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CREDIT MARKETS UPDATE

In our Q1 review of Credit Markets, we cited the following Q1 themes:

- 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 fixed mortgage rates
- The blow out in credit yield spreads from government bonds to ALL credits, even the good credits.

OUTLOOK

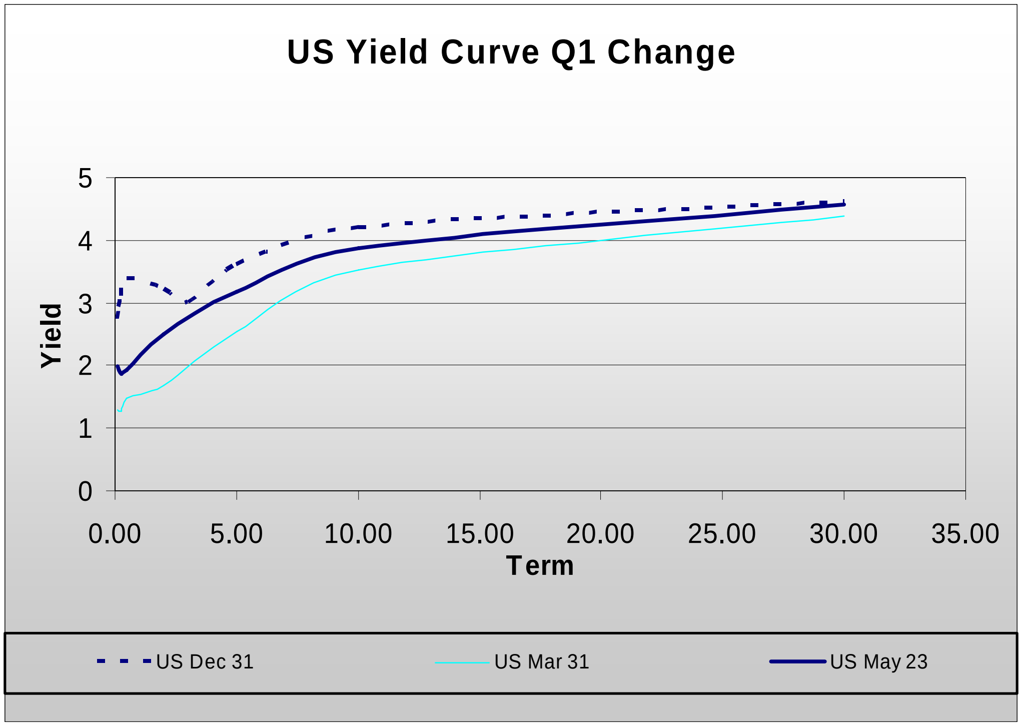
We stated that tentative signs were beginning to emerge showing that the flight to quality was beginning to reverse and that credit spreads would contract dramatically. This reversal is displayed in the accompanying charts. The **TED spread** has shrunk significantly but at its current level of 90, is still much higher than long term norms of 15 to 20.

The **US Housing Market** shows no signs of bottoming yet with prices sliding and listings at record levels. Major financial institutions continue to write off huge amounts of subprime and structured debt related losses and there are more to come.

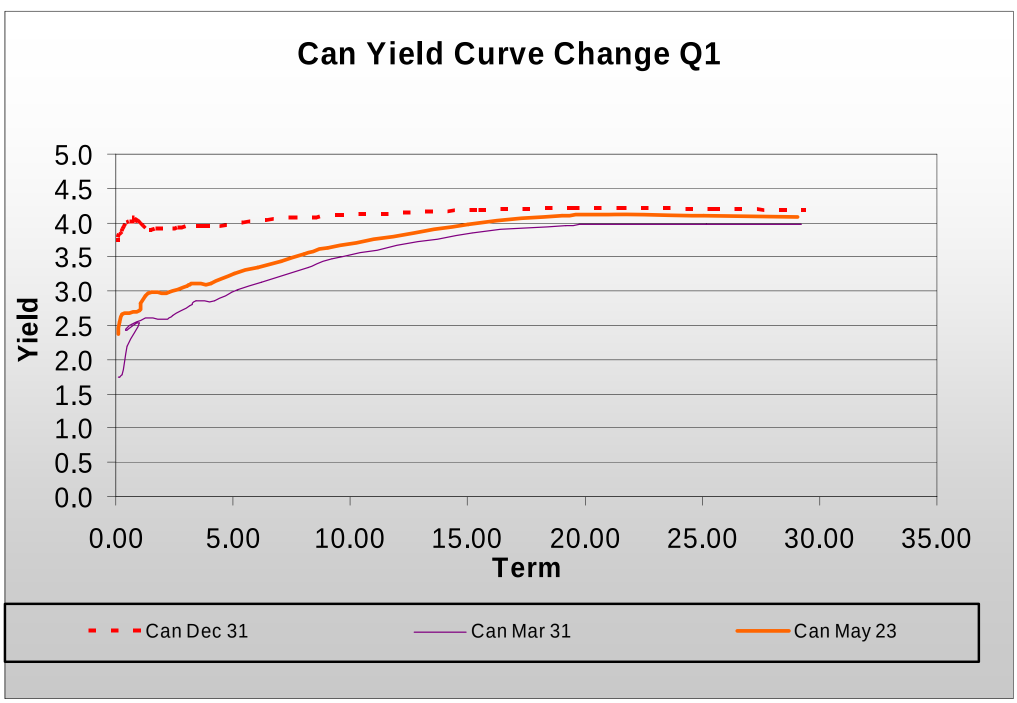
In addition, the Fed and the Bank of Canada continue to provide needed liquidity as counterparties remain wary of each other.

