



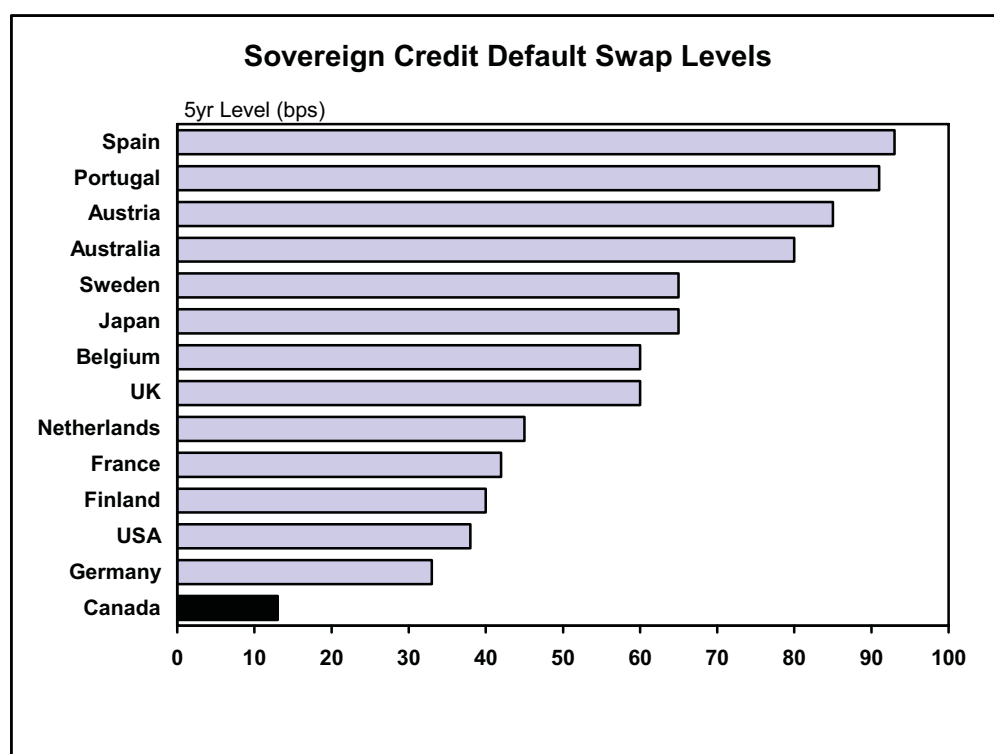
Market Musings

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The Teflon Maple Leaf

- A peek at the latest sovereign credit default swap data reveals that Canada is now regarded as quite possibly the world's safest sovereign country in terms of the solvency of the country's government.
- On the surface, this seems surprising given how closely Canada is linked into the U.S. economy and into commodity prices, and how both of those two erstwhile pillars have recently crumbled.
- But a closer look reveals that there may be some method to the market's madness – Canada is indeed in a remarkably good position by several metrics, which we pursue in this piece.



The Rankings

- Among the countries we examined, Canada has by far the lowest sovereign CDS level, as illustrated in the chart above and the table on the next page. In fact, the Canadian level is less than half that of the next country. This means that the market believes that – roughly speaking – the Canadian government is less than half as likely to default on its debt than are other countries. Since it is the government that is generally called upon to fix major problems that crop up, this suggests that the market does not expect major problems out of the broader Canadian economy and financial sector.
- Our investigation included all major countries, including The U.S., U.K., Japan, China, Germany, France, and the list goes on to include twenty-five major players.

Country Rankings		
Rank	Country	CDS Level
1	Canada	13
2	Germany	33
3	USA	38
4	Finland	40
5	France	42
6	Netherlands	45
7	UK	60
8	Belgium	60
9	Japan	65
10	Sweden	65
11	Australia	80
12	Austria	85
13	Portugal	91
14	Spain	93
15	Hong Kong	109
16	Ireland	113
17	Italy	115
18	Greece	127
19	China	210
20	Chile	266
21	Malaysia	350
22	Thailand	352
23	Mexico	401
24	Brazil	414
25	Korea	561
5yr CDS level (bps)		
As at Oct 30, 2008		

What's So Special About Canada?

- What makes Canada so special to deserve this ranking? We can think of several things.
- First, on an out-and-out economic comparison with the U.S., Canada wins hands down. Canada's housing market is not as sorely pressed as in the U.S., Canadian consumers are doing considerably better, and the Canadian banks (and credit market) are in far better shape than in the U.S.
- Second, Canada's debt-to-GDP ratio is the lowest among the major countries. Canada's debt-to-GDP ratio is just 33%, whereas Germany is 39%, the U.K. is 43%, France is 63%, the U.S. is 67% (and rising rapidly), and Japan is 163%. Moreover, the Canadian measure has been trending sharply downward, and Canada has run over a decade of consecutive surpluses.
- On a clearly related note, Canada's government bond supply has shrunk persistently over this timeframe, and as this happens the risk of default declines and the recovery prospects in the event of a default improve.
- According to a recent World Economic Forum survey, Canada's banking sector is viewed as the soundest in the world, beating out 57 other countries.

- And even though it appears fairly likely that Canada will dip back into deficit in the next little while given a slowing economy (with implications for tax revenues), the implication for the bond supply should not be as severe in Canada as in many other countries as the Canadian government has been less active in introducing new forms of financial sector bailouts (the main plank has been a \$25B government program to buy MBS, but there is no explicit equity injection program, nor have there been any outright bailouts).
- In short, Canada does look fairly attractive when viewed through this lens.

Implications

- We should begin by noting that we believe Canadian bonds should continue to underperform the U.S. because sovereign debt concerns have not played a major role in the market to date, and because Canada's economic prospects are somewhat better than in the U.S. and so less rate cutting will be needed.
- However, should the market begin to differentiate between countries based upon their debt-to-GDP ratios and other measures of fiscal pressure, Canadian bonds would ultimately be a winner in that contest. At present, there is little evidence that this is happening – case in point, both Japanese and U.S. debt continue to be happily purchased, yet the Japanese debt burden is extremely high and the U.S. debt burden is growing quickly. Nor do we necessarily expect this to change. But should the market grow more fickle about what it buys, there could be a quick reversal and this would prompt us to favour Canada over the U.S. in bonds.
- Third, throughout the credit crunch, Canadian bonds have been less volatile than in the U.S., and this speaks in no small part to the relatively more stable fiscal and economic foundations in Canada. We expect this trend of relative stability to continue.

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