# QUARTERLY INTEREST

## VIEWPOINT

### 2008 in Review: A Year of Exceptions

The year 2008 was marked by a number of political, social and financial highlights.

Barack Obama's election as President of the United States undoubtedly tops the list. However, the president-elect will not have an easy go of it, as his country's economy started out the year in a recession that will still be going strong at the time of his inauguration. The United States isn't the only country whose economy is not firing on all cylinders: Japan and the Euro Zone are also in the doldrums. The Bank of Canada went so far as to state that this country's economy was entering a recession in its December 9 press release announcing that it was reducing the overnight funding rate by 75 basis points. The size of this reduction stands in sharp contrast to the Bank's tradition of limiting changes to its policy rate to 25 basis points increments.

Canada's central bank was not alone in taking drastic action. Indeed, the U.S. Federal Reserve Board (Fed) declared that it would maintain its fed funds target rate between 0% and 0.25%, which is of course its lowest level ever. Even the uncompromising European Central Bank (ECB) abandoned its anti-inflationary dogma in an effort to kick-start the economy. Most central banks in the world, including those in developing countries, took measures to support economic growth rather than to fight inflation.

Admittedly, following the surge in consumer prices that culminated in mid-year, the inflation rate plummeted primarily as a result of lower commodity prices. Recall that crude oil prices reached an all-time high of $147 in July before falling dramatically, another victim of the heralded recession.

Such recessionary, indeed depressionary conditions sent stock prices tumbling: the S&P 500 Index lost 37% and the S&P TSX Index, 33%, declines that echoed those of the 1930s depression. In Canada, the tremendous drop in commodity prices, combined with the expected negative impact of the credit crisis, wrought havoc with our leading stock market index. In the United States, the credit crisis revealed the fragility of the financial system and of the residential real estate market and precipitated the demise of several financial institutions. In addition many industrial firms, chief among them the auto makers, are close to the edge.

The stock market collapse drove investors to seek a safe haven in benchmark bonds, i.e. those issued by central governments. Although interest rates remained low throughout the year, deteriorating economic conditions pressured them down to unheard of levels for all maturities. On December 31, a 30-year federal bond provided a scant yield to maturity of 3.54% in Canada, and a meagre 2.68% in the United States.

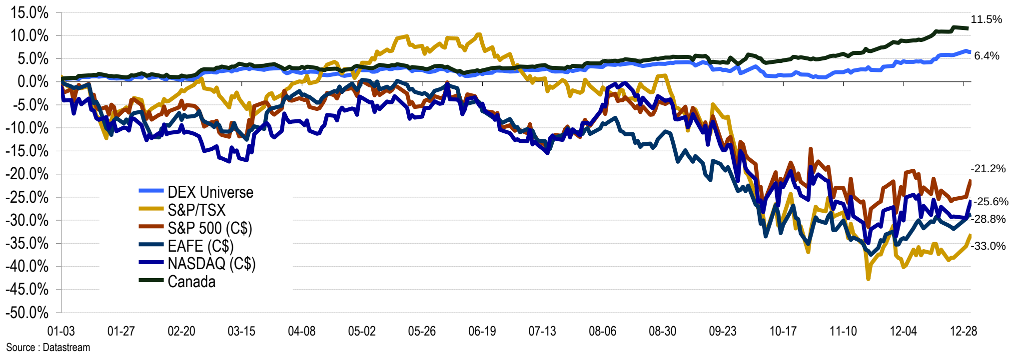
While investors were bullish on benchmark bonds, it can be said that they avoided – or were allergic to – credit securities (i.e. bonds issued by provinces, corporations or even federal agencies); accordingly, yield spreads for corporate bonds increased to a level that was over six standard deviations above their average. This was exceptional, in as much as there is barely a 3% probability that this could occur.

The DEX Universe Index returned 6.41% for all of 2008, driven by lower benchmark yields; for instance, Federal bonds advanced 11.51%, compared to 5.31% and 0.23% for provincial and corporate issues.

The situation was so serious that governments flew to the rescue of their financial firms, and then of their leading business concerns. The newly elected minority government needed the threat of being overturned to suspend parliament (a first since 1926) to understand the urgency of the situation. In general, governments resorted to increasingly ingenious solutions in an attempt to restore liquidity to their financial systems and mutual confidence to their banks. The largest of these attempts occurred not in traditionally socialist countries, but rather in that bastion of capitalism, the United States. After years of unbridled capitalism, Keynes was resurrected.

Yes, exceptions were indeed the rule last year!

Financial Markets Indices Cumulative % Change
from December 31, 2007 to December 31, 2008



# VIEWPOINT (CONTINUED)

## 2009 : A Very Gradual Return to Normal

In 2009, the world economies and capital markets are awakening to the considerable havoc created during the previous year. The new year promises to be far from easy, as the success of many economic recovery programs remains doubtful. What is certain, though, is that governments – following years of fiscal discipline – will be running up deficits once again. They will therefore be taking over as the engine of growth from the private sector, still struggling with dreadful economic conditions.

Traditionally the spearhead of economic growth, especially in terms of consumer expenditures, the private sector will be mired in neutral this year. Indeed, following years of rampant – and usually leveraged – consumption, particularly in the United States, consumers will be keeping a low profile in 2009. Their discretion will be justified by an adverse labour market, which will continue to contract in the United States. In Canada, the labour market should backpedal for the first time since 1992. However, consumers should be able to depend on the newly-found generosity of governments, which will lighten the load on taxpayers.

Households and corporations will therefore reduce their consumption. Demand-side pressure on prices should, therefore, ease in 2009. In addition, more reasonable commodity prices will also help keep the growth of the consumer price index (CPI) close to the lower limit of the Bank of Canada's target range. It should be pointed out, however, that the favourable impact of the GST reduction throughout 2008 will disappear from the CPI, thus raising the inflation rate by 0.6%. Accordingly, Canada's inflation rate should approximate 1.5% in 2009.

The forecasts of organizations such as the IMF and the OECD call for weak global growth of around 2% in 2009; such a level indicates that the entire planet has fallen into recession. Even developing countries will post lower growth rates, while industrial nations will be in overall decline. This means that the economies of the developed world will find it hard to break out of the doldrums by simply relying on developing countries.

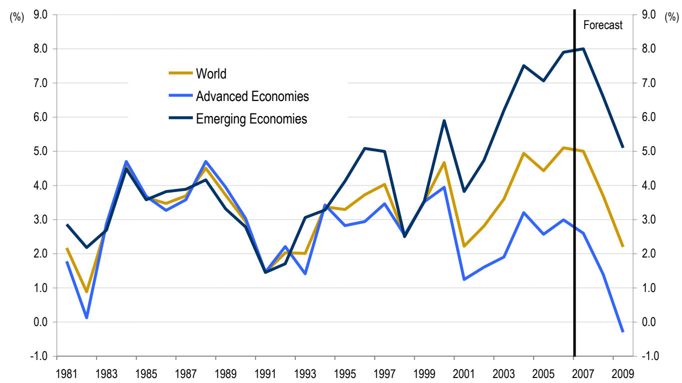
There are no quick fixes or miraculous solutions to the imbalances that have developed over the years. The credit crisis, which turned into a liquidity crisis, shook the global financial system to its very core, and governments would be well-advised to implement adequate corrective measures patiently, with an eye on the longer term.