We still think that yield spreads of investment grade sectors (such as Federal Agency bonds (CMBs), Provincials and Corporates) over Gov't of Canada bonds are very attractive and will narrow further as credit conditions ameliorate further.

There is a mountain of cash on the sidelines in the form of money market funds awaiting deployment in capital markets upon further credit market improvements.

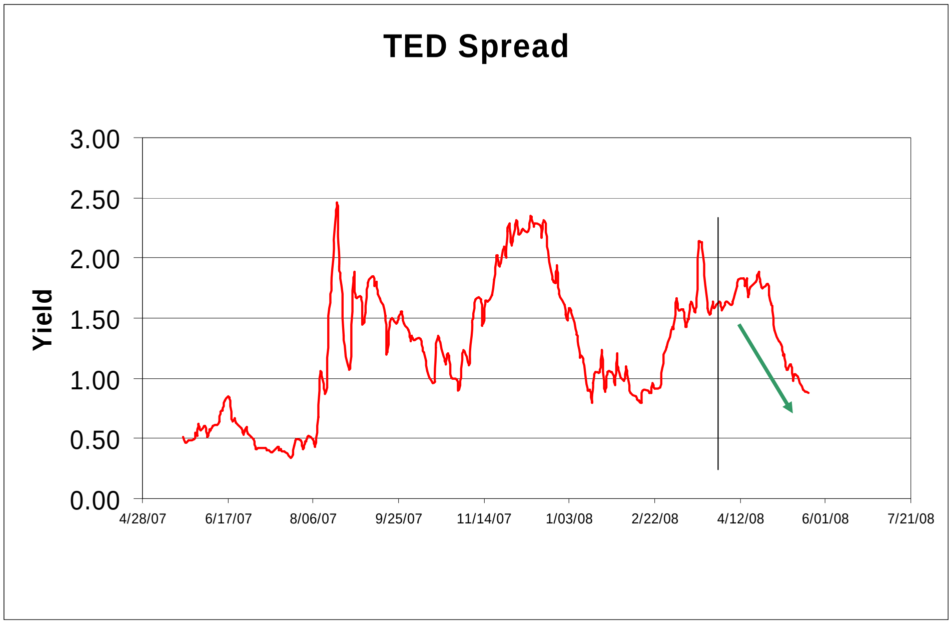


The US yield curve steepening took place entirely on the short end.
It has since flattened somewhat, while the long end has remained more or less flat.



