2008 Economic and Market Outlook

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The Leaping Loonie

Warren Jestin, Senior Vice-President & Chief Economist

The unprecedented jump in the loonie over the past nine months highlights both the extraordinary volatility of exchange markets and the inherent vulnerability of the U.S. dollar to shifts in global investor sentiment. From its early-February low to the high briefly touched in early November, the Canadian dollar appreciated by almost 30%. It subsequently reversed direction but by late November was still up nearly 20% from its February low. Over the same period, the euro rallied close to 14%, the yen climbed almost 12% and the Australian dollar rose 11%.

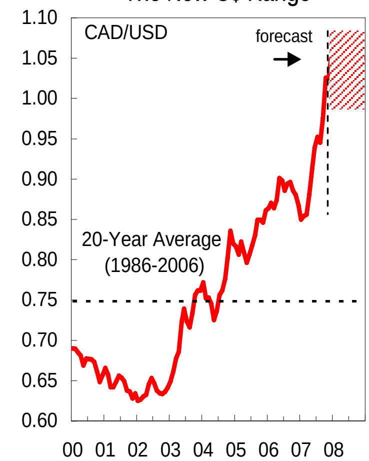
The retracement of the Canada-U.S. exchange rate over the past two weeks is a clear indication that our currency has moved too far, too fast. Given the extraordinary volatility of the exchange markets, it may even temporarily move back below parity. However, looking through these wild gyrations, the underlying economic fundamentals remain broadly supportive for the loonie and negative for the greenback. Against this background, we expect the Canada-U.S. exchange rate to average close to 1.05 over the next year.

In the United States, the impact of the credit crunch flowing from the sub-prime mortgage crisis will probably continue to roil financial markets into next spring. The associated negative fallout on U.S. economic activity will last much longer, lingering into 2009 as the big setback in residential sales and construction triggers a retrenchment in consumer spending. Weak economic activity will also take its toll on profit margins and growth in business investment. Aggressive price discounting should dampen U.S. inflation, providing room for the Federal Reserve to cut interest rates by three-quarters of a percentage point or more over the winter. As the Fed moves further out of sync with other central banks, the U.S. dollar will be prone to a broad deterioration against other global currencies.

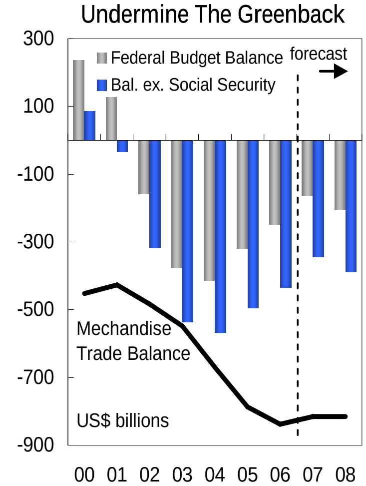
Weaker U.S. domestic demand is tempering import growth at a time when currency depreciation and robust sales to emerging nations are underpinning double-digit export gains. However, with imports roughly 70% larger than export receipts, a prolonged export outperformance would be needed to allow a big reversal of the US$800 billion merchandise trade shortfall. About 70% of the overall shortfall reflects energy imports and the bilateral deficit with China, so rapid adjustment requires a big downdraft in commodity prices and reining in U.S. consumers' proclivity to buy low-cost imports — both unlikely in the near future. Since the trade deficit must be financed by massive capital inflows, the U.S. dollar is vulnerable as long as deficit remediation lags actions by nervous foreign investors to cap or diversify heavily overweight U.S. dollar positions.

The Canadian dollar's impressive rise against the U.S. currency in part reflects Canada's newfound attraction as a resource-rich economy in a resource-short world — a positive for the currency that will be sustained by longer-term strength in commodity markets. While oil may recede from recent peaks and industrial metals may soften further, prices will remain historically high and act as a magnet for further large-scale investment. Our twin trade and fiscal surpluses, a more cautious monetary policy and the tendency for global investors to diversify their portfolios across currencies and asset classes also favours the Canadian dollar. Even if, as we expect, an emerging trend to slower growth and lower inflation encourages the Bank of Canada to cut domestic interest rates by half a percentage point or more in the months ahead, these favourable currency fundamentals should keep the loonie flying high.

