

# Review and Outlook

## PERHAPS THE MOST LIKELY SOURCE OF MARKET MALAISE IS THE DRAMATIC INCREASE IN OIL PRICES.

### The Economy

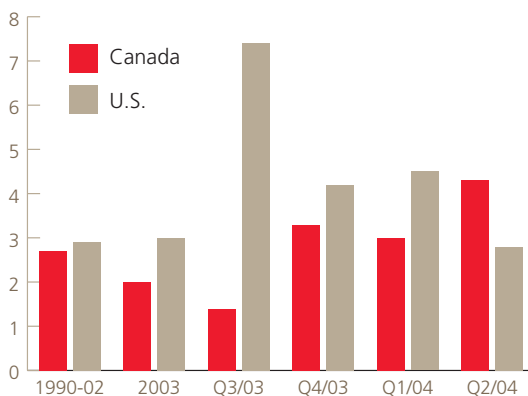
The capital markets showed little Olympic spirit this past quarter, there was no "higher, faster or stronger" in the lack luster returns investors earned. In looking for a culprit, both the economy and corporations appear to be doing their part to lead the markets to the medal podium. Canadian GDP has risen to 4.0%, with U.S. growth near 3.0%. Corporate profitability has been averaging quarterly gains above 20% in the U.S. and double-digit gains in Canada for the past four quarters.

The one element that the markets have honed in on is that U.S. growth rates in GDP and earnings are declining. Is this slowing a period of transition, a respite before renewed expansion, or part of an extended downward slide in performance? Currently, forecasters expect positive growth for the rest of 2004 and 2005 as well. Growth is expected, however, to be more in the range of 3.0% for GDP and 7.0% for earnings. Most other indicators are also moving in a positive direction, varying month to month in their relative strengths. Consumer and capital spending and even more recently job growth have all been healthy, if not robust. Globally, Europe is muddling along or bottoming out,

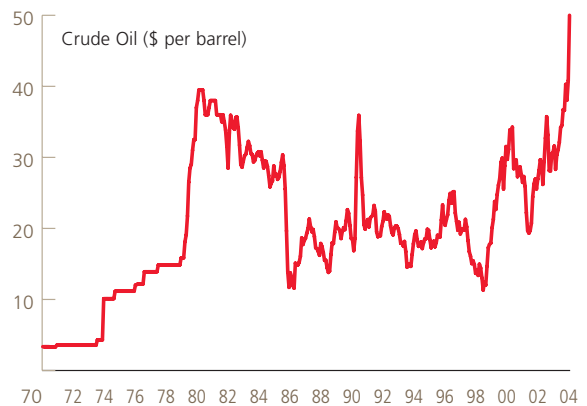
depending on interpretation, while Asia is basking in the China phenomena, which though less vigorous than in past quarters is still growing at more than two times the rest of the planet.

Perhaps the most likely source of market malaise is the dramatic increase in oil prices. As \$50 oil becomes a reality, consumers, business and political leaders, and investors are attempting to gauge the impact of this pervasive commodity. As pump prices spiral higher, concerns over inflation mount. Paradoxically, as prices rise, concerns about a slow down in the economy raise deflationary issues. Bond yields, a common barometer of inflation trends, have actually been declining as oil moved above \$40. Oil prices are reflecting the rising demand from stronger global economies, including the seemingly insatiable demand for commodities from an emerging China. In addition, markets have tacked on a "terrorist" premium for the threat of supply disruption. On the positive side, higher prices will lead to increased conservation, alternate energy development, and expand the sources of economically recoverable oil. The graph below shows that only once before has oil breached the \$40 level, and that was prior to the recession in 1980. However, then energy costs represented over 3.8% of GDP, today they have less impact at only 2.1%.

Canadian & US GDP Growth



Oil Prices Since 1970



Source: Scotiabank Commodity Price Index

## Financial Markets

On the basis that higher oil prices in a growing economy would lead to rising inflation, most forecasts have been pointing to higher short term yields. In particular, Central Banks were expected to implement tightening policies through the latter portion of 2004. On June 30th, August 10th and on September 21st the U.S. Federal Reserve hiked rates by 25 basis points. The Bank of Canada did not act until September 8th. Over the course of the 3rd quarter, the moderation in the rate of economic activity, oil related or not, caused the expected level of monetary intervention to be more subdued than originally anticipated. Further, as mentioned above, bond yields have actually declined in recent months, suggesting less inflationary concerns exist in the market place. We continue to look for short rates to rise, from here to year end by 50 to 75 basis points. Canadian Government and U.S. Treasury 10 year bond yields will most likely move in a 25 basis point range around current levels of 4.50% and 4.00% respectively.

Equity markets appear to have taken the summer off. Trading on very light volumes in the third quarter and most of 2004, U.S. and Canadian markets have remained in fairly narrow ranges.

### Market Moves 2004

	Current	3Q Move	2004 Range	2004 Forecast
S&P TSX	8325	+1.5%	8200 - 8600	+3.0% to 5.0%
S&P 500	1140	-1.5%	1075 - 1300	+2.0% to 4.0%

A review of global equity markets places North America in the middle of the performance spectrum. Thematically, Energy stocks seem to be the consistent drivers of positive results across all markets, while interest sensitive stocks, such as Utilities, have been under performers.

## Investment Strategy

While we do not expect dramatic results from bonds, we are more constructive on fixed income markets than most investors. We look for rising short rates in line with what we noted above, i.e. about 50 basis points before year end. Our inflation outlook has always been more positive than consensus, and thus stable or moderately rising long bond yields would be our forecast. A 10-year Government of Canada or U.S. Treasury bond is expected to return about 2.0% before year-end and 4.5% over the next 12 months.

We are cautious on the economic prospects for 2005 and thus our expectation for equity markets is to provide a modest rate of return, matching earnings gains of 7% – 10%. Given that market valuations have recently returned to more reasonable levels and if oil retreats from its \$50 per barrel high, there is the possibility of a 2004 year end rally. This would require U.S. economic growth to stabilize however, from its recent weak patch in the third quarter, and for terrorist attacks to be averted.

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