NATCAN WEEKLY MARKER

February 05, 2008

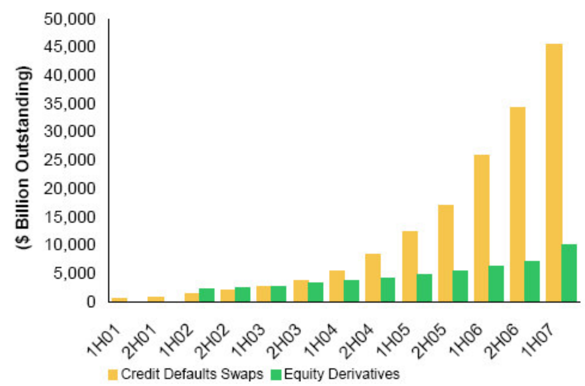
CREDIT DERIVATIVES - ABOUT TO BE PUT TO THE TEST

A year ago we reviewed credit derivatives in order to provide an overview of this important asset category. In this week's edition of the Marker, we provide an update on growth and highlight the changes that have occurred in the credit environment over the past 12 months.

GROWTH CONTINUES UNABATED

In the February 28, 2007 Marker, we reported credit derivatives notional exposure to total $26 trillion. Growth in this area has been very strong as highlighted in the accompanying table. Total notional exposures at year end 2007 were $45 trillion, more than three times the size of U.S. GDP, or greater than the U.S. government bond and housing markets combined.

A Lot of Notional Outstanding CDS......



Sources: Morgan Stanley, ISDA

DETERMINING THE TRUE EXTENT OF RISKS AND EXPOSURE IS CRITICAL

Such large numbers most often make investors' heads spin. Several bearish investors have in fact referred to these numbers to incite grave concern in less informed parties' minds. To better dimension the issues surrounding credit derivatives, one must distinguish between gross and real credit exposures. The most popular credit derivatives are by far Credit Default Swaps (CDS), i.e., swaps between two counterparties willing to exchange default risk on an *arbitrarily set amount* (the swap's notional) of a given issuer's debt obligations. The critical point here is that while the swap is based on a notional value (summing $45 trillion as previously mentioned), the actual economic amount of risk created in the system is a small fraction of this. First, by nature of the swap instrument, notional contract amounts are double counted at the outset. Real notional exposures are thus cut in half to $22.5 trillion. Furthermore, swaps are side bets, and their creation does not lead to the creation of new credit in size anywhere near the referenced notional amount. In fact, at inception, a swap's market value is zero. It is this fluctuating market value that represents new credit risk. In a recent survey, Fitch Ratings estimated net CDS exposures to be worth $1 trillion, or 45 times less than the headline notional numbers. We are well aware that $1 trillion is not insignificant. However, considering that two thirds of CDS are written on investment grade debt, and factoring historical average default and recovery rates, a more sensible estimate of economic risk related to CDS is probably in the $10 to 30 billion range.

2008, THE YEAR OF THE COUNTERPARTY RISK

Economic risks related to CDS are far less severe than their notional value. Yet, one cannot simply brush off $10 to 30 billion worth of risks, particularly at the end of a credit cycle when losses are likely to mushroom. And though CDS are intended to protect one party from default risk, one is still exposed to the risk the counterparty is unable to make good on his promise. Let us remember that these contracts are negotiated privately, thus making it difficult to analyze the credit rating of the concerned parties. Since the implosion of Long Term Capital Management, most of these counterparties must post collateral of 2 to 3% at inception. While this mitigates the risk of failure to pay a claim, the risk that problems arise from a major player failing to meet his obligations cannot be ignored.

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The year 2007 saw the CDS market grow quite vigorously. The credit cycle seems to be on the verge of experiencing a downward phase; a clear indication that this type of insurance contract will be put to the test in 2008. To ride the storm unscathed, one should avoid adopting an alarmist outlook, and instead ensure that the risks are calculated accurately. It is in fact now more important than ever to recognize the nature of the counterparty risk. Investors stand to gain from discussing these issues thoroughly with their advisors and managers.

Michael Quigley, CFA
Senior vice president, Distribution

FINANCIAL MARKETS

RETURNS AS AT FEBRUARY 1, 2008 (%)	MTD	QTD	YTD
S&P/TSX	1.24	-3.54	-3.54
S&P 500	0.24	-4.84	-4.84
S&P/TSX Small Cap*	2.07	-4.87	-4.87
Russell 2000	1.42	-4.56	-4.56
MSCI EAFE	0.50	-6.82	-6.82
MSCI World	0.40	-5.27	-5.27
DEX Universe Bond	0.41	1.04	1.04

	RATES AS AT FEBRUARY 1, 2008
CAD/USD	1.00
CAD/Euro	1.48
US Treasuries yield 10-yr/30-yr	3.60/4.32
GOC bond yield 10-yr/30-yr	3.82/4.14
Fed Fund Rate (target)	3.00

Note: Returns in Canadian dollars, London 4h exchange rates. Source: Datastream, PC Bond, MSCI-Barra, and Bloomberg. PC-Bond, a business unit of TSX Inc. Copyright © TSX Inc. All rights reserved.