Against this backdrop, the recession should be reflected in the economic growth data. The decline in U.S. GDP will be 1.5%. The contraction will be more apparent during the first part of the year, whereas tax incentives will have more impact towards the end of the year.

In Canada, meanwhile, excesses in consumption and indebtedness have been more moderate than south of the border. Still, it won't be easy to completely avoid the recession that our major trading partner is experiencing. Accordingly, there will be very little growth for 2009 as a whole: we estimate that GDP will edge up 0.3% for the year.

After enduring the violent shocks of 2008, we're expecting economic conditions to settle down by late 2009, and we anticipate a return to more normal conditions in 2010. Please refer to the section on strategy to see how these economic conditions will be reflected in our strategy.

IMF Growth Estimates




Source: International Monetary Fund, November 2008

| Forecast | 2007 | 2008 | 2009 f |
|---|---|---|---|
| Canada | | | |
| GDP | 2.7% | 0.8% e | 0.3% |
| Inflation | 2.1% | 2.3% e | 1.4% |
| Unemployment Rate | 6.0% | 6.2% | 6.8% |
| United States | | | |
| GDP | 2.0% | 1.3% e | -1.5% |
| Inflation | 2.9% | 4.0% e | 3.0% |
| Unemployment Rate | 4.6% | 5.7% | 8.0% |

f: forecast

e: estimate

# ECONOMIC COMMENTS

## International

It's official: the Economic and Monetary Union (the "Euro Zone") fell into recession during the third quarter. After its GDP contracted at an annualized 0.7% during the second quarter, the economy of the Euro Zone fell another 0.8% in the third quarter. Declining economic activity and a drop in the annual inflation rate (to 2.1%) in November drove the European Central Bank ("ECB") to lower its policy rate by 1.75% during the quarter, reflecting a new direction for its monetary policy, from inflation towards growth.

The economic picture is also deteriorating in Asia. Japan's economy slipped officially into recession during the third quarter, and the Bank of Japan lowered its policy rate on two occasions to come within 0.1% of the 0% floor. Meanwhile, China's growth rate slowed to 9% during the third quarter, prompting the People's Bank of China to lower its funding rate by 1.35% during the quarter.

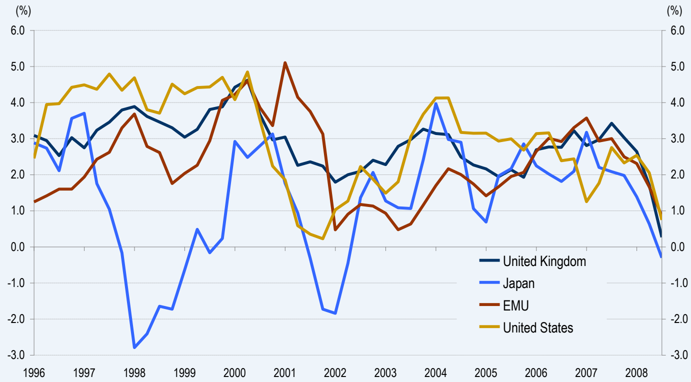
## United States

Close to 2.5 million jobs were lost in the United States during 2008, as businesses slashed their payrolls to come to grips with the slowdown. In fact, the behaviour of the labour market was instrumental in convincing the National Bureau of Economic Research to announce, in December 2008, that the recession had in fact begun in January 2008. Recall that job numbers declined every month in 2008.

After holding up through the third quarter, consumer expenditures finally capitulated in the home stretch of 2008. Retail sales declined in September, October and November, confirming that harsh reality had finally caught up with consumers, already struggling with the ongoing collapse of the residential real estate market.

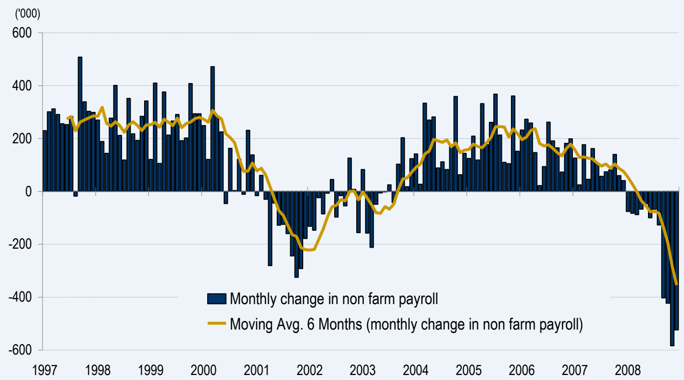
New motor vehicle sales shrank by 18% in 2008, their worst annual performance since 1980. The fate of U.S. auto makers remains uncertain, despite government measures to help them survive temporarily. This action is part of the many-faceted actions of the U.S. government in its efforts to curtail the impact of the recession. Even before the measures that will be announced by the incoming administration in January and estimated to cost over $1 trillion, the federal government was heading for a deficit of $438 billion.

Gross Domestic Product
Annual Change



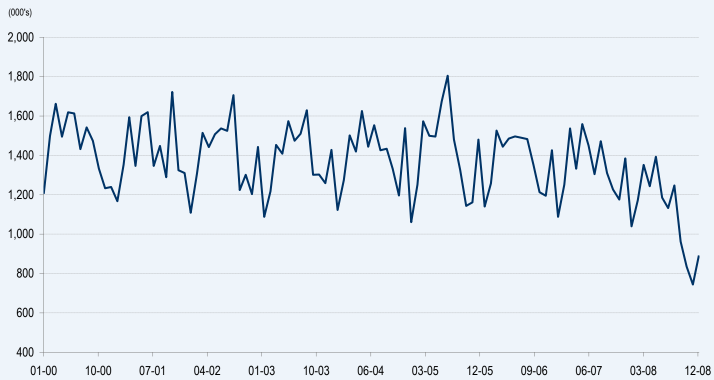

Source : Datastream

Change in Non Farm Payroll Employment
United States




Source : Datastream

Total Vehicle Sales
United States




Source: Datastream

# ECONOMIC COMMENTS (CONTINUED)

## Canada

For a second straight quarter, economic activity picked up in Canada, albeit marginally. After inching up 0.6% in the second quarter, Canada's GDP rose an annualized 1.3% in the third. Following the Bank of Canada's comments to the effect that Canada was entering into a recession, overall growth for 2008 can be expected to be less than the annualized increase of 1% posted after the first three quarters of the year.

