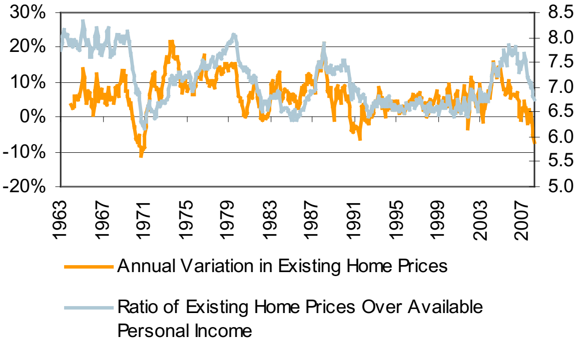
However, once leading interest rates returned closer to neutral for the long term (4-5%), the debt-to-income relationship turned out to be very difficult to sustain. Moreover, prices hit a ceiling when the combination of interest rates and higher home prices discouraged new arrivals on the real estate market. In fact, while real estate appreciation is a gain for existing homeowners, it is perceived as inflation by people looking to buy.

To get an idea of the future of this market, we first of all need to understand that, in the long-term, home prices rise only a little more than overall price levels, which corresponds approximately to the growth rate of salaries, i.e. 1.6% per year. As an illustration of this, the following graph shows the ratio of existing home prices over personal income available per capita. We can see that, in the long term, this ratio remains relatively stable.

Another aspect indicated by the graph is the strong cyclical component of home prices, which have seen periods of appreciation from 10-20% per year, pushing the ratio upwards, followed by periods of downturn and stagnation, bringing the ratio back to 6.5 to 7 times available personal income.

Finally, the graph shows us the duration of these cycles. The return of the ratio to values approaching 6 times the level of income often takes several years (except during the 1969-1971 episode, when a market correction led to a 17% drop in home prices over 18 months). During the bubble of the late 1980s, the peak in home prices was reached at the end of 1989, at 7.5 times the level of income, falling back to only 6.4 by the end of 1993.

The ratio reached a summit of more than 7.8 times income in April 2006; it is currently at 6.8 times income. The overall situation is therefore not that bad. The risk comes especially from individual borrowers and regional markets. In fact, even though home prices are stabilizing, this will not settle everything. Renewed financing conditions will still cause many U.S. homeowners to be unable to pay back their loans.



Europe

	Europe 30.5%									
	Weight (%)	Monthly returns (%)			Quarterly returns (%)			Annual returns (%)		
		Mar 08	Feb 08	Jan 08	Mar 08	Dec 07	Sept 07	2007	2006	2005
Equities	52.6	0.4	1.6	-10.4	-8.6	-0.4	1.7	14.3	34.3	9.9
Nominal bonds	28.9	3.1	2.4	2.7	7.5	3.4	8.0	9.5	11.8	-6.3
Real bonds	13.2	2.6	1.6	2.6	7.1	3.4	7.4	11.1	14.7	-4.4
Cash	5.3	3.4	2.3	1.5	7.4	2.2	5.2	11.8	16.0	-9.9
Total	**100.0**	**1.7**	**1.9**	**-4.3**	**-1.0**	**1.3**	**4.5**	**12.4**	**24.3**	**2.3**
Currencies		3.0	1.9	1.1	6.3	1.1	4.1	7.3	12.3	-12.4
Cost of hedging (forward)		-0.1	-0.1	-0.0	-0.0	0.1	0.2	1.4	1.3	-0.6

- Euro up 8.4% for the quarter.
- Stock exchanges have seen major decreases – more than 20% in Germany.
- Long-term rates remain stable, supported by inflationary fears.

Fannie and Freddie to the rescue

One of the first actions undertaken by the U.S. government to end the credit crisis was to enable two companies that securitize mortgages in the United States, Fannie Mae and Freddie Mac, to increase their business volume. This volume increase will be reached through a combination of two measures. First of all, each company will raise between US$5 billion and US$10 billion in new capital, thereby enabling them to increase the securitization volume. Then, they will reduce their regulatory capital from 30% to 20%. Given the current situation in which the crux of the problem is the high leverage level in the financial sector, this solution appears rather uncertain. Although it may be easier and faster to implement this solution than to raise capital, it seems rather risky in the current context.

Another idea making the rounds is to authorize the Fed to directly purchase securities backed by mortgage assets. However, this proposal may be even worse than the idea of increasing the GSE (Government Sponsored Enterprises) risk mentioned above. On one hand, the idea of literally taking securities in difficulty out of circulation, thereby avoiding any unfortunate consequences for the loan issuers – i.e. the stakeholders who securitized them and the investors who then purchased the securities – seems in our opinion to guarantee that the situation will happen again every time there is a low point in the credit cycle. It would also lead to a second problem, i.e. how to determine at which price the securities should be withdrawn from the market. Given that the value of these securities is already a topic of discussion, it seems to use that this would engage the Fed in some very difficult negotiations.