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

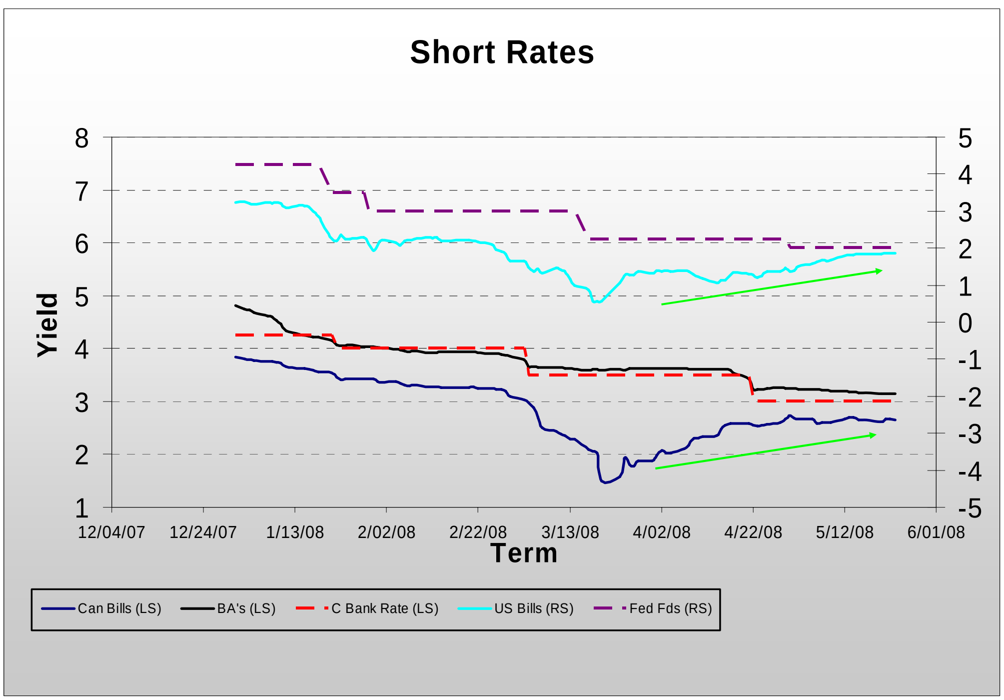
Short bonds have risen in yield as the market adjusted the amount of cuts expected out of the Bank of Canada.



TED spread
(line represents end of Q1 ’08)

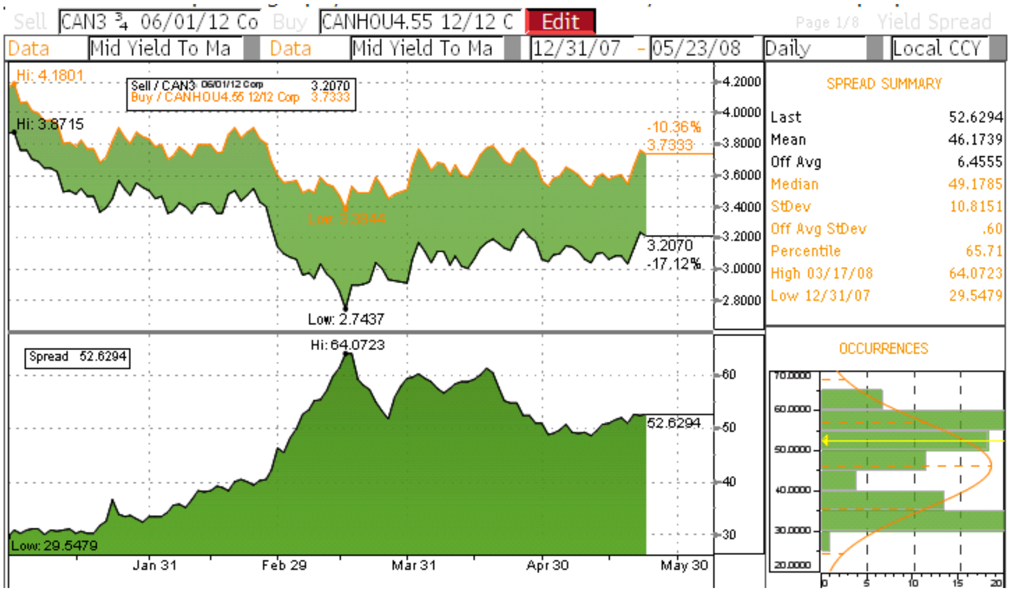
Risk aversion was volatile, but has eased considerably in Q2/2008

“Normal” for this series is 20 to 30



The spread between Canadian BA’s and Bills (black and dark blue) widened significantly during Q1. That spread narrowed VERY quickly during Q2, justifying our call to stay in Bankers. Short rates on gov’t instruments rose as the market appears to have overshot in their rate cut expectations.

Canada Housing Trust vs. Canada bonds, 5 year term



The top panel shows the outright yield of these two instruments over the YTD (brown line CHT's, black line Canadas).

The bottom panel shows the difference in yield. The Canada Housing Trust bonds have been fighting their way back to more normal spreads, outperforming the Canadas
Keep in mind; these both carry the same Government of Canada guarantee.