Although employment declined in the fourth quarter, jobs in Canada posted an increase of 1.4% for all of 2008. Based on the slowdown in the latter stages of the year, 2009 can be expected to be a challenging year. However, the relatively sustained level of job creation against a background of a fairly scarce labour force caused average hourly wages to jump 4.5% in 2008.

This comparatively solid performance of the labour market probably boosted retail sales, which grew 4.7% in nominal terms over the first 10 months of the year, and 3.8% in real terms. The Canadian consumer therefore contributed to solid domestic demand.

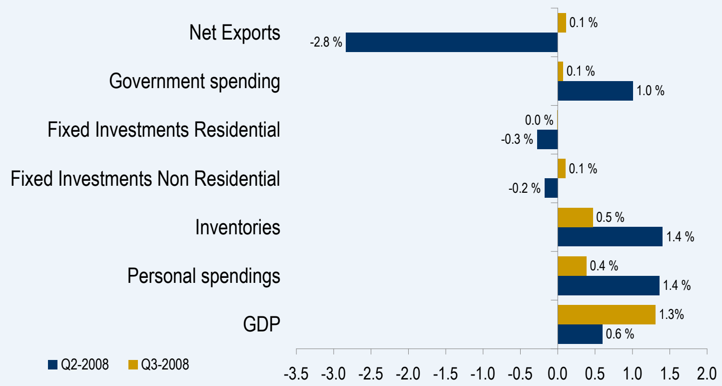
The annual inflation rate as measured by the all-items index peaked at 3.5% in August and fell back to 2% in November. The trend inflation rate, as measured by the core index, behaved differently, remaining below 2% for the first 10 months of the year and rising to 2.4% in November.

The foot dragging that followed the federal election last October, triggered by the economic statement in November, prompted the federal government to suspend the session, so that it could table a likely more expansionistic budget early in the new year. The Finance Minister has already conceded that the fiscal year ending in March 2009 will result in a deficit.

| ECONOMIC INDICATORS (annual % change)* | UNITED STATES | | CANADA | |
|---|---|---|---|---|
| | 2007 | 2008 | 2007 | 2008 |
| REAL GDP | 2.0 | 1.8 | 2.7 | 1.0 |
| UNEMPLOYMENT RATE ** | 4.6 | 5.8 | 6.0 | 6.1 |
| INFLATION | 2.9 | 4.2 | 2.1 | 2.5 |
| RETAIL SALES | 4.2 | 0.6 | 5.8 | 4.7 |
| INDUSTRIAL PRODUCTION | 1.7 | -1.2 | 0.2 | -3.6 |
| CAPACITY UTILISATION ** | 81.0 | 78.7 | 81.6 | 77.9 |
| EXPORTS OF GOODS | 12.3 | 17.0 | 2.1 | 7.0 |
| IMPORTS OF GOODS | 5.7 | 12.0 | 2.7 | 6.3 |

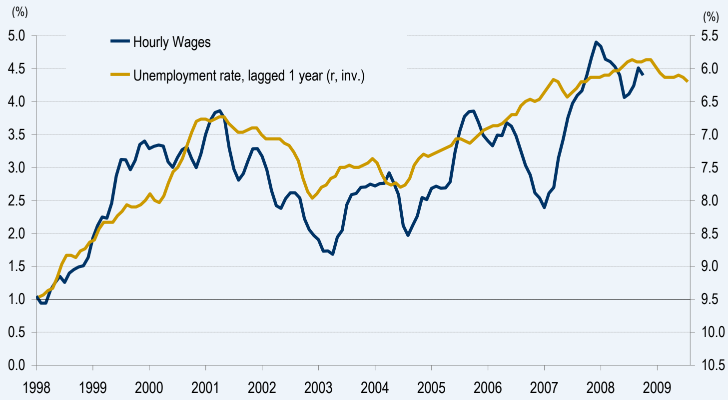
** Most recent cumulative data (as at January 9, 2009)*
*** Average*

Contribution to Canadian Growth



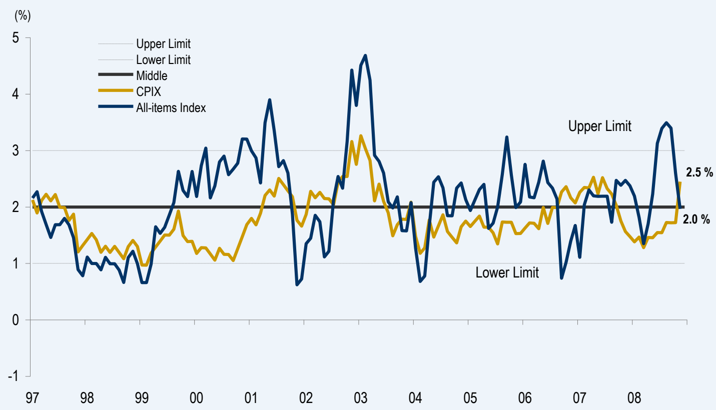

Source : Datastream

Hourly Wages and Unemployment Rate - Canada
Annual Percent Change - 3 Month Moving Average




Source : Datastream

Annual Inflation Rates in Canada




Source: Datastream

# MARKET COMMENTS

## Monetary Policy and Interest Rate Trends

In a quarter to challenge all quarters in terms of volatility, government intervention, record setting in financial markets, and the list goes on, central bankers across the globe were also center stage. The message was consistent; the intensifying financial market turmoil had led to significant worsening of global growth outlooks and aggressive policy responses could be required. And aggressive they were. On October 8th, we witnessed coordinated rate cuts of 50 basis points from the central banks of six major countries. This moved the fed funds rate to 1.5% and the Bank of Canada's overnight rate to 2.5%. China also cut by 27 basis points. Prior to the announcement, the Treasury Euro Dollar (TED) spread reached a new high of 391.5 basis points, indicating that the passing of Troubled Assets Relief Program (TARP) and the Fed agreeing to buy commercial paper had yet to impact the market. The cuts were followed by the G7 bailout.

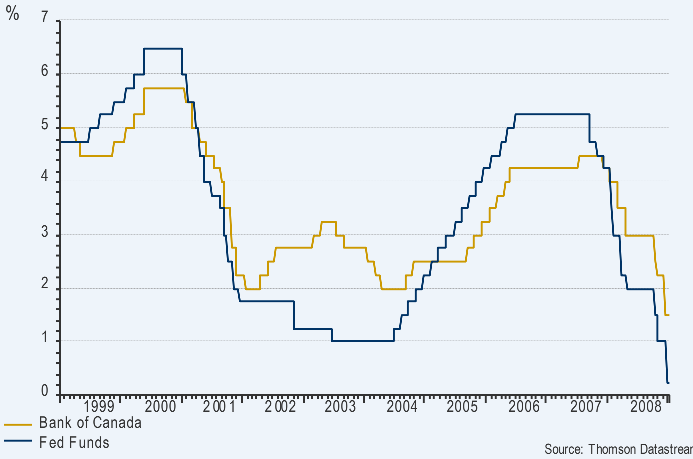
Two weeks later, the Bank of Canada cut its benchmark rate further by 25 basis points, stating that the US economy was already in recession. The following week, the Fed cut its policy rate by 1%, matching the lows achieved from June 2003 through June 2004.