Finally, the Financial Stability Forum (FSF), held in Rome among representatives of the Finance Ministries and Central Banks of the countries involved in the crisis, will be tabling proposals on the subject at the G7 meeting in mid-April. Among those proposals, the simplest appears to be the most significant, whereby FSF members will propose that all mortgage-backed security positions be disclosed. They will also give details on the form in which these positions are being held, their estimated values as well as the justification for them. We believe this proposal to be essential. A major part of the complications we are seeing on the markets today comes from the ill-will of the banks, as they try to keep their profits high and also obtain government support, while not revealing the positions that are the most in difficulty until the decision to liquidate them has been made.

Emerging markets countries

	Emerging market countries 11.3%									
	Weight (%)	Monthly returns (%)			Quarterly returns (%)			Annual returns (%)		
		mars 08	févr 08	janv 08	mars 08	déc 07	sept 07	2007	2006	2005
Equities	60.6	-5.2	7.4	-12.5	-10.9	3.7	14.4	39.7	32.5	35.7
Nominal bonds – local currencies *	16.7	-1.8	1.4	3.0	1.9	1.2	2.8	5.1	5.4	6.9
Nominal bonds – USD *	16.7	0.2	0.2	1.0	1.4	2.1	2.2	5.5	5.5	5.3
Cash	6.1	-0.5	1.7	0.4	2.3	2.3	3.4	11.9	9.8	6.0
Total	**100.0**	**-3.5**	**4.9**	**-6.9**	**-5.9**	**2.9**	**9.8**	**26.5**	**22.1**	**24.0**
Currencies	**0.0**	-1.2	1.2	-0.1	-0.1	0.7	1.7	4.7	2.9	-0.7
Cost of hedging (forward)	**0.0**	-0.3	-0.3	-0.2	-0.6	-0.4	-0.3	-1.3	-2.3	-3.7

N.B. Previously grouped into a single category, nominal bonds have been divided into local currencies and USD since the third quarter of 2007. This affects historical portfolio performance for this region.

- Stock markets down nearly 11%.
- The deterioration of sovereign spreads was more substantial on securities in U.S. dollars than those in local currencies.

Stock market correction: Contagion among emerging countries?

The stock markets have done well in resisting the difficulties experienced by the credit market. However, the emerging Asian stock market saw a 22% downturn since last October. Of course, this drop follows an outstanding performance led by China, which has lasted for several years now. We should still expect a correction in proportion to the economic slow-down. In our opinion, the move in portfolios towards equity – a phenomenon we've been seeing since the beginning of this year – is a valid solution, but only in a long-term perspective.

In a context of growing inflation, equity represents a better investment. However, there are two warnings to be heeded. In the short term, equity will be penalized if inflation accelerates. More specifically, if the recession is confirmed, we can expect to see a decrease in earnings of about 20% to 25% and, consequently, a similar movement in prices. In addition, despite the strength of the economies of the emerging countries, these countries had – and still have – a cost/benefit ratio that is higher than that of developed countries, despite a considerably higher risk level. In our opinion, we must still expect a stronger correction on emerging markets before taking a position to profit from their long-term potential.

The Pacific region

The Pacific region 13.0%										
	Weight (%)	Monthly returns (%)			Quarterly returns (%)			Annual returns (%)		
		Mar 08	Feb 08	Jan 08	Mar 08	Dec 07	Sept 07	2007	2006	2005
Equities	52.6	-4.3	1.1	-6.4	-9.4	-4.6	3.5	5.6	12.7	22.8
Nominal bonds	28.9	-0.4	2.7	5.6	7.9	4.0	8.7	10.3	1.5	-9.6
Real bonds	13.2	-1.4	5.6	3.2	7.5	0.2	6.5	16.4	9.5	3.2
Cash	5.3	3.0	2.9	4.3	10.5	2.5	6.8	9.4	2.2	-9.6
Total	**100.0**	**-2.4**	**2.3**	**-1.1**	**-1.1**	**-1.1**	**5.5**	**8.6**	**8.5**	**9.1**
Currencies		2.6	2.5	3.8	9.1	1.9	6.2	7.1	0.7	-10.9
Cost of hedging (forward)		0.1	0.1	0.1	0.4	0.6	0.7	3.4	2.9	1.0

- The Pacific region stock market has seen its strongest decrease.
- With the yen's performance, up by more than 12%, the Japanese currency has dominated the regions' currencies.
- It is also the Japanese market that determined the performance of the Pacific stock markets, recording a drop of 18%.

