Economic & Market
Outlook
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Beyond Economic Recovery – New World Realities

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The road to recovery won't take us back to the world that existed before the sub-prime crisis began. The global financial system is being revamped and, in some areas, reconstructed. Big government deficits are back and will be politically difficult to unwind. We soon will begin to experience the profound impact of an aging global population and the crusade to improve energy efficiency and environmental outcomes.

The global economic landscape also is changing, with developed nations like Canada and the U.S. likely to experience relatively subdued growth in the decade ahead. World activity will be driven increasingly by China, India, Brazil and other emerging powerhouses, with their production and investment decisions having a major impact on world trade, commodity prices and financial markets. The unprecedented meeting of G20 government heads in Washington last December to deal with the financial crisis officially recognized the need to broaden global economic management beyond the traditional G7 developed nations. At the same time, the great divide in performance between G7 and emerging nations has the potential to heighten friction over international trade and investment, which have been powerful drivers of the global economy over the past two decades.

For many Canadian businesses, these new world realities point to tougher competition in traditional markets, but a world of opportunity in emerging ones. Focussing our collective attention and scarce national resources on supporting the familiar while avoiding the unfamiliar is a losing strategy. Government subsidies and other temporary palliatives can't insulate domestic business from the powerful forces reshaping the global economic landscape. Currency depreciation won't be riding to the rescue — rising commodity prices may soon push the loonie to parity and beyond. Skilled labour shortages also will intensify as the economy revives, limiting the potential for businesses to cut costs in the quest for a better bottom line performance.

In this environment, successful business strategies will increasingly hinge on identifying high value-added, skill-based products and services which can plug into global supply chains or take advantage of unique local or international niche market opportunities. Highly entrepreneurial small- and medium-sized businesses will be a key source of job creation. At a time when the auto sector and other traditional manufacturing industries are shedding jobs, new enterprises associated with environmental remediation, global infrastructural development, and emerging market demands have the potential for sustained, rapid growth.

When it comes to helping business adjust to these new world realities, Canadian governments have limited resources and a long *'to do'* list that includes fully implementing the proposed plan for a more competitive corporate tax structure, returning to fiscal balance and investing in big-ticket transportation, power and communications projects. Among the many competing priorities, however, education and skills training should be right at the top of the list because work force quality is one area where we must be able to compete with the best.

Economic and Market Outlook 2009 - 2010

Canada	2008	2009f	2010f
Economic Performance (annual average)			
Real GDP (% change)	0.4	-2.3	2.8
Consumer Prices (% change)	2.4	0.8	2.0
Core CPI (% change)	1.7	1.7	1.4
Unemployment Rate (%)	6.1	8.5	8.8
Housing Starts (units, thousands)	211	140	150
Motor Vehicle Sales (units, thousands)	1,642	1,445	1,500
Merchandise Trade Balance (C$ billions)	46.9	-2.0	6.0
Yield Curve (%, end of period)			
Bank of Canada Overnight Target Rate	1.50	0.25	1.50
2-Year Canada Bond	1.09	1.20	2.85
10-Year Canada Bond	2.68	3.50	4.70
United States			
Economic Performance (annual average)			
Real GDP (% change)	1.1	-2.4	3.0
Consumer Prices (% change)	3.8	-0.5	1.9
Core CPI (% change)	2.3	1.6	1.3
Unemployment Rate (%)	5.8	9.3	9.8
Housing Starts (units, millions)	0.90	0.58	0.78
Motor Vehicle Sales (units, millions)	13.2	10.2	11.5
Merchandise Trade Balance (US$ billions)	-840	-490	-550
Yield Curve (%, end of period)			
Fed Funds Target Rate	0.25	0.25	1.50
2-Year Treasury	0.76	0.95	3.00
10-Year Treasury	2.21	3.50	4.65
Foreign Exchange Forecast (end of period)			
Canadian Dollar (CAD/USD)	0.82	0.96	1.01
Yen (USD/¥)	91	92	85
Euro (€/USD)	1.40	1.50	1.60
Chinese Yuan (USD/CNY)	6.8	6.8	6.3
WTI Oil (US$/bbl) (ann. avg.)	99.6	62.0	90.0
Nymex Natural Gas (US$/mmbtu) (ann. avg.)	8.90	3.90	5.25

f: Forecast - Scotia Economics *Global Forecast Update* (October 7, 2009)

Source: Scotia Economics, Statistics Canada, U.S. Dept. of Commerce, U.S. Bureau of Labor Statistics, Bloomberg

Canadian Equity Strategy

Canada – Still a Great Place to Invest

GARETH WATSON, CFA – DIRECTOR, PORTFOLIO ADVISORY GROUP

After a rocky first quarter of 2009, Canadian equity markets appreciated by 19% in the second quarter and continued to post impressive returns in the third quarter by adding another 9.8% bringing year-to-date gains as of September 30 to the 26.8% level. Over 90% of these gains have come from the three highest weighted sectors in the TSX Index (Financials, Energy and Materials), thus indicating that investors expect signs of economic recovery already witnessed will only strengthen.