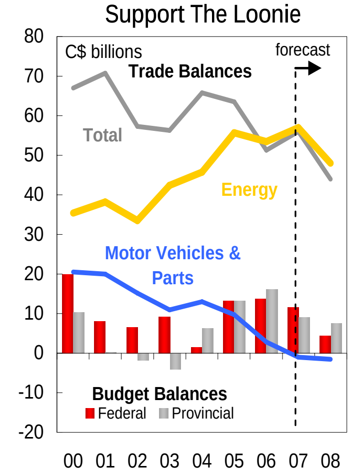
Parity Central To The New C$ Range



U.S. Twin Deficits Undermine The Greenback



Canada's Twin Surpluses Support The Loonie



While the one-two punch from currency appreciation and weakening U.S. activity is dampening Canadian growth, we expect output to expand by about 2% in 2008, supported by greater resilience in domestic demand. The continued fast-track performances of China and other emerging nations will underpin exports of energy and industrial metals. The ramping up of global biofuel production, along with tight global inventories, is assisting agricultural export receipts. Taken together, these commodity sales account for 40% of our export revenues.

On balance, the strength in resource exports has more than offset weakness in manufacturing sales, keeping Canada's merchandise trade surplus close to C$60 billion this year. For 2008, weaker U.S. demand may narrow this surplus to C$40 billion. Longer-term, however, foreign sales will be supported by ramping up oil sands output and new capacity in industries such as potash and uranium mining. Among industrialized nations, Canada stands out for its ongoing major hydro-electricity projects.

Canadian manufacturers will continue to face considerable challenges in adjusting to currency appreciation and competition from low-cost offshore imports. Yet, even in the industrial heartland of Central Canada, weaker exports and job losses in manufacturing have been mitigated by solid growth in services and construction. At the national level, new jobs in construction over the past year have roughly matched those lost in manufacturing, with Canada's overall employment growth running at about twice the U.S. pace.

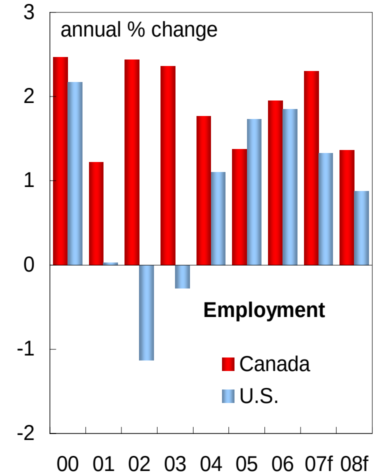
In some important respects, Canadian household balance sheets are in better shape than their U.S. counterparts. Unlike U.S. households, who reduced home equity to finance consumer spending, Canadian families have more equity invested in their homes than a decade ago. The levering up of higher-risk households that continued to fuel the U.S. housing boom, but ultimately set the stage for the U.S. sub-prime mortgage crisis and the crunch in residential activity, has not been replicated in Canada. Residential activity will be much less of a drag on growth on this side of the border.

The commitment of Canadian governments to balancing budgets and reducing debt represents a strategic competitive advantage and a key factor insulating our economy from setbacks in the U.S. With combined federal and provincial surpluses surpassing C$30 billion last year, both levels of government have introduced spending initiatives and tax relief, adding significant stimulus. Federal tax cuts alone, from last spring and this fall, will approach C$8 billion this fiscal year.

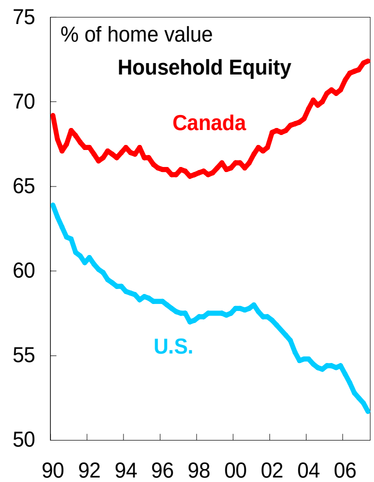
In addition to personal income tax savings, as of January 2008, a further one percentage point will be trimmed from the federal Goods & Services Tax rate. As well, corporate tax relief will be substantially enhanced over the next five years in a bid to achieve the lowest tax burden on business investment among G7 nations. Ambitious investment agendas from Ottawa and the Provinces for Canada's transportation, education and health care infrastructure also will continue to underpin job creation and enhance our national competitiveness. In the U.S., Washington's chronic fiscal deficit constrains the leeway to provide stimulus. On a longer-term basis, the need to fund U.S. Medicare and Social Security obligations ultimately will lead to fiscal retrenchment and possibly a less competitive tax structure.