Throughout the quarter, the US Treasury and the Federal Reserve, as well as other similar authorities around the globe, continued to unveil additional measures to deal with the global credit crunch, such as the purchase of asset-backed securities through Term Asset-Backed Securities Loan Facility (TALF). At the beginning of December, the Fed Chairman Ben Bernanke even evoked the possibility of buying long-dated Treasuries and agency debt to lower long-term interest and mortgage rates.

On December 9th, the Bank of Canada lowered its key overnight rate by 75 basis points to 1.5%, bringing the rate to its lowest level since 1958, and indicating there will be further monetary stimulus if needed. The Bank also stated that the Canadian economy is "now entering a recession." In mid-December, the FOMC established a target range for the fed funds rate of 0 to 0.25%. It commented that "all available tools to promote the resumption of sustainable economic growth and to preserve price stability" would be employed. The Committee also stated that the fed funds rate was likely to be exceptionally low for some time.

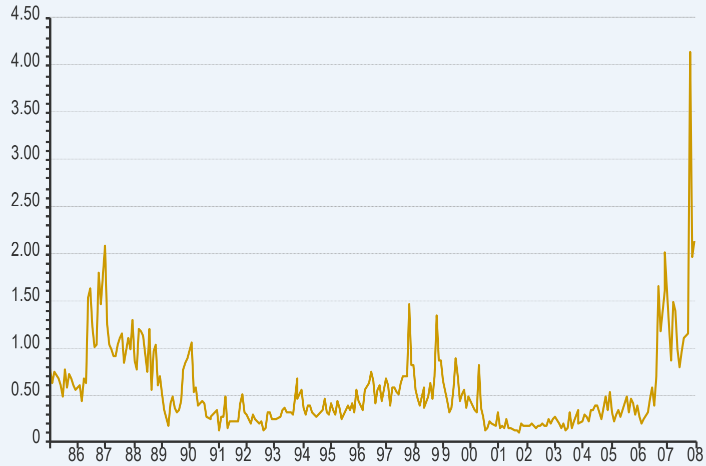
The last phrase of the FOMC's statement pretty much sums up where many central bankers and governments seem to stand, stating that it will "continue to consider ways of using its balance sheet to further support credit markets and economic activity." Basically, the Fed, and others will do wathever it takes, regardless of inflation, the quality and size of the balance sheet and the deficit.

North-American Monetary Policy Target Rates



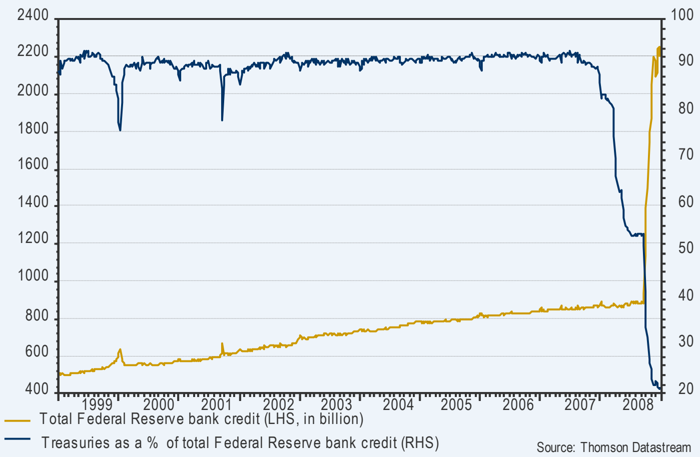

Source: Thomson Datastream

U.S. Interbank Market
3-month LIBOR minus 3-month U.S. T-Bills (TED Spread estimate)




Source: Thomson Datastream

The Federal Reserve has Expanded its Balance Sheet
but its composition is different




Source: Thomson Datastream

# MARKET COMMENTS (CONTINUED)

Interest rates collapsed in late 2008. Historically accommodating monetary policies, the sustained intervention of governments throughout the world to counter a troubled financial system and the anticipated recessions in North America and Europe made it possible for yields to smash the record levels set during the previous quarter.

However, the return related to a dramatic drop in interest rates was largely wiped out by the lacklustre performance of corporate and government bonds during this period. Thus, the DEX Bond Index returned 4.50% from September 30 to December 31. With an advance of 5.21%, the long-term index outperformed its short and medium counterparts, which rang in at 4.30% and 4.25% respectively.

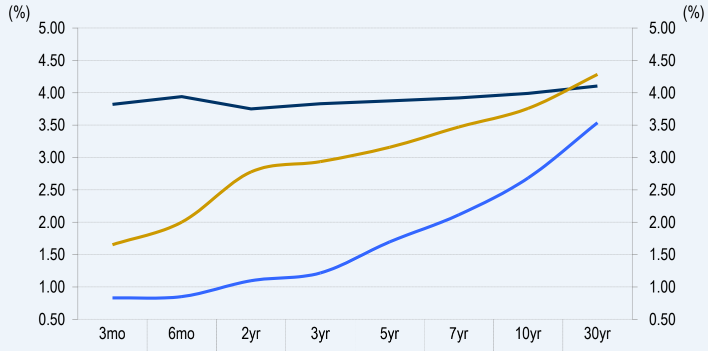
For 2008 as a whole, the underperformance of credits also offset much of the gain generated by lower yields. The short-term sector was the top performer, with a return of 8.55%, followed by the mid and long-term sectors, at 7.01% and 2.66% respectively. The DEX Universe Index closed out 2008 with a return of 6.41%.

In the United States, yields contracted for all maturities in 2008, and especially in the final quarter. From September 30 to December 31, 2-year yields declined from 1.96% to 0.76%, giving up 120 basis points for the quarter and 229 points for the year. Meanwhile, 5-, 10-, and 30-year yields stood at 1.55%, 2.21% and 2.68% respectively at year's end, following decreases of 142, 161 and 163 basis points respectively and accounting for a very large part of the one-year declines of 189, 181 and 178 basis points.

The spread between 2-year and 30-year yields widened by 77 basis points during the quarter. It peaked at 312 basis points on November 13, and subsequently narrowed by 140 basis points in the latter half of the quarter to a level of 172 basis points on December 31.

In Canada, the quarter was marked by a swift decline in short-term yields, while long yields reached both their high (4.40%) and their low (3.49%) for the year. This variance of 91 basis points for the quarter contributed to the largest annual shift in 30-year yields since 2003. In fact, yields in all sectors fluctuated in wider bands than their historical average of the past 10 years.

