

March 31, 2008

Economic Indicators Canada

	Dec. 2006	Feb. 2008	
GDP ⁽¹⁾	2.8	2.7 ⁽²⁾	↘
CPI ⁽¹⁾	1.6	1.8	↗
Unemployment	6.1	5.8	↘

United States

	Dec. 2006	Feb. 2008	
GDP ⁽¹⁾	2.9	2.2 ⁽²⁾	↘
CPI ⁽¹⁾	3.2	4.0	↗
Unemployment	4.5	4.8	↗

(1) Year-over-year % variation

(2) December 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	-4.2	-4.2	↘
S&P500	-10.3	-7.2	↘
Russell 2000	-10.8	-7.6	↘
Nikkei	-18.2	-4.9	↘
S&P 350 Europe	-17.0	-6.4	↘

THE SUBPRIME CRISIS: FOUR CAUSES

Due to recent action in the financial sector, the subprime crisis has earned the title of the most eventful crisis in decades. The takeover of Bear Stearns by JP Morgan, repeated interventions by the Federal Reserve to address liquidity problems, a run on the bank at the U.K. mortgage lender, Northern Rock, followed by its nationalization, and the freeze of the Canadian non-bank, asset-backed commercial paper (ABCP) market are each rare events. But put together, they become an exception among exceptions. Let's review four elements that we view as causes of this crisis.

- 1- Low interest rates:** From 2000 to the middle 2003, the U.S. Federal Reserve reduced its key interest rate from 6.50% to 1%, and kept it at this level for almost a year before increasing it again. Prolonged periods of very low interest rates induce fixed-income investors to take more risk in their portfolios rather than accept a near-zero yield.
- 2- Explosion of complexity:** Financial markets have always been complex. Nonetheless, two recent innovations have drastically increased their complexity. First, the securitization of low-quality assets (such as subprime mortgages) within sophisticated structures has blurred investment risks. Second, credit derivative products have been abundantly used to create high-yield "structured" investment vehicles or SIVs. The problem is that the complexity of these vehicles is beyond the understanding of most financial market experts.
- 3- Financial market regulation—insufficient transparency requirements:** Most recently created SIVs are subject to minimal disclosure requirements: details about their underlying assets or use of leverage are sometimes not even made public.
- 4- Financial institution regulation—excessive emphasis on credit-rating agencies:** To compensate for the lack of transparency in high-yield products, investors relied on the credit ratings issued by such agencies as Standard and Poor's, Moody's and DBRS. This is the main reason that a major Canadian pension-fund manager was caught off-guard with half of its money-market portfolio in non-bank ABCP. Most, if not all, of these securities were rated "AAA," which provided reassurance that the risk of default was next to zero. These top-notch ratings, which were awarded across the board to a huge number of SIVs, ended up being a huge mistake with costly consequences for those who put their faith in them.

This article recaps our views on the causes of the subprime crisis. Of course, our explanation is a simplification of the reality; and, factors other than those mentioned above also factored into these events. The good news is that U.S. Treasury Secretary Henry Paulson has come up with promising proposals to deal with some of these factors. In the end, private investors should remember one thing: in times of rock-bottom interest rates, it may be better to stick to low-risk / low-yield investments for the fixed-income part of their portfolio, rather than get involved with higher-risk complex and non-transparent investment vehicles.

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