Adding up the pluses and minuses, U.S. dollar depreciation appears far from over. With the process unlikely to go smoothly, the historically high volatility currently gripping global currency markets is likely to persist over the balance of the decade. From a Canadian perspective, the immediate outlook for the loonie will hinge on short-term fluctuations in commodity markets and the relative timing of the anticipated easing by the U.S. Fed and the Bank of Canada. On a longer-term basis, the combination of positive domestic and negative U.S. currency fundamentals suggests that the loonie will tend to remain above parity against the greenback.

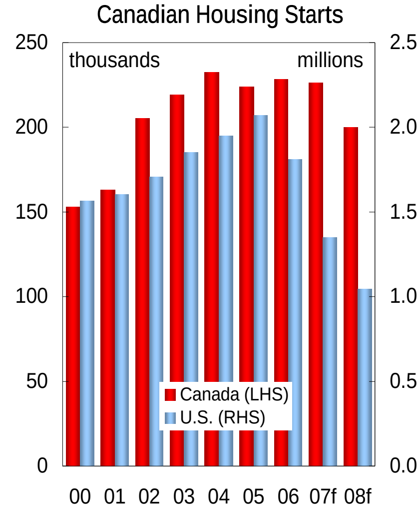
Stronger Canadian Employment Gains ...



... And Household Finances ...



.. Lead To More Resilient Canadian Housing Starts



Repricing Risk

Vincent Delisle, Director, Portfolio Strategy

Market complacency was shaken last summer as the sub-prime crisis erupted. Volatility and uncertainty have resulted in a massive re-pricing of risk since August '07 and we believe this environment will extend into next year. U.S. 3-M Libor rates spreads over U.S. Treasuries have swelled to 215 basis points (highest levels since 1987) which highlights the market's heightened risk aversion. The flight-to-quality has been beneficial to higher-quality government bonds and credit spreads have widened noticeably. As an illustration of the market's thirst for safety, U.S. 10-Yr Treasury yields have declined 100 basis points to 4.03% since June '07 and 2-Yr Notes are yielding 3.18% level. This year's monetary policy reversal (anyone remember Central Banks were still fighting inflation last August?) has translated into a steepening of the yield curve, and we expect U.S. growth prospects to look brighter towards the second half of '08. Absent a prolonged U.S. recession, inflation could become enemy number one again by the end of the decade.

Equity performance has been mixed and extremely volatile since July and we expect indices to trade in a very wide range until the end of Fed rate cuts. Large capitalization equities should outperform in an environment of weaker U.S. growth, interest rate cuts, and challenging earnings outlook. We believe we are entering an environment that typically favours less cyclical sectors. Under a U.S. soft landing scenario, we would argue for a combination of defensive (Gold, Staples, Utilities) & early cyclical (Financials, Telecom) sectors. As long as the trend in interest rates is down, however, we believe late cyclical sectors (Energy, Mining) should be underweight. The historically positive correlation between commodity prices and interest rates also points towards a more challenging environment for resources in 2008. We expect U.S. and European equities to outperform Canadian and Emerging indices in 2008.

Equities & Fed Easing: Long-Term Gains, But Near-Term Volatility

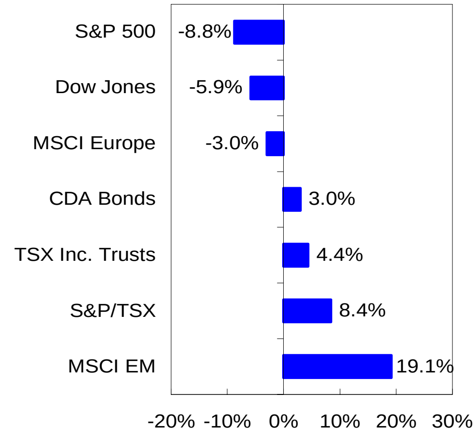
Equity markets initially overshot following the Fed's 50 basis point cut in its discount rate on August 17, 2007. With the November pullback, however, the S&P 500 and the TSX have moved closer to their average Fed easing behaviour. Although equity performance is typically positive 18 months after the start of a Fed easing cycle (average performance of +20% S&P 500 and +16% TSX), gains tend to be more modest in the first 6 months. The U.S. yield curve should continue to steepen until investors start pricing the end of rate cuts. This is typically when equity upside accelerates, i.e., once we reach the maximum level of steepness (circa 6 months after start of easing cycle). Fed easing cycles average 29 months with actual rate cuts averaging 17 months. The Fed cut rates 23 times in 40 months during the longest easing cycle (1989-1992), bringing Fed funds down to 3.00% from 9.75%. The shortest easing episode was 3 months (-75 bp) in the Fall of '98.