In the past we have provided you with some larger macroeconomic arguments; however, since those arguments really haven't changed much we will instead provide you with some observations as to what we are currently witnessing from an economic and market perspective:

- Equity markets worldwide have rebounded nicely off their lows. Canada is not alone as the emerging BRIC (Brazil, Russia, India and China) markets have lead major market returns in 2009. The TSX Index has provided the best equity market returns this year amongst the G7 Industrialized nations.

- The worst of the credit crisis is likely behind us, but problems will persist for years. A real estate crisis ballooned into a corporate credit crisis and is now a consumer credit crisis south of the border. While the absolute worst of the credit crisis is likely over, we will feel remnants of it for years to come and especially as governments and central banks continue to provide life support to the global financial system.

- Government intervention/rescue/stimulus appear to have averted a depression. Now we just need to see the global economy get back to a self sustaining level without the need for intervention.

- Canadian interest rates are at all time lows and will remain there for months. While this is good news for individuals that want to borrow and can get access to such credit, it is also remarkably clear that over the next few years interest rates have nowhere to go but up.

- Emerging markets are recovering more quickly as producers replenish inventories. Before the western world can consume goods and services, the emerging markets have to produce them in the first place. Therefore, it is only logical to see the emerging markets improve economically before the western world follows.

- The western world consumer appears to be saving rather than spending – unemployment is still high and U.S. housing prices are still low. These factors do not create an environment ripe for consumption; therefore the global recovery is not without its challenges.

- The recession may technically end in the third quarter for North America, but the recovery could be sluggish if the consumer does not pick up his/her rate of consumption. The specific time the recession ends is irrelevant; how we position ourselves for the recovery is what's important.

- U.S. dollar weakness has pushed commodity prices higher and speculators have returned to markets they briefly abandoned. Fundamental analysis of commodity prices can become meaningless when commodities are used for investment rather than consumption.

- Canada emerged as a winner during a difficult time. Not only has our financial system withstood the blows of the credit crisis; our federal and provincial governments are holding in much better than our counterparts in the United States. While deficits are certainly a reality this year, those deficits in relative terms to our debt are still manageable.

There is no denying the fact that the rebound for the TSX Index has been impressive. While we can raise some near term concerns when it comes to things such as resource prices and U.S. consumer equity, we are bullish for the Canadian stock market over the long term and believe this country will be a great place to invest as the global economy accelerates into 2010 and beyond.

U.S. Equity Strategy

A "Sweet Spot" for U.S. Equities

PAUL DANESI, CIM – U.S. EQUITY ADVISOR, PORTFOLIO ADVISORY GROUP

The U.S. equity market is likely to remain in a "sweet spot" through the end of the year, although buying power seems to be waning in the short term. While the S&P 500 appears ripe for a correction, periods of consolidation should be short lived and shallow. Persistent wholesale selling of U.S. equities doesn't seem likely in our opinion given improvements in the global economy, low inflation expectations, and a rebound in corporate profitability.

U.S. equities are under-owned at both the retail and institutional level. Cash in U.S. money market funds remains well above historical norms and investors are being paid very little to hold cash. U.S. Treasury securities offer little appeal outside their defensiveness and a narrowing of corporate spreads reduces the appeal of corporate bonds. Low interest rates drive investors back into risky assets.

Global Economy is on the Mend

In 2008 and early 2009 we witnessed a synchronized global economic contraction, the worst downturn since the Great Depression. It now appears we are in the midst of a synchronized global economic recovery led by China, reinforced by highly stimulative monetary and fiscal policies, and improvements in financial markets. Industrial production collapsed in many countries last year, but has begun to rebound sharply. World trade volume is expanding again. Japan, Germany, France and many emerging market economies all grew in the second quarter. Others, including the U.S. and the U.K., will grow in the third quarter.

Corporate Profitability Could Rise Sharply in 2010

U.S. corporations have aggressively cut costs reducing headcount at a record pace, trimming SG&A, and mothballing production to maintain margins. Cost cutting has been the major driver of positive earnings surprises in the first half of the year, typical of a normal earnings cycle. However, costs can only be reduced so far and sales must ultimately improve to sustain earnings growth. Sales should begin to improve as industrial production starts to rebound in the third quarter.

Cyclical Stocks Should Lead

While a correction would be an opportunity to add broad-based exposure to the U.S. market through mutual funds and ETFs, cyclical stocks should lead the market into year end. U.S. dollar weakness and stronger growth in developing markets support buying U.S. multinationals and exporters. Generally, we favour companies that provide exposure to the emerging market consumer and infrastructure development. Please contact your ScotiaMcLeod advisor for suitable recommendations.

Interest Rates Could Sour the Mood

It is very possible U.S. economic activity could slump again later in 2010. Signs of a rapid recovery in the U.S. economy could force central bankers to remove economic stimulus and raise interest rates prematurely. A low interest rate environment remains a key element supporting sustained economic growth. There is little doubt the highly leveraged consumer balance sheet has very little tolerance for higher rates. However, central bankers appear to be in no rush to remove economic stimulus creating a "sweet spot" for the economy and financial markets.

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