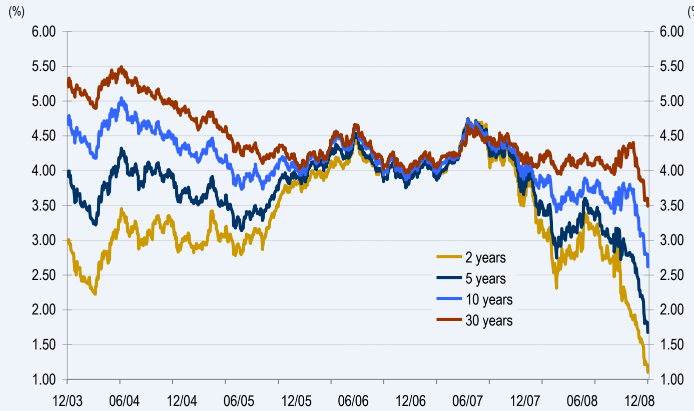
Canadian Yield Curves




| | 3mo | 6mo | 2yr | 3yr | 5yr | 7yr | 10yr | 30yr |
|---|---|---|---|---|---|---|---|---|
| 12/31/07 | 3.82 | 3.94 | 3.75 | 3.83 | 3.87 | 3.92 | 3.99 | 4.10 |
| 09/30/08 | 1.65 | 2.00 | 2.78 | 2.93 | 3.16 | 3.47 | 3.76 | 4.28 |
| 12/31/08 | 0.83 | 0.85 | 1.10 | 1.22 | 1.69 | 2.11 | 2.68 | 3.54 |

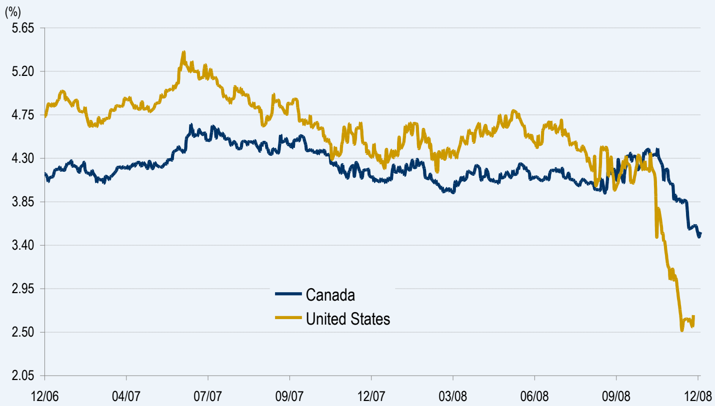
Canadian Interest Rate Trends

The yield curve steepened




Canada and United States 30-year Yields

December 2006 - December 2008



# MARKET COMMENTS (CONTINUED)

Yields bottomed out at 1.05% for 2-year bonds, 1.61% for the 5-year bonds and 2.57% for their 10-year counterparts. Over the year as a whole, 2-, 5-, 10- and 30-year yields fell 265, 218, 131 and 60 basis points respectively. The extent of this decline is a reflection of investor concern over the economy and capital markets.

With 2-year yields steadfastly below the Bank of Canada's overnight funding rate, it's clear that market players are anticipating additional rate cuts.

The yield spread between 2-year and 30-year yields steepened dramatically during the quarter (90 basis points), reaching 236 basis points, its highest level since 2003.

Canadian bonds outperformed their U.S. counterparts in the short sector, but underperformed with respect to 10- and 30-year maturities. Thus, 2-year and 5-year spreads narrowed 48 and 4 basis points respectively, to 34 and 14 basis points. Meanwhile, 10-year and 30-year spreads returned to positive territory, moving from -6 to 47 basis points and from -3 to 86 basis points respectively between September 30 and December 31. Part of this underperformance was probably due to changes in asset allocation by pension funds (which reduced bond positions in favour of equities), at a time when liquidity was practically non-existent.

## Real Return Bonds (RRBs)

Long RRB yields in Canada decreased slightly, from 2.27% at the beginning of the fourth quarter to 2.15% three months later. A similar phenomenon was noted in the United States, where they lost 26 basis points, to 2.39%. Thus, the expected inflation rate declined 62 basis points in Canada, to 1.39%, nearing the lower limit of the Bank of Canada's target inflation range. Expected inflation also moderated in the United States, from 1.79% to 0.66% at the end of the quarter.

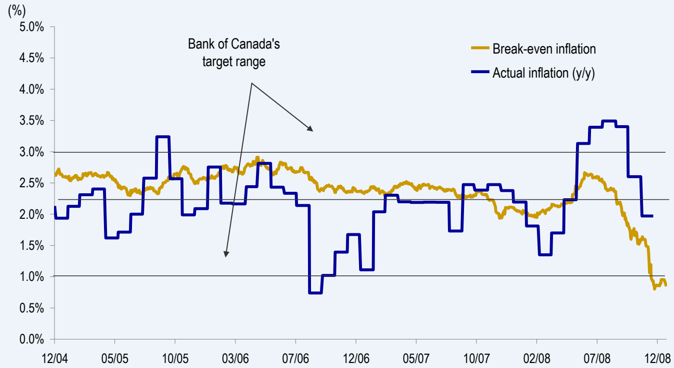
During the fourth quarter of 2008, the RRB Index posted a negative return of -0.37%, compared to a positive 5.21% for the DEX Long Term Bond Index. As a result, the RRB Index wiped out most of the gains accrued over the first half of the year, resulting in a return of 0.42% for the whole of 2008, compared to 2.66% for the long term index. This poor showing of RRBs suggests that market players are worried about the financial crisis and its deflationary impact.

Canada - United States 10 Year Spread
(in basis points)


Source: Datastream

| | Yield (%) | | | Change (b.p.) | |
|---|---|---|---|---|---|
| | 12/31/08 | 09/30/08 | 12/31/07 | Q4-2008 | 2008 |
| Canada | | | | | |
| 3-month | 0.83 | 1.65 | 3.82 | -82 | -299 |
| 2-year | 1.10 | 2.78 | 3.75 | -168 | -265 |
| 5-year | 1.69 | 3.16 | 3.87 | -147 | -218 |
| 10-year | 2.68 | 3.76 | 3.99 | -108 | -131 |
| 30-year | 3.54 | 4.28 | 4.10 | -74 | -56 |
| U.S. | | | | | |
| 3-month | 0.03 | 0.79 | 3.16 | -76 | -313 |
| 2-year | 0.76 | 1.96 | 3.05 | -120 | -229 |
| 5-year | 1.55 | 2.98 | 3.44 | -143 | -189 |
| 10-year | 2.21 | 3.82 | 4.02 | -161 | -181 |
| 30-year | 2.68 | 4.31 | 4.45 | -163 | -177 |
| Canada/U.S. Yield Spread (b.p.) | | | | | |
| 3-month | 80 | 86 | 66 | -6 | 14 |
| 2-year | 34 | 82 | 70 | -48 | -36 |
| 5-year | 14 | 18 | 43 | -4 | -29 |
| 10-year | 47 | -6 | -3 | 53 | 50 |
| 30-year | 86 | -3 | -35 | 89 | 121 |

Break-even Inflation Implied by Canada Real Return Bonds and Actual Inflation
December 2004 - December 2008



# MARKET COMMENTS (CONTINUED)

## Provincial Bonds

During the quarter, there was another dramatic widening in the risk premium of provincial bonds. Indeed, this sector returned 5.06%, compared to 8.18% for Canada bonds. The largest underperformance was turned in by long bonds, at 5.15%, compared to 11.80% for their Canada counterparts. During the whole of 2008, provincial bonds generated 5.31%, as opposed to 12.09% for Canada bonds; the short, mid and long term sectors returned 8.91%, 8.75% and 2.16% respectively.