Stay Long, But Don't Go Deep

The extreme volatility witnessed in 2H07 should extend to the start of '08 and we expect North American indices to trade within a very wide range (13000-14500 for the TSX; 1400-1575 for the S&P500). We believe rebounds will prove temporary until the earnings outlook improves and should thus be treated as an opportunity to add some defense to portfolios.

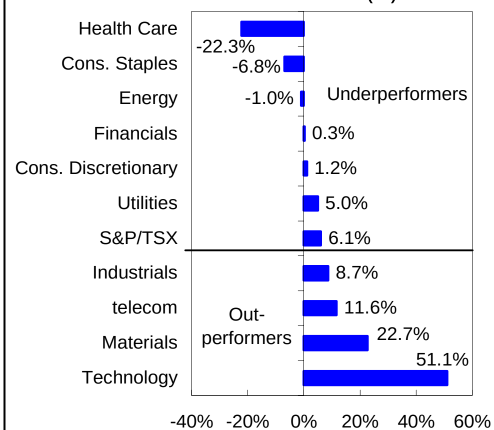
Earnings & equities will lag the yield curve steepening by 18 months. Based on the historical relationship between the U.S. yield curve and S&P 500 trailing earnings growth rate, earnings could bottom late next year before

2007 YTD Market Performance
(C$; Total Return)



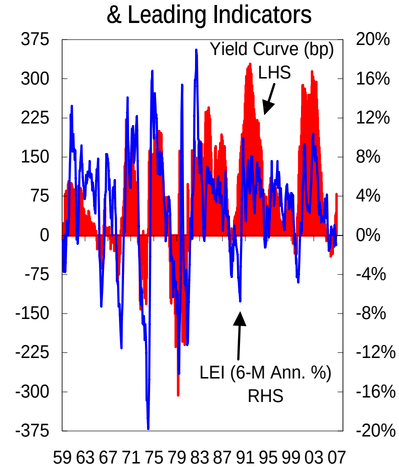
* As at Nov. 30, 2007
Source: Bloomberg

S&P/TSX Sector Performance:
2007 YTD (%)



* As at Nov. 30, 2007
Source: Bloomberg

U.S. Yield Curve
& Leading Indicators



* U.S. yield curve based on 10-Yr Yield minus 1-Yr Yield (basis point). Source: Bloomberg

picking up speed by Q1-09. Inverted curves have almost always translated into a decline in earnings, and the jury's still out as to whether this cycle will be similar to '97-'98 (flat YOY EPS) or an outright decline.

Taking the yield curve relationship with earnings and Equity performance a bit further, we would also note that the S&P 500 tends to bottom 9 months before profits. Considering the massive curve steepening witnessed since August '07, we would argue for a S&P 500 trough by March-April 2008, i.e., 9 months before earnings.

The Scotia View On '08 Earnings

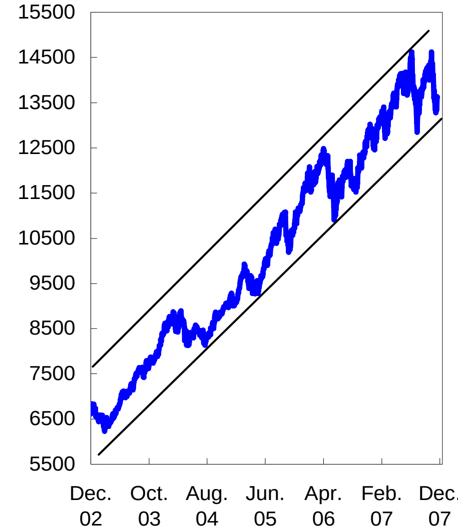
Based on our '08 assumptions, S&P/TSX earnings should grow 3% to $840 (from $815 in '07) and S&P 500 should increase 5% to US$95 (from US$90 in 2007). Extending our forecast period to December '08, our price targets are set at 14500 for the TSX (17x forward P/E) and 1575 for the S&P 500 (16.5X forward P/E). From November 30th closing prices, our 2008 total return forecasts are set at 8% for both the S&P/TSX and S&P 500. We expect a low mid-single digit EPS growth and multiple expansion to lift equity markets in 2008.

