

Review and Outlook

IN 2005, WE CONTINUE TO FIND RESOURCE STOCKS ATTRACTIVE SUPPORTED BY STRONG DEMAND FROM CHINA

The Economy

In the wake of a U.S. Presidential election and seemingly inured to the high prices of energy, markets this past quarter have focused on trade flows and deficits. In particular the focus is on the very large trade imbalances that exist between the U.S. and the rest of the world. The U.S. is frequently referred to as the global engine of growth, which points to their enormous propensity to consume, both corporately and individually. Europe, Asia and Canada are all beneficiaries of the U.S. consumptive power, to the extent that the U.S. is running a record trade deficit of \$650 billion, or 5.7% of GDP. This pattern cannot continue indefinitely. The number of mechanisms to rebalance are numerous, but the most visible are interest rates, tariffs and currency, with the latter being very prominent in recent months.

The decline in the U.S. dollar, part of a two-year trend, has accelerated in the latest quarter nurtured by the seeming willingness of both the U.S. Federal Reserve and the U.S. Administration to neither directly confront their trade or

fiscal deficits, nor support their falling currency. A weaker U.S. dollar, while going a long way to rebalancing U.S. trade problems, will have profound effects on global GDP trends and interest rates. For example, in Canada, the U.S.'s largest trading partner, 2005 GDP forecasts are being cut from over 3.0% to the 2.5% range as the higher Canadian dollar bites into exports. The Bank of Canada's expected plans to hike short rates was put on hold in December and is likely to stay there until well into 2005. The higher dollar raises particular concern for manufacturers who depend on exports, where although these companies are only 5.0% of the TSX market cap, they are the employers of 30.0% of Canadian workers. Similar weakness, and worse is expected in Europe and other economies dependent on exporting into the U.S. consumer juggernaut. Ironically, China, who currently runs a \$125 billion dollar trade surplus with the U.S., the largest of any country, has pegged the Yuan to the U.S. dollar and thus has experienced no comparative currency appreciation versus the dollar, and in fact has gained advantage over the rising Yen and Euro.

The net of this currency focus has been to modify our global growth expectations. The U.S. should close out 2004 strongly with a 4.4% GDP growth rally. Next year, 3.0% is the forecast, with some improvement in exports but moderation in consumer spending as home and car sales retrench. Tax incentives for individuals and companies will have expired, and this will also moderate spending. In Europe, with a record level for the Euro, high energy prices, and weak domestic economies in key nations such as Germany and France, forecasts are for middling growth of under 2.0%. Japan faces similar problems but will likely increase their focus on its Asian trading partners. As growth moderates, inflation should remain relatively more subdued, running between 2.0% and 3.0% in most economies and thus mitigating any significant increase in bond yields. Only the U.S. is seen to be committed to continue raising short term rates, while most nations should leave short rates unchanged.

Canadian \$ vs. U.S. \$



Financial Markets

A post election rally has resulted in the S&PTSX and the S&P500 closing the year out well into positive territory. The S&P500 rose 10.9% (in U.S. \$ terms) while the TSX rose an impressive 14.5%. On the TSX, returns were dominated by the heavily weighted Energy and Financial stocks, with only 10 of the top 25 performing companies in 2005 falling outside these two sectors. In the U.S., Energy was also the top performer, with Telecom Services a distant second.

The pattern of positive returns, led by gains in Energy, and other resourced based companies, was replicated in most global stock markets. The weakest areas tended to be associated with the consumer, with the noteworthy poor results of Health Care stocks. Resource companies rode the wave of the China growth story, while large Pharmaceutical companies were beset with drug recalls. While 2004 did not repeat the very strong results seen in 2003, the hard earned gains in 2004 were well supported by a near 20% improvement in earnings.

Fixed income markets were also in positive territory in 2004. Canadian money market yields, after the Bank of Canada imposed three cuts and two raises, closed the year virtually where they began. U.S. short-term rates were raised four times doubling the yield on money market securities. Bond yields in Canada declined across most of the yield curve adding capital gains to income. In the U.S. bond trends were mixed with shorter maturities increasing yields slightly, and longer-term yields declining.

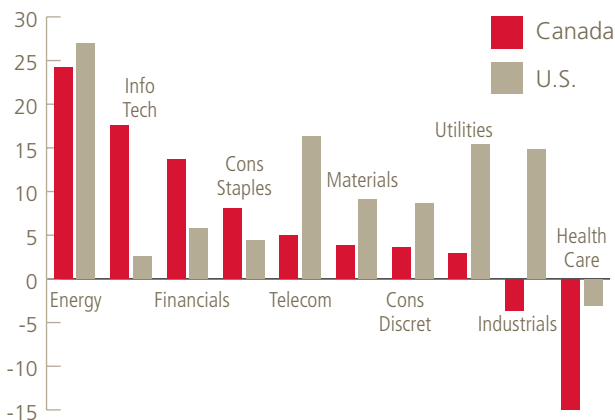
Outlook

If economies are slowing and earnings growth is slowing, it would seem logical to expect less from stocks. In 2005, our outlook for equity markets is cautiously optimistic, expecting returns in Canada and the U.S. of around 5.0%. Internationally, we expect Europe to lag, and Asian markets to be volatile but outperform North America. As to themes in 2005, we continue to find Resource stocks attractive supported by strong demand from China. Consumer Staples and Health Care should rebound as investors look for conservative stocks in a slowing environment. Dividends should also be attractive as capital gains opportunities become more limited. Here Utilities and large cap companies should appeal.

Fixed income markets should return only slightly less than the current market yields. The currency realignment, means lower inflation for most regions and a reduced need to hike short-term interest rates, except perhaps in the U.S. A moderating economic environment, even in Asia, will enable bond prices to move within a narrow range. The inflation adjusted yield on 10 year bonds is sufficiently high to perhaps see a modest decline in yields for at least the first part of 2005.

SCOTIA CASSELS™ RESEARCH TEAM

Sector Performance



™ Trademark of The Bank of Nova Scotia. Scotia Private Client Group consists of private client services from The Bank of Nova Scotia, The Bank of Nova Scotia Trust Company, Scotia Cassels Investment Counsel Limited, Scotia Cassels U.S. Investment Counsel Inc., and ScotiaMcLeod, a division of Scotia Capital Inc., all members of the Scotiabank Group. Scotia Capital Inc. is a member of CIPF.