Provincial spreads in all sectors of the curve reached all-time highs. The 10-year spread for Québec peaked at 200 basis points in the fourth quarter, compared to 181 basis points for Ontario. This sector recorded the largest increase in spreads during the quarter. In the 30-year sector, spreads closed out the quarter at 147, 124 and 123 basis points for Québec, Ontario and British Columbia respectively, representing increases of 47 points for Québec, 40 points for Ontario and 43 points for British Columbia.

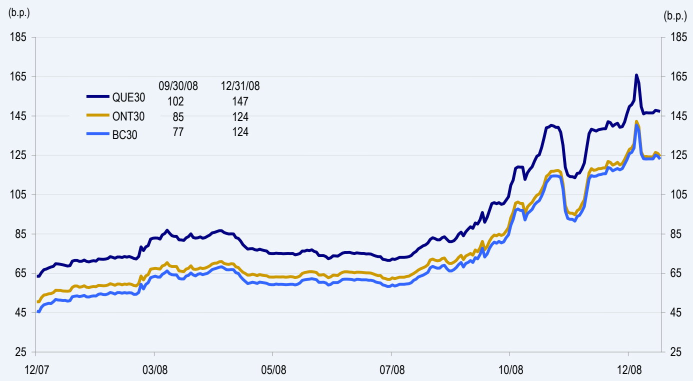
The dismal performance of provincial bonds is due to low demand for these securities caused by the ongoing liquidity crisis. Another major factor was the rebalancing of portfolios, which involved the sale of provincial bonds in favour of equities. The Québec election had little impact on provincial spreads.

Moreover, the provinces continued to carry out their funding programs, fairly smoothly for the most part. A total of $14.7 billion was funded during the quarter, up from the $10.6 billion raised during the same quarter last year. It should be pointed out that Ontario issued nearly $1.5 billion on foreign markets, while most domestic issues were made in response to reverse inquiries.

The recession and the auto industry bail-out will probably have a negative impact on the financial results of provincial governments. In the Fall Economic Statement that it published last October, the Province of Ontario was already anticipating a $500-million deficit. Meanwhile, Québec's minister of Finance will have to use the reserve fund that's earmarked for this purpose to balance her budget.

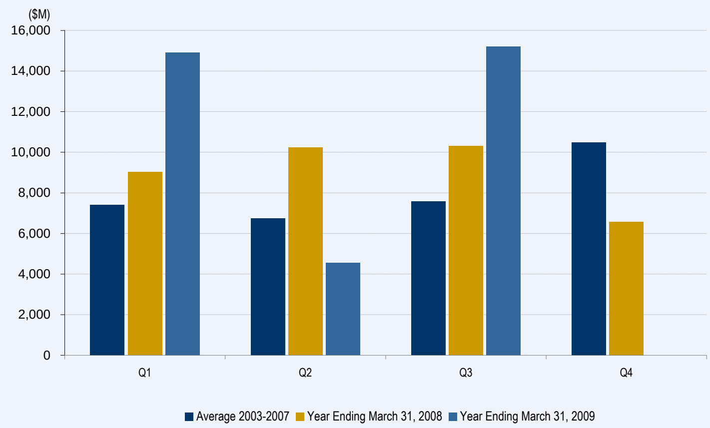
Federal agency bonds were also outperformed by Canadas (6.31% vs. 8.18%). However, this appears to be due to the shorter duration of these securities. Short-term agency bonds outperformed their Government of Canada counterparts by 1.05% (6.16% vs 5.11%).

### 30-year Provincial Spreads over Canada Bonds
December 2007 - December 2008




| | Yield Spreads (b.p.) | | | Change | |
|---|---|---|---|---|---|
| | 12/31/08 | 09/30/08 | 12/31/07 | Q4-2008 | 2008 |
| Quebec/Canada | | | | | |
| 5-year | 130 | 86 | 43 | 44 | 87 |
| 10-year | 174 | 104 | 56 | 70 | 118 |
| 30-year | 147 | 100 | 64 | 47 | 84 |
| Ontario/Canada | | | | | |
| 5-year | 119 | 83 | 40 | 36 | 79 |
| 10-year | 155 | 100 | 48 | 56 | 108 |
| 30-year | 124 | 84 | 51 | 40 | 74 |
| BC/Canada | | | | | |
| 5-year | 124 | 78 | 38 | 47 | 86 |
| 10-year | 148 | 83 | 40 | 65 | 107 |
| 30-year | 123 | 80 | 46 | 43 | 77 |
| Yankee/US Treasuries | | | | | |
| Qc-30 yr | 112 | 92 | 67 | 20 | 45 |

### Quarterly New Issues



# MARKET COMMENT (CONTINUED)

## Corporate Bonds

The Canadian corporate bond market experienced an extremely tumultuous fourth quarter. The real economy took a turn for the worse with the Lehman bankruptcy followed by the seizure of the global credit markets. This in turn shifted the credit markets focus on companies that may have a more difficult time weathering a deep recession. Corporate spreads also felt the brunt of asset mix shifts from bonds towards equities as pension funds tried to rebalance their portfolios amidst an already strained liquidity environment.

Financial institutions lined up at the government bailout soup kitchen and issued over $112 billion of government guaranteed debt in the United States. In Canada, banks jumped at the opportunity to sell $25 billion of mortgage debt to the government at attractive prices. This bailout program was increased to $75 billion along with other measures such as the possibility for Canadian banks to issue government guaranteed debt in order to ensure they maintain access to attractively priced liquidity.