Asset Mix

We are keeping our recommended asset mix unchanged. +5% Equity overweight, +5% Cash overweight, and -10% Bond underweight. Based on our targets and Scotia Economics' interest rate scenario, we are forecasting '08 total returns of 8% for Equities, 4% for Cash and 2% for Bonds.

Year-to-date, Equities (TSX +5.9%) are outperforming Bonds (3.0%) in Canada. In the U.S., equity performance is positive but not strong enough to outpace the U.S. JP Morgan Gvt. bond index (+9.3%), marking the first real challenge for equities since 2002. Bonds may have the upper hand in the first half of '08 but we remain comfortable with an equity bias in our asset mix. If the Fed stops easing in the spring of '08 meeting (3 more 25 bp rate cuts), our next move will be to raise our equity weighting and reduce cash. Should the U.S. go through a recession, however, the easing cycle will last longer and we would consider raising our bond exposure. The latter would be dictated by deteriorating employment and will be closely monitored in coming months.

S&P/TSX Trading At The Low End Of Its 5-Year Channel



Source: Bloomberg

Scotia Capital Sector Allocation

Sector	Scotia Capital Recommendation
Defensive & Interest Sensitive	
Financials	Overweight
Telecommunication	Overweight
Utilities	Market Weight
Health Care	Underweight
Resources	
Energy	Underweight
Materials	Market Weight
Economic Sensitive	
Industrials	Overweight
Information technology	Overweight
Consumer	
Consumer Staples	Market Weight
Consumer Discretionary	Underweight

Source: Scotia Capital

Economic and Market Outlook - 2007/2008

	2005	2006	2007f	2008f
Economic Performance		------------ *(annual average)* ------------		
Real GDP (% change)				
Canada	3.1	2.8	2.6	2.2
United States	3.1	2.9	2.2	1.9
Euro zone	1.5	2.9	2.5	2.0
Japan	1.9	2.2	1.8	1.6
China	10.4	11.1	11.5	10.5
Consumer Prices (% change)				
Canada	2.2	2.0	2.2	1.7
United States	3.4	3.2	2.8	2.5
Euro zone	2.2	1.9	2.8	1.6
Japan	-0.1	0.3	0.1	0.3
China	1.6	2.8	5.0	3.5
Markets		------------ *(end of period, %)* ------------		
Yield Curve - Canada				
Bank of Canada Overnight Target Rate	3.25	4.25	4.25	4.00
2-Year Canada Bond	3.86	4.03	3.30	3.90
10-Year Canada Bond	3.98	4.09	3.80	4.30
Yield Curve - U.S.				
Fed Funds Target Rate	4.25	5.25	4.25	3.50
2-Year Treasury	4.40	4.81	2.80	3.70
10-Year Treasury	4.39	4.70	3.80	4.40
Foreign Exchange				
Canadian Dollar (C$/US$)	86.2	85.8	1.02	1.05
Yen (US$/¥)	118	119	1.08	1.03
Euro (€/US$)	1.18	1.32	1.49	1.48
Sterling (£/US$)	1.72	1.96	2.07	2.04
Equities*				
S&P/TSX*	11272	12908		14500
EPS*	603	750	815	840
S&P 500*	1248	1418		1575
EPS*	76.44	87.71	90.00	95.00
		------------ *(average price)* ------------		
WTI Oil (US$/bbl)	56.56	66.22	72.50	86.00
Nymex Natural Gas (US$/mmbtu)	9.00	6.99	7.15	6.95
Copper (US$/lb) *LME Base Metals*	1.67	3.05	3.30	2.95
Aluminium (US$/lb) *LME Base Metals*	0.86	1.17	1.19	1.05
Gold (US$/oz) *London PM Fix*	445	604	811	850

f: Forecast (Scotia Economics, December 4, 2007)
Source: Scotia Economics, Statistics Canada, U.S. Department of Commerce, U.S Bureau of Labor Statistics, Bloomberg
* Source: Scotia Capital, CPMS, S&P