Investment conclusion

To conclude on the credit crisis, it seems evident that, in the end, the losses related to asset-backed securities will be socialized. This will mean an increased deficit for governments as well as a debt-to-GDP ratio that is higher than before, especially in the United States. This is, in fact, how the financial crisis that struck Japan in the 1990s was resolved. The United States benefit from a major advantage that Japan did not have at the time: a rapid reduction in rates will push inflation upward, which is a more diffuse manner of sharing the cost of the crisis among all taxpayers. In this regard, inflation forecasts for the Treasury Inflation Protected Securities (TIPS) market – based on a provisional model developed by the Federal Reserve Bank of Cleveland (one of the Fed's regional banks) and taking into account the effect of liquidities – have now reached a level of 3.4% for the next ten years.

Since economic growth in developed countries depends on the constant growth of leverage, monetary and government authorities cannot risk a long recession that will drive individual consumers to liquidate their real estate assets at a low price or shrink their debt by reducing their spending. Because the crisis needs to be resolved quickly and that clean-up of poor quality assets has only just begun, we must expect a U.S. rescue that is 'by the book'. Now, what remains to be seen is the cost of that rescue for the entire community and the consequences with respect to redistribution.

From an overall point of view, the financial environment is very difficult. Equities have undergone very little correction and interest rates are still very low. This is the time to hold cash on hand and slowly accumulate positions before the financial recovery expected at the end of the year.

While it is not impossible that, in a few months' time, long-term interest rates may still decrease slightly in the United States – even falling briefly under the 3% threshold in case of a recession – the current interest rate level (around 3.6%) is still quite low when looked at over the long term. The probability of capital losses over a 12- to 18-month horizon is considerable. Taking into account the current level of spreads, which are hovering close to historic averages, credit securities are not sheltered from a downward movement caused by sovereign securities. In a long-term investment context, nominal bonds should be avoided.

On the subject of stock markets in developing countries, scenarios for an economic slowdown currently being circulated are not consistent with earnings forecasts. When a recession hits, a typical drop in earnings runs from 20% to 25%, while the decrease to date has only been around 3% for developed countries in general (MSCI World) and 9% in the United States. All this leads us to believe that it is preferable to wait awhile before acquiring equity positions.

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.

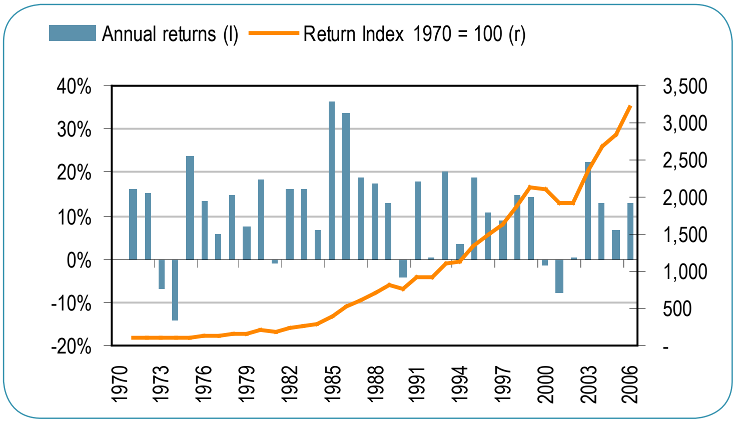
The global portfolio returned 11% from 1970 to 2005, with a same level standard deviation. Despite this relatively solid performance and major diversification, such a portfolio generated negative returns for several years following major macroeconomic shocks. The years 1973, 1974 and 1981 were marked 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 %
World	**100.00**
Developed countries	**88.67**
North America	**45.19**
Canada	3.81
United States	41.38
Europe. Australia. Far East	**43.48**
Western Europe	**30.47**
Austria	0.26
Belgium	0.57
Switzerland	3.14
Germany	3.99
Denmark	0.44
Spain	1.93
Finland	0.80
France	4.75
United-Kingdom	9.37
Greece	0.31
Ireland	0.30
Italie	1.68
Netherlands	1.25
Norway	0.46
Portugal	0.15
Sweden	1.07
Pacific	**13.01**
Australia	2.77
Hong-Kong	0.95
Japan	8.74
New-Zealand	0.05
Singapor	0.50

Aggregats / regions / countries	relative %
Emerging Countries	**11.33**
Latin America	**2.57**
Argentina	0.06
Brasil	1.63
Chile	0.16
Colombia	0.05
Mexico	0.58
Peru	0.08
Venezuela	0.00
Eastern Europe	**1.65**
Czech Republic	0.10
Hungary	0.08
Poland	0.20
Russia	1.13
Turkey	0.13
Asia	**5.97**
China	1.58
Indonesia	0.19
India	0.80
South Korea	1.56
Malaysia	0.28
Philippines	0.05
Taïland	0.18
Taiwan. Province of China	1.33
Africa. Near East	**1.14**
Egypt	0.09
Israël	0.26
Jordan	0.01
Morocco	0.05
Pakistan	0.02
South Africa	0.71



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