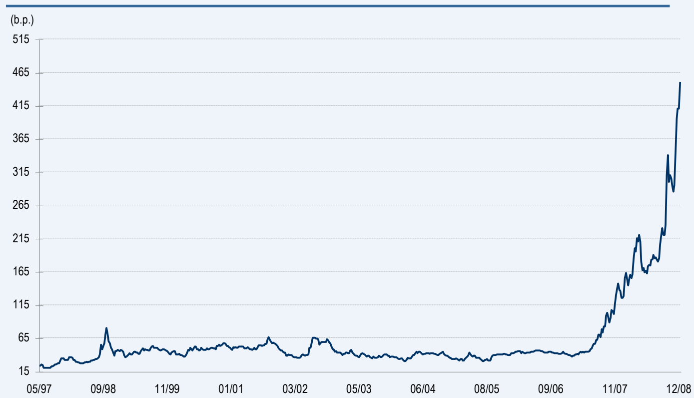
On December 17th, credit markets worldwide were shocked as Deutsche Bank became the first major bank ever not to redeem a subordinated bond on the scheduled redemption date. Most subordinated bonds have a fixed five or ten year maturity with an additional five years on a floating rate basis. The German bank's action had a substantial impact on spreads for subordinated bank debt worldwide, including Canada where spreads widened over 100 basis points on the news. Market participants will closely watch upcoming maturities to judge if this was a one time event from a troubled bank or the new market reality.

Spreads in Canada have widened significantly in the fourth quarter. Generic bank spreads widened 165, 150 and 145 basis points during the fourth quarter for the 5-, 10- and 30-year sectors respectively.

The generic bank curve closed at 450, 465 and 465 for the 5-, 10- and 30-year sectors respectively at the end of the fourth quarter. Since December 2007, the generic bank spreads have widened 325, 317 and 317 for the 5-, 10- and 30-year sectors respectively. Current indicative new issuance bank spreads are pricing almost a 9% default rate with a recovery rate of zero for subordinated debt over the next five years for the six big Canadian banks. We consider this scenario highly unlikely and therefore believe tremendous value exists in Canadian corporate bank bonds.

With the widening in credit spreads, corporate bonds underperformed government bonds posting a -0.25% return compared to a +7.40% return for federal government bonds over the quarter. Over the past five and ten years, corporate bonds were left with a return of 3.91% and 5.43%, compared to 6.38% and 6.22% for Canada bonds, erasing all of the excess returns recorded by Corporate bonds over the past ten years.

Historical Credit Spread
(Generic 5-year Bank note)




| Yield Spreads (b.p.) - Corporate Bonds | 12/31/08 | 09/30/08 | 12/31/07 | Change Quarterly | Change 2008 |
|---|---|---|---|---|---|
| **Royal Bank** | | | | | |
| 5-year | 450 | 285 | 125 | 165 | 325 |
| 10-year | 465 | 315 | 148 | 150 | 317 |
| 30-year | 465 | 320 | 148 | 145 | 317 |
| **Bell Canada** | | | | | |
| 5-year | 510 | 470 | 330 | 40 | 180 |
| 10-year | 540 | 525 | 375 | 15 | 165 |
| 30-year | 540 | 545 | 400 | -5 | 140 |
| **Loblaw** | | | | | |
| 5-year | 420 | 340 | 185 | 80 | 235 |
| 10-year | 470 | 390 | 235 | 80 | 235 |
| 30-year | 540 | 470 | 320 | 70 | 220 |
| **GTAA** | | | | | |
| 5-year | 360 | 185 | 103 | 175 | 257 |
| 10-year | 370 | 205 | 117 | 165 | 253 |
| 30-year | 370 | 235 | 125 | 135 | 245 |
| **TransCanada Pipelines** | | | | | |
| 5-year | 385 | 225 | 93 | 160 | 292 |
| 10-year | 420 | 275 | 112 | 145 | 308 |
| 30-year | 460 | 320 | 156 | 140 | 304 |

Source: National Bank Financial

# MARKET COMMENT (CONTINUED)

## International Bonds and Currencies

The coordinated interest rate reductions by the world's major central banks in early October set the tone for what would become the best quarter ever for the Global Government Bond Index (GBI) since its creation by JPMorgan in 1991. Also driven by deflationary concerns, the tax incentives announced by a good many governments and the aggressiveness shown by the Fed, the GBI gained 6.1% during the final quarter of 2008. For the year as a whole, it turned in an excellent 9.2%.

The hedged GBI (covering the risk of currency fluctuations against the Canadian dollar) also recorded its best quarter since the inception of the index, rising 6.4%. The hedged GBI closed out 2008 with an advance of 9.9% for the year.

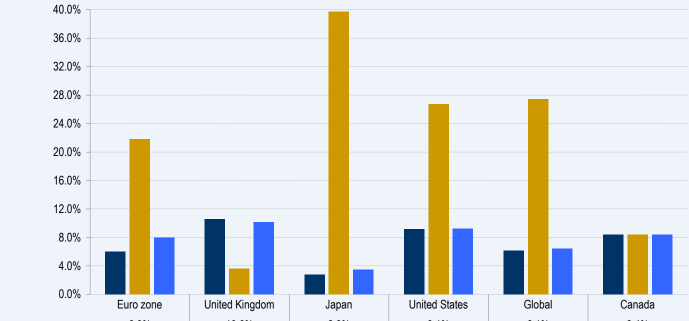
Fuelled by a material depreciation of the Canadian dollar against most currencies, especially the yen, the unhedged GBI in Canadian dollar terms closed out the quarter up 27.4%. For the year 2008 as a whole, the unhedged GBI generated an outstanding return of 40.1%.

The U.S. bond market was obviously one of the best-performing during the quarter. Indeed, the aggressiveness of the Fed at its December meeting (lowering the policy rate to next to zero, mentioning that rates would remain low for an extended period, redeeming the securities of U.S. agencies and, potentially, of long Treasury notes) helped the market to advance 9.1% during the quarter in U.S. dollar terms. For all of 2008, the U.S. market returned 14.3%.

Bond markets in other countries whose central banks were more aggressive in lowering policy rates outperformed all others during the fourth quarter. Given their narrower economic ties to the United States, the countries of the dollar bloc (the United Kingdom, Canada and Australia) turned in the best performances of the quarter.

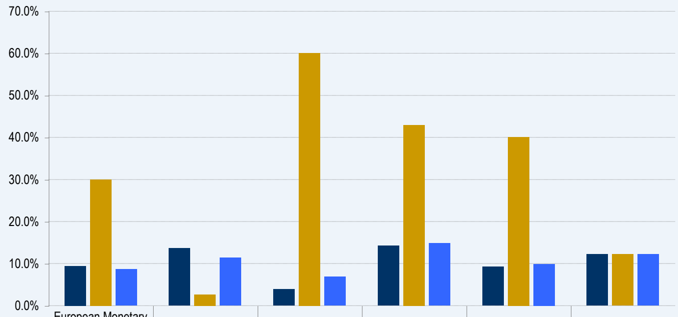
The ECB's decision to finally reduce its rates in October after raising them in July propped up most of the Euro Zone markets. With less pressure on prices and many economies in recession, bond markets were able to climb 6.0% during the fourth quarter of 2008. Returns varied substantially from country to country. Thus, investors' flight to quality favoured the German market, which was up 7.8%, while rumours of a potential withdrawal from the Euro Zone weighed down on the Italian bond market, which returned only 3.7%.

Quarterly Returns International Bonds
Q4-2008



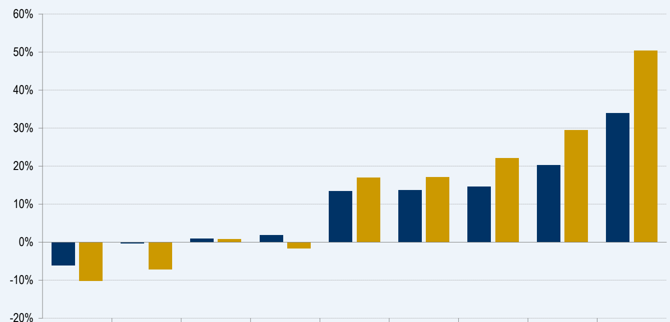

| | Euro zone | United Kingdom | Japan | United States | Global | Canada |
|---|---|---|---|---|---|---|
| Local Currency | 6.0% | 10.6% | 2.8% | 9.1% | 6.1% | 8.4% |
| Unhedged (C$) | 21.8% | 3.6% | 39.8% | 26.7% | 27.4% | 8.4% |
| Hedged (C$) | 8.0% | 10.1% | 3.5% | 9.2% | 6.4% | 8.4% |

Annual Returns International Bonds
2008




| | European Monetary Union | United Kingdom | Japan | United States | Global | Canada |
|---|---|---|---|---|---|---|
| Local Currency | 9.4% | 13.6% | 3.9% | 14.3% | 9.2% | 12.2% |
| Unhedged (C$) | 30.1% | 2.6% | 60.1% | 42.9% | 40.1% | 12.2% |
| Hedged (C$) | 8.6% | 11.3% | 6.9% | 14.8% | 9.9% | 12.2% |

Exchange Rate Fluctuations vs Canadian Dollar
Q4-2008




| | £ | $NZ | SK | $AUS | EURO | DK | $US | CHF | Yen |
|---|---|---|---|---|---|---|---|---|---|
| Q4- 2008 | -6.1% | -0.4% | 1.0% | 1.8% | 13.4% | 13.7% | 14.7% | 20.2% | 34.0% |
| 2008 | -10.2% | -7.1% | 0.7% | -1.6% | 16.9% | 17.1% | 22.1% | 29.5% | 50.4% |

# MARKET COMMENT (CONTINUED)

Closely tied to commodity prices, the Canadian dollar depreciated markedly against most major currencies during the quarter. Declining equity markets exacerbated this trend, especially against the U.S. dollar, by forcing the closure of currency hedges. From a high of $0.9407 in late September, the loonie traded as low as $0.7682 in November to finally close out the year at $0.8204. Its 12.8% drop against its U.S. counterpart during the quarter raised its total depreciation to 18.1% for 2008. However, our dollar's greatest depreciation was against the yen, at -25.4% for the final quarter and -33.6% for 2008 as a whole.

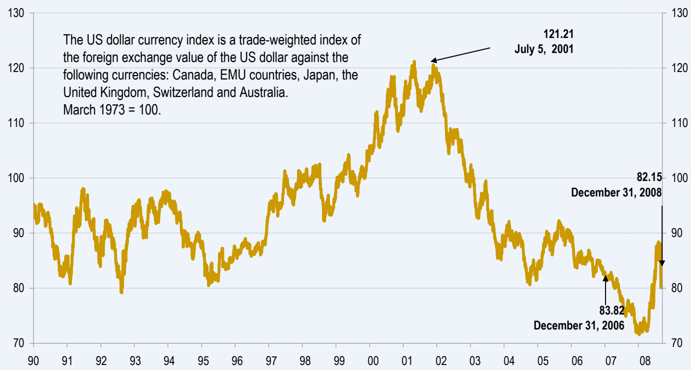
As was the case between the end of June and late September, a realization that the crisis in the United States would rapidly spread to other global economies helped the U.S. dollar sustain its momentum. The flight to quality and the safe haven represented by U.S. Treasury notes also supported the greenback against other major currencies. Based on the importance of trade with major nations, the U.S. dollar rose 2.3% during the quarter and 6.0% for all of 2008. The yen, supported by the closure of unhedged operations (primarily yen carry trades), resisted the trend, closing out the quarter up 16.8%.

Monetary Policy Rates (%)

| | 12/2007 | 09/2008 | 12/2008 | Quarterly Change (b.p) | Annual change (b.p) |
|---|---|---|---|---|---|
| Canada | 4.25 | 3.00 | 1.50 | -150 | -275 |
| United States | 4.25 | 2.00 | 0.25 | -175 | -400 |
| Europe | 4.00 | 4.25 | 2.50 | -175 | -150 |
| United Kingdom | 5.50 | 5.00 | 2.00 | -300 | -350 |
| Japan | 0.50 | 0.50 | 0.10 | -40 | -40 |

U.S. Dollar Index

( 1973 = 100)




Source : Datastream, Federal Reserve

Exchange Rates

| | 12/31/07 | 09/30/08 | 12/31/08 | Quarterly change | Annual change |
|---|---|---|---|---|---|
| VS US$ | | | | | |
| Euro | 1.4588 | 1.4116 | 1.3964 | -1.08% | -4.28% |
| Canadian Dollar | 1.0021 | 0.9407 | 0.8204 | -12.79% | -18.13% |
| Japanese Yen | 0.0090 | 0.0094 | 0.0110 | 16.82% | 23.09% |
| Danish Krona | 0.1956 | 0.1892 | 0.1876 | -0.84% | -4.11% |
| British Pound | 1.9864 | 1.7834 | 1.4603 | -18.12% | -26.48% |
| NZ Dollar | 0.7660 | 0.6707 | 0.5827 | -13.12% | -23.94% |
| Australian Dollar | 0.8756 | 0.7944 | 0.7052 | -11.23% | -19.46% |
| Swiss Franc | 0.8826 | 0.8922 | 0.9355 | 4.85% | 5.99% |
| Swedish Krona | 0.1546 | 0.1448 | 0.1275 | -11.92% | -17.53% |
| VS C$ | | | | | |
| Euro | 1.4557 | 1.5005 | 1.7020 | 13.43% | 16.92% |
| US Dollar | 0.9979 | 1.0630 | 1.2189 | 14.67% | 22.15% |
| Japanese Yen | 0.0089 | 0.0100 | 0.0134 | 33.95% | 50.36% |
| Danish Krona | 0.1952 | 0.2011 | 0.2287 | 13.70% | 17.13% |
| British Pound | 1.9822 | 1.8958 | 1.7800 | -6.11% | -10.20% |
| NZ Dollar | 0.7644 | 0.7129 | 0.7102 | -0.38% | -7.09% |
| Australian Dollar | 0.8737 | 0.8444 | 0.8595 | 1.79% | -1.63% |
| Swiss Franc | 0.8808 | 0.9484 | 1.1402 | 20.22% | 29.46% |
| Swedish Krona | 0.1543 | 0.1539 | 0.1555 | 1.00% | 0.74% |