

February 18, 2008

Economic Indicators Canada

	Dec. 2006	Dec. 2007	
GDP ⁽¹⁾	2.8	2.8 ⁽³⁾	-
CPI ⁽¹⁾	1.6	2.4	↗
Unemployment	6.1	5.8	↘

United States

	Dec. 2006	Dec. 2007	
GDP ⁽¹⁾	2.9	2.9 ⁽²⁾	-
CPI ⁽¹⁾	3.2	4.1	↗
Unemployment	4.5	4.9	↗

(1) Year-over-year % variation
(2) September 2007 (3) October 2007

Sources: Statistics Canada, U.S. Dept. of Commerce, U.S. Dept. of Labor Statistics.

Equity Indices

% Change	2008 in local currency	2008 in C\$	
S&P/TSX	-6.7	-6.7	↘
S&P500	-9.4	-7.8	↘
Russell 2000	-10.1	-8.7	↘
Nikkei	-11.0	-5.2	↘
S&P 350 Europe	-11.7	-9.8	↘

A Few Facts About Derivative Products—Part 1

Last month, a rogue trader at the Société Générale lost \$7 billion on unauthorized transactions. In 1995, trader Nick Leeson lost \$1.4 billion also on unauthorized transactions, pushing Barings Bank into a collapse. In 1994, Orange County treasurer Robert Citron drew his regional government into financial difficulties with \$1.5 billion in trading losses. All of these financial disasters share a common point: they involved the trading of derivative products.

What are derivative products? And why are they associated with such huge losses? Are they really that bad? Let's review a few basic facts about them.

- 1. They are a type of security:** Basically, a derivative product is a contract whose value is based on (or *derived* from) the changing price of an underlying asset, such as commodities, currencies, interest rates, stock indices, and corporate debt.
- 2. They are not new:** For example, wheat futures traded on the Winnipeg Commodity Exchange as early as 1904.
- 3. They are enormous:** Derivative products have a larger trading volume than stocks. As a result, the market capitalization of the CME Group, owner of the largest derivative exchange, is \$34 billion, compared to \$20 billion for NYSE Euronext (owner of the New York Stock Exchange), the largest stock exchange company.
- 4. They are everywhere:** For example, as of October 2007, the Royal Bank of Canada held \$4.8 trillion in off-balance-sheet derivatives. That's roughly 8 times their total assets of \$600 billion. Just about every financial institution and major corporation has derivative positions.
- 5. Exchange-traded vs. over-the-counter:** While there are a number of different types of derivatives (futures, options, swaps, etc.), they are traded through two different channels. Exchange-traded derivatives are standardized contracts that are traded anonymously in a central marketplace. Over-the-counter derivatives are custom-made contracts between two entities.

Derivative products, although they are not readily visible, are part of our everyday lives. Our governments, banks, life insurance companies, and utilities are all greatly involved with derivatives.

In Part 2 of this article, we will review more of their characteristics and discuss some of their uses—